

Understanding the LIT structure

By Perpetual Asset Management

21 April 2020



Moving beyond traditional managed funds, there are now a variety of product structures available to investors which offer unique characteristics, benefits and a broad range of asset classes. The Perpetual Credit Income Trust (ASX: PCI) (PCI or Trust) is structured as a Listed Investment Trust (LIT). A LIT provides an efficient way to invest in a diversified portfolio of assets which are professionally managed by an experienced investment team. Similar to a share,

investors can buy and sell units in a LIT on the ASX and have all their investment holdings consolidated under their CHESS Holder Identification Number (HIN).

Closed-end structure

A key feature of a LIT is the closed-end structure which means the Investment Manager has a fixed amount of capital to invest, as the number of units issued to investors and capital raised is fixed. This usually starts with an Initial Public Offer (IPO) as PCI did in May 2019, raising \$440 million. If the Responsible Entity of the Trust wants to issue new units to increase the size of the investment pool, then it must launch another capital raising such as a placement or entitlement offer. This will increase the size and scale of the LIT, providing the Investment Manager with additional capital to invest and further opportunity to diversify the portfolio.

Importantly, the closed-end structure means that the Investment Manager is not a forced buyer or seller. The benefit of a LIT is that where markets are strong and assets may be considered expensive, the Investment Manager is not required to buy assets to satisfy an application of new units as is the case in vehicles with an open-end structure such as an exchange traded fund (ETF) or traditional managed fund. Similarly, where markets are weak, the Investment Manager does not need to satisfy redemptions but rather has the ability to take advantage of investing opportunities at good value.

Diverse investment strategy

The LIT structure enables trusts such as PCI to have an investment strategy that offers a broad range of investments that may not be available to retail investors in an open-end vehicle such as an ETF. This enables investments that are diversified across a range of asset classes, sectors and geographies. For PCI this includes tradeable securities such as bonds and floating rate notes and alternative assets such as private debt (e.g. corporate loans). Assets such as private debt may not always be appropriate to be a material proportion of the assets held in an open-end vehicle that is required to satisfy applications and redemptions, as the underlying assets are generally not as liquid as other assets such as tradeable securities.

While private debt does not have the liquidity profile of shares, bonds and other tradeable securities, it provides opportunities for diversification and potential for high coupons and higher yield via repayment of interest and principal on the loans compared to these other assets. The Investment Manager for PCI conducts deep analysis over several weeks or months on the issuer of private debt by considering several factors including the company's balance sheet, quality of their management team and duration of the loan. They will also consider where the debt sits in regard to the capital structure of the company, with a focus on ensuring it sits towards the top (that is, would rank higher in the priority of payments if a liquidation event occurs).

Accordingly, the LIT structure suits the nature of private debt in PCI's portfolio. It also means that LITs have the potential for a broader investment universe than ETFs.

Robust pricing and calculation of the net tangible asset value

Listed investment companies (LICs) and LITs are required to lodge their net tangible assets (NTA) or net asset value (NAV) with ASX at least monthly. On a daily basis, PCI lodges the estimated NTA for the Trust with the ASX. This provides transparency to investors to understand the current value of the underlying assets held in the Trust.

The NTA or NAV reflects the total market value of the LIC or LIT's investments which can include investments such as shares, bonds, cash and cash equivalents, derivatives or alternative assets such as private debt. The valuation method of the NTA or NAV will differ depending on the pricing and nature of the assets held. For example, the majority of the assets in PCI are tradeable securities which are priced daily. The loan assets held in PCI are valued monthly or more frequently if impaired with PCI's Investment Manager having regular access to information to enable credit risk to be monitored on an ongoing basis.

ASX unit price

The listed nature of the LIT also means that the unit price of the LIT may be different to the value of the underlying assets held in the LIT. The unit price on the ASX is determined by the demand and supply of the market with a range of factors including investor sentiment or performance potentially leading to the unit price trading at a premium or discount to the NAV of the LIT.

In contrast, Investment Managers issuing ETFs are required to appoint a market maker to ensure that the vehicle trades at or around its NAV. While this provides investors with certainty that the ETF should trade close to its NAV, the NAV may be impacted by the ETF being a forced buyer or seller to satisfy applications and redemptions.

ETFs and LITs may be affected by market volatility from the underlying investments in the portfolio. For example, change in company management, corporate activity or the default of a bond issuer can impact the NAV. The ability of an investor to sell their units in a LIT or ETF on ASX will also depend on the turnover or liquidity of the units at the time of sale. Therefore, investors may not be able to sell their units at the time, in the volumes or at the price they desire.

Tax and distributions

All trusts structures including LITs, ETFs and managed funds will distribute all of the fund's taxable net income to unitholders over a financial year. The income generated by a trust may include franking credits, coupon payments, interest payments or capital gains depending on the underlying assets held by the trust. This income is distributed to investors and forms part of their assessable income taxed at their own marginal tax rate. The frequency of distributions paid and the availability of a distribution reinvestment plan will be determined by the responsible entity of the trust. For example, the responsible entity of PCI intends to pay distributions to investors monthly and has established a distribution reinvestment plan.

On the other hand, a listed investment company (LIC) structure has a Board of Directors who is able to declare dividends. As a company is required to pay company tax which is generally 30%, the Board has the discretion to pay dividends that can be partially franked or fully franked at 100%. Generally, to the extent that the dividends are franked, an amount equal to the franking credits attaching to the dividends will be included in the assessable income of the shareholder. Further, shareholders will generally be entitled to a tax offset equal to the amount of franking credits on the dividends (i.e. shareholders will effectively get a tax credit for the corporate tax paid in respect of the dividends). Similar to trusts, LICs generate their income from franking credits and capital gains received from underlying assets held in the company. However, a LIC has the flexibility of when and how much income it returns to investors whereas, a LIT or trust is required to distribute all income. A LIC is able to retain earnings and reinvest it into the portfolio or pay dividends out of profit reserves. This provides the company with the opportunity to smooth dividend payments to shareholders.

This document has been prepared by Perpetual Investment Management Limited ABN 18 000 866 535, AFSL 234426 (PIML or Perpetual Investments) and issued by Perpetual Trust Services Limited ABN 48 000 142 049, AFSL 236648 (PTSL). PTSL is the responsible entity and issuer of the Perpetual Credit Income Trust ARSN 626 053 496 (Trust). PTSL has appointed PIML to act as the manager of the Trust. This document is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Past performance is not indicative of future performance. This information is believed to be accurate at the time of compilation and is provided in good faith. This document may contain information contributed by third parties. PIML and PTSL do not warrant the accuracy or completeness of any information contributed by a third party. Any views expressed in this document are opinions of the author at the time of writing and do not constitute a recommendation to act. The information in this document is current as at 16 April 2020.

Before making any investment you should consider the Product Disclosure Statement (PDS) for PCI issued by PTSL and PCI's other periodic and continuous disclosure announcements lodged with the ASX which are also available at perpetualincome.com.au.

No company in the Perpetual Group (Perpetual Group means Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of the Trust or the return of an investor's capital. This information does not constitute an offer, invitation, solicitation or recommendation with respect to the purchase or sale of the Trust's units.