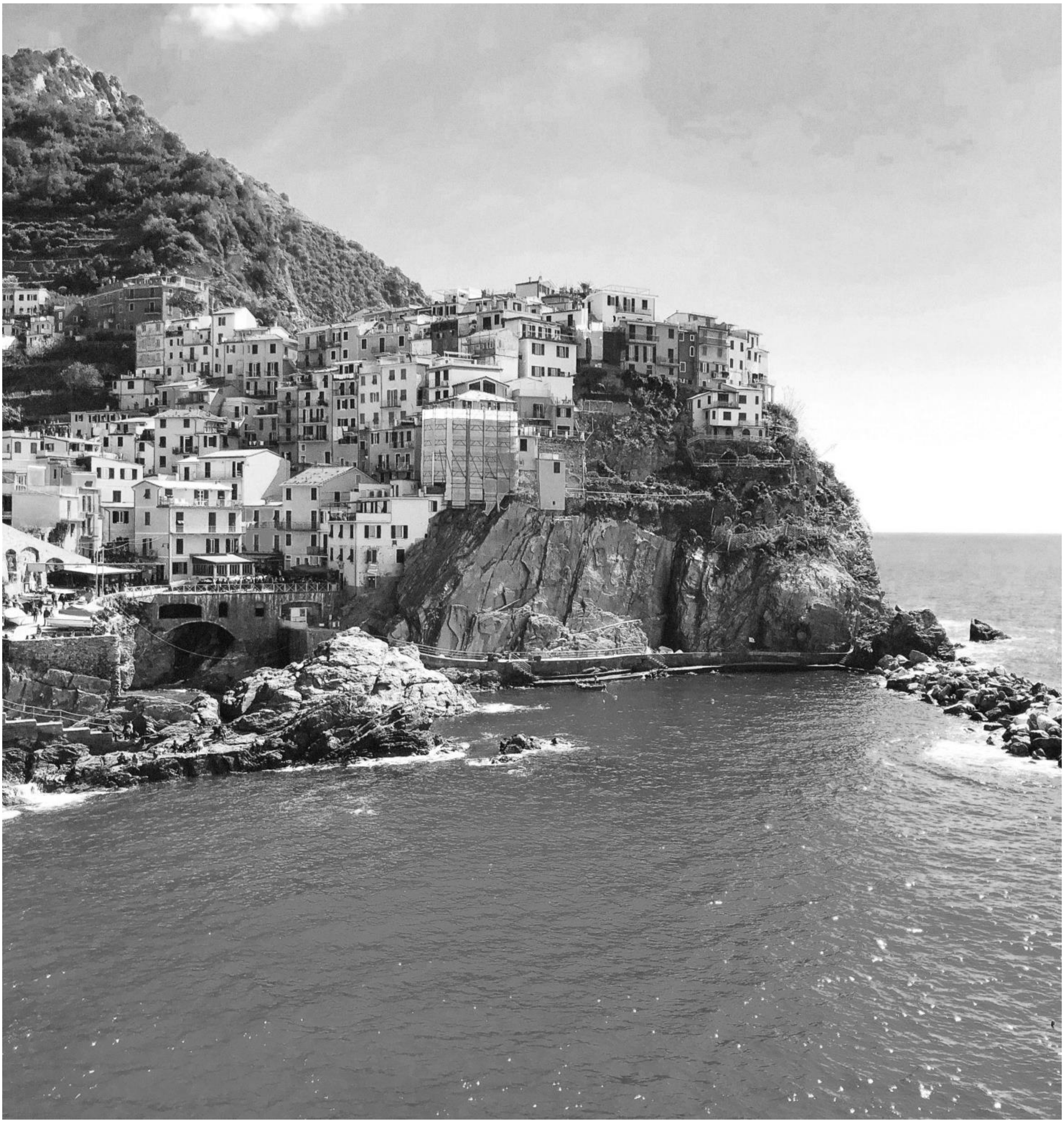
Fund Research

Perpetual Credit Income Trust (ASX: PCI)



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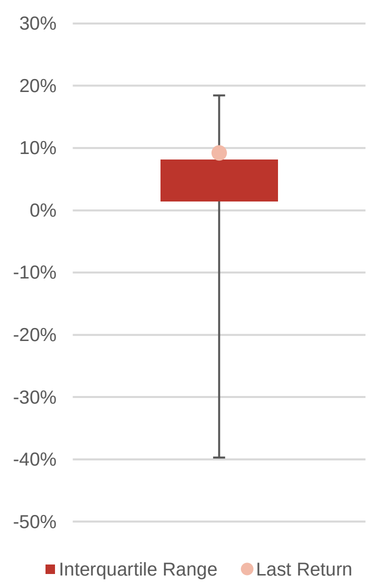
Overview

The Perpetual Credit Income Trust ('PCI' or 'the Trust') is an ASX-listed investment trust (LIT) designed to provide investors with exposure to an actively managed diversified portfolio of predominantly Australian dollar credit instruments with a focus on high-yield bond, syndicated loan, and securitised asset classes. The Manager, Perpetual Investment Management Limited, is an established fixed income team that manages $22.1 billion across multiple strategies as at 31 December 2022. PCI offers a unique investment opportunity to a market typically inaccessible to Australian retail investors. Specialist knowledge is critical to success in such a niche market and the management team comprises skilled and experienced professionals with a proven track record. The team is supported by Perpetual Investment's broader investment network that together manages $7.6 billion of assets as at 31 December 2022.

The Trust targets a return of the RBA Cash Rate + 3.25% p.a. (net of fees) through the economic cycle. The Trust is designed to deliver consistent monthly cash distributions while limiting capital drawdowns. Foreign currency exposure is limited to 30% of gross asset value (GAV) but risk is typically hedged into AUD. Leverage is permitted through derivative positions, which despite increasing downside risk, can be used to take advantage of market opportunities, or hedge against currency, interest rate or credit risks. The leverage limit on uncovered derivative positions is 15% of the Trust's NAV.

Figure 1. Annualised Monthly Net Returns Box Plot



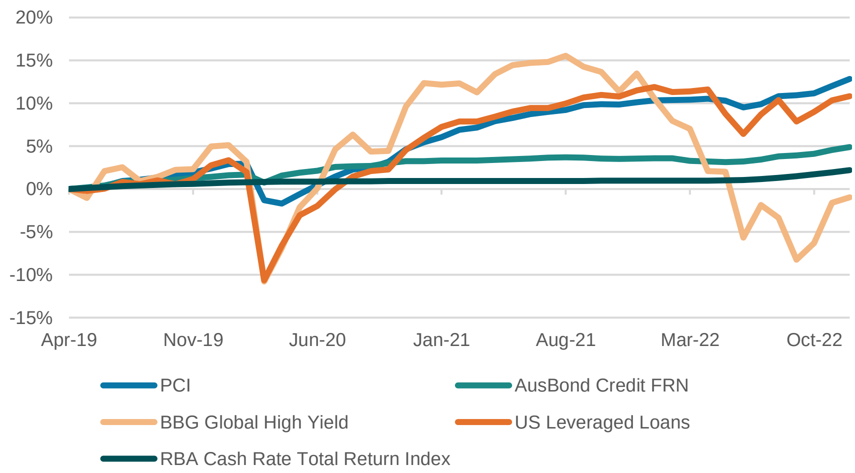
Source: BondAdviser, Perpetual. As at 31 December 2022. Monthly investment return net of fees and operating expenses since inception based on growth of NTA.

Figure 2. Monthly Net Investment Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	0.21	0.04	0.04	0.08	-0.18	-0.72	0.34	0.84	0.13	0.20	0.75	0.74	**2.46**
2021	0.55	0.82	0.27	0.67	0.35	0.43	0.23	0.21	0.48	0.12	-0.03	0.23	**4.33**
2020	0.53	0.01	-4.13	-0.38	1.10	1.07	0.99	0.81	0.24	0.65	1.42	0.78	**3.08**
2019					0.10	0.26	0.59	0.12	0.28	0.28	0.30	0.44	**2.36**

Source: BondAdviser, Perpetual. As at 31 December 2022.
** Monthly investment return net of fees and operating expenses since inception based on growth of NTA and assuming all distributions are reinvested on the ex-date.*

Figure 3. Relative Cumulative Performance (Investment Return)



Source: BondAdviser, Perpetual, Bloomberg. As at 31 December 2022.
Perpetual performance calculated as cumulative net monthly investment returns based on NTA and assumes all distributions are reinvested (not based on traded unit price).

Product Assessment

Recommended

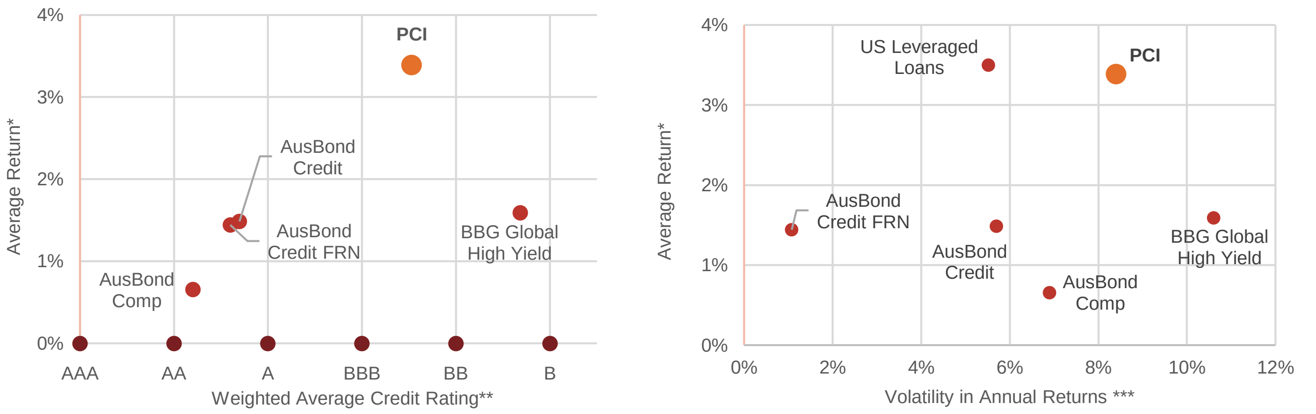
The Fund's hedged interest rate exposure has shielded the majority of the duration-induced losses experienced across global credit markets.

PCI seeks to provide investors exposure to a diversified portfolio of credit investments to deliver consistent and reliable income with a yield over the cash rate that is commensurate with its risk profile. Since inception, on an investment return basis (excluding movements in unit price), the **portfolio has underperformed its target** of the RBA cash rate + 3.25%, returning 3.35% p.a. (assuming distribution reinvestment). In line with broader credit markets, PCI's performance suffered during the onset of COVID-19 in 2020, however the floating rate exposure protected the portfolio from the duration burn in mid-2022. It is this floating rate exposure that has generated market outperformance in what was an especialy weak year for credit markets as the Global Aggregate Total Return Index (LEGATRUU) shed 16.25%. Positively, in the last 12 months, the portfolio returned a stronger 2.48%, however when benchmarked to floating rate indices the returns have been less compelling The AusBond Credit FRN Index (BAFRN0) returned 1.28% for the year while having a far superior weighted average credit quality (AA-/A+ versus PCI's BBB-/BB+).

PCI stands ready to capture an upswing in returns in the near future as bond prices pull to par.

PCI sits at the limit of our **Upper Medium** Risk Score designation, meaning a deterioration in credit quality would see our risk rating fall to High. Additionally, we view best practice from a governance perspective as having the non-rated loans portion of the portfolio externally valued, especially considering this is 29.4% of PCI excluding cash, however, valuations are performed by an internal team that is independent of the Fund. Further, the RE and the investment manager are not independent at the parent level, which is not in line with our preferred structure.

Figure 4. Estimated Risk-Adjusted Comparison*



** All returns for indices calculated using annualised monthly returns from 31 May 2019 to 31 December 2022. ** Calculated as at 31 December 2022. Excludes equity holdings, BondAdviser estimate per unrated assets. *** Calculated based on annualised monthly returns data from 31 May 2019 to 31 December 2022.*

A requirement under our Alternative Fund Research Methodology in order to qualify for a "Recommended" Product Assessment is for the Fund's past 24 months of returns to exceed the annualised target return and the Fund was upgraded to Recommended in January 2022. PCI's performance to 31 December 2022 on a rolling 24-month basis is below its target return. This is a function of widening in credit spreads which commenced in mid-2021 and extended through the first half of 2022. Over the first half of 2022, a potent combination of surging inflation, monetary policy tightening, and rising geopolitical and economic uncertainty drove a spike in market volatility, seeing most assets classes fall precipitously. While higher running yields will be a positive for the Fund in the medium-term, there was a material capital return impact from lower marks to market as yields rose. It is our base case that the recent negative impacts will be reversed as securities approach maturity and return to par, driving outperformance over the next 12-24 months. The Manager expects to hold such investments to maturity where appropriate and as such any securities that are currently below par will generate a positive carry as they mature.

Although returns are beneath the requirement to qualify for a “Recommended” Product Assessment, the hurdles for a downgrade to occur are substantially larger. The reason for this is that fund research reviews are conducted at a single point in time, while a fund will typically have a long-term investment horizon. As such, we prefer to look through factors that can be volatile in the short-term and are more systematic rather than idiosyncratic.

From a governance and key-person perspective, we note (June 2022) departure of long-term Fund Manager Anne Moal who was the Head of Corporate High Yield at Perpetual for 8 years. The team has since been restaffed but experience is arguably inferior compared to Anne Moal’s. Importantly, whilst we are comfortable with manager capabilities – we emphasise that key-person risk for Michael Korber has increased.

Prior to the marketwide sell-off in March 2020, PCI consistently traded at a premium to NAV. For three years now, this discount has not recovered and the unit price remains meaningfully beneath the Fund’s net asset value (NAV discount of -10.3% as at 24 March 2023). Whilst ASX pricing is subject to market dynamics exogenous to the control of Perpetual, unfavourable unit pricing presents a risk to investors. Disappointingly, PCI still has not implemented mechanisms for internally mitigating this risk (such as a unit buyback or creating a parallel unlisted vehicle which has the same strategy but can also invest in the listed units). These mechanisms have been implemented by other funds but the success of such strategy is mixed.

BondAdviser has covered PCI for several years, across which, it had consistently exceeded our expectations. The Fund’s net returns are only slightly beneath the target on a rolling 24-month basis (3.44% p.a. versus target of 3.90% p.a.) following a year of broadly horrific performance in credit. We also take into account that the Fund is designed for investors with a minimum five-year investment horizon. While our expectation is for PCI’s returns to perform above its target in the medium-term, this is predicated on the thesis of a broadly strong year for bonds in 2023. There are too many exogenous factors at present for this base case to carry enough weight for our Outlook to remain Stable. Additionally impeding on our Outlook is the transitionary phase the team is currently in following the recent departure of key team member, Anne Moal. Accoringly we place the Fund on a **Deteriorating** Outlook. Should the returns profile of the Fund continue to be underperforming the target return in 12 months’ time, the Fund’s Product Assessment will likely be downgraded. We maintain a **Recommended** Product Assessment on expectations that the Fund will: (1) outperform its return target, and (2) reduce key person risks. **The bar to reach our Recommended status is high**, hence the benefit of the doubt is provided when marginal underperformance may be present.

Investment Process and Portfolio Composition

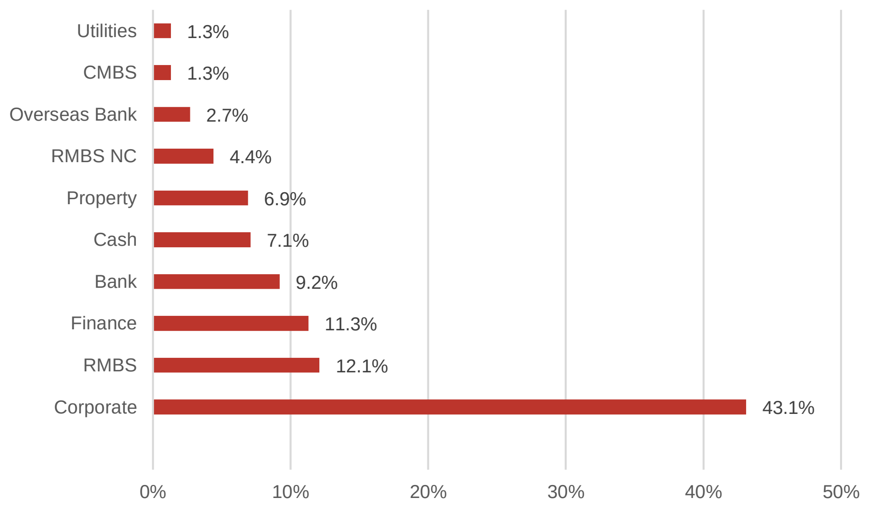
There have been **no material changes** to PCI's portfolio construction and investment process, although the Manager's active management amidst the changing market conditions have driven gradual shifts in the portfolio's composition. In line with its investment strategy, PCI has maintained an almost-zero duration exposure via hedging. This has been highly advantageous to PCI investors over the past 18 months as inflation and subsequent interest rate hikes have seen base rate yields spike, smashing fixed rate sensitive (high duration) alternatives.

Figure 5. Portfolio Individual Investment Mix*

	Nov-21	Dec-22
NTA	$444m	$433m
Number of holdings	117	119
Number of issuers	89	88
Running yield	3.8%	6.5%
Portfolio weighted average tenor	3.5 years	2.9 years
Interest rate duration	56 days	43 days

Source: BondAdviser, Perpetual. As at 31 December 2022.

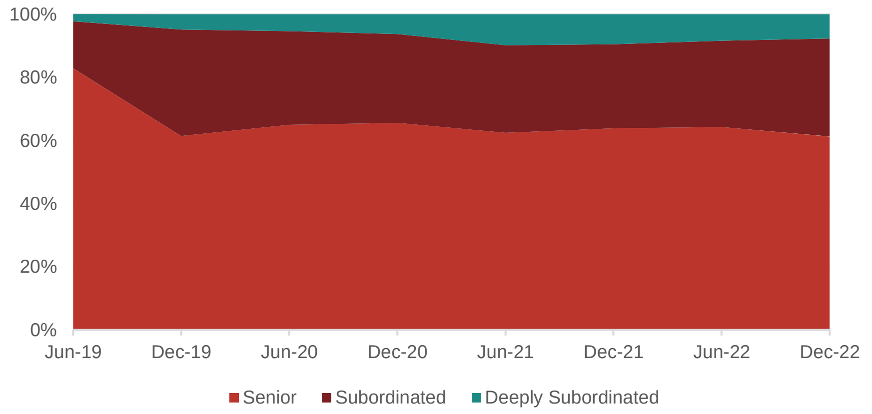
Figure 6. Portfolio Individual Investment Mix*



*Source: BondAdviser, Perpetual. As at 31 December 2021 * Excluding cash and derivatives.*

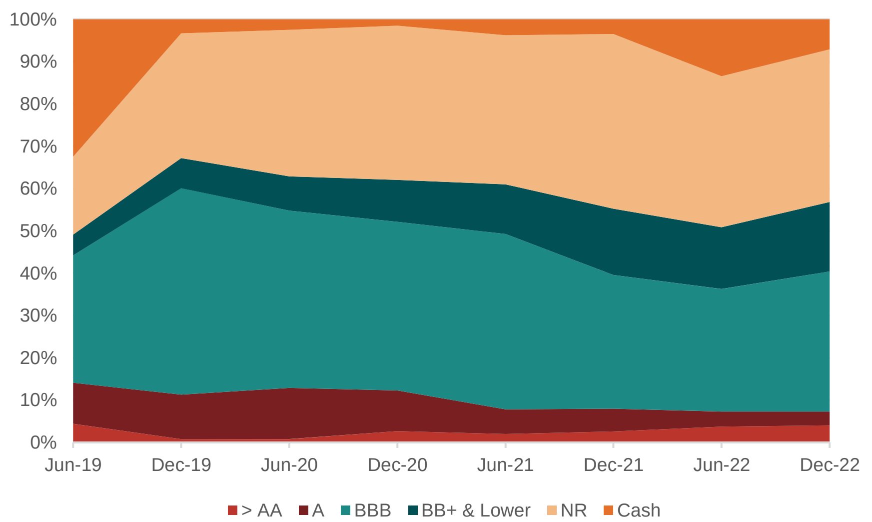
PCI has over the past year operated its portfolio at around a 40% weighting to investment grade securities, a significant reduction from the previous ~55% exposure. Whilst the portfolio has deteriorated from a credit rating perspective, the weighting to senior debt has held steady around 60-65% of the portfolio since the Fund's cash has been fully deployed.

Figure 7. Portfolio Individual Investment Mix*



*Source: BondAdviser, Perpetual. As at 31 December 2022. * Excluding cash and derivatives.*

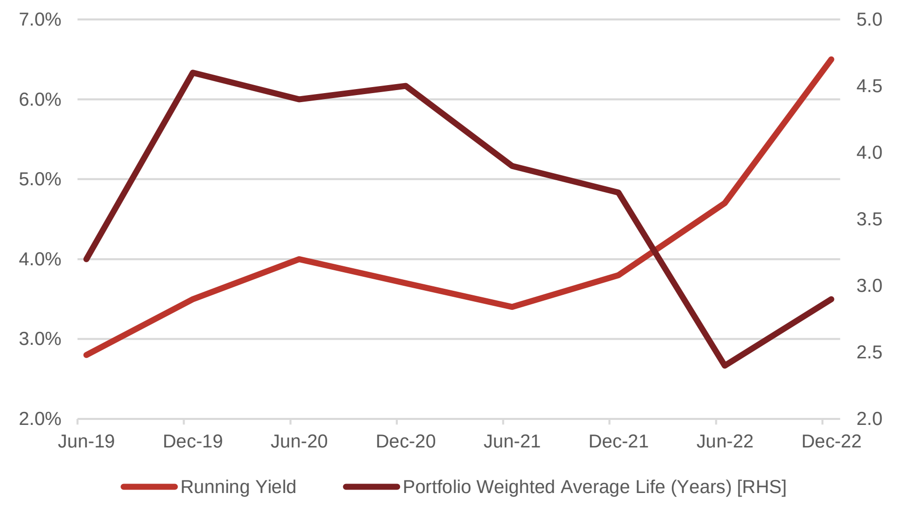
Figure 8. Portfolio Individual Investment Mix*



Source: BondAdviser, Perpetual. As at 31 December 2022.

Although risk metrics of the portfolio have not improved from a credit rating, seniority, or a diversification perspective, the Manager has targeted shorter tenors while allowing the book to roll down the curve. This has seen the weighted average tenor of the portfolio fall from ~4.5 years to ~2.5 years. It is worth noting that this is not a duration induced decision as the portfolio has de-minimus interest rate exposure. Typically, we would view the purpose of this posturing as a reduction in credit risk from the perspective that as bondholders with 2.5 years to maturity are at lesser risk of the issuer defaulting before maturity than that same issuer's likelihood of default over 4.5 years. Our analysis suggests that instead of moving to the front of the curve with the same issuer, the Manager continues to gradually increase its exposure to non-investment grade securities and is doing so at a shorter tenor for a similar spread.

Figure 9. Portfolio Individual Investment Mix*



*Source: BondAdviser, Perpetual. As at 30 September 2021 * Excluding cash and derivatives.*

Portfolio Risk Management

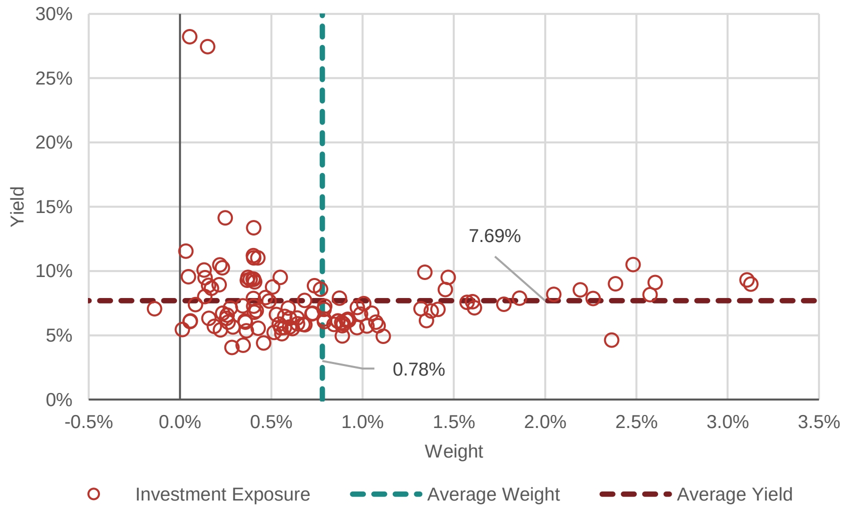
There have been **no material changes** to PCI's portfolio risk management.

Perpetual maintains strict governance oversight along with strong risk controls throughout the investment process. The Manager utilises a top-down credit scoring process in combination with extensive bottom-up fundamental research to select investment assets. The portfolio is actively managed and regularly monitored to ensure compliance with investment guidelines. Guideline compliance is required for diversification across asset type, credit quality, maturities, countries (typically hedged into AUD) and issuers.

Financial (credit) risk is actively monitored by the Credit and Fixed Income Team with oversight at a corporate level through the Investment Review Committee and a recently upgraded proprietary **risk management system**. Given the asymmetric nature of returns in credit, single security selection, subsequent active monitoring, and appropriate diversification is critical in managing credit risk at the portfolio level.

Figure 10 illustrates the portfolio continues to have a solid level of diversification while attaining an average yield of 7.69% as at 31 December 2022. As shown in Figure 5, there has been little change in diversification over the past year while the exposure to non-investment grade holdings continues to gradually climb (Figure 8). Importantly, this 56.5% weighting to non-IG excluding cash is within the Fund's guidelines of 0-70% non-investment grade exposure. The Fund must also hold a minimum of 30% investment grade assets with a cap of 100%. While the relatively broad mandate brings risk to the portfolio, it is also one of the key benefits of investing in an actively managed fund. This is because, unlike a passive strategy, investors are able to leverage the expertise of an experienced investment team and potentially get a superior risk-adjusted return from active asset allocation as opportunities arise.

Figure 10. Portfolio Individual Investment Mix*



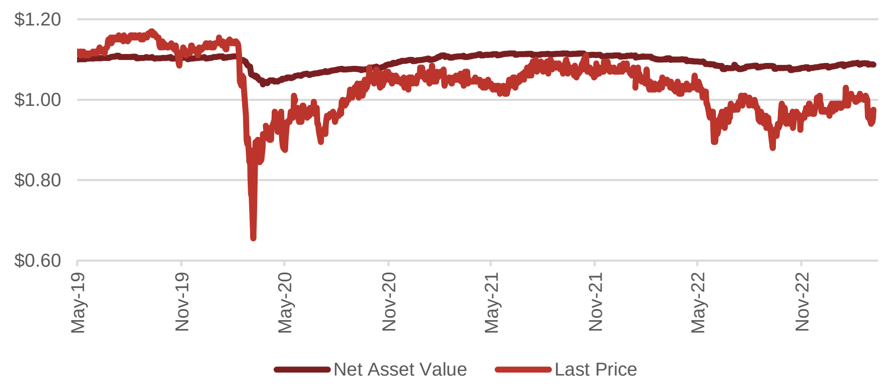
*Source: BondAdviser, Perpetual. As at 31 December 2021 * Excluding cash and derivatives.*

Investors in PCI benefit from access to intraday liquidity via trading units as a function of the Fund being listed on the ASX. The downside here is the unit price can be subject to market irrationality and may not reflect intrinsic value of the Trust despite its NAV being published daily. Consequently, investors are vulnerable to adverse capital movements which in turn impacts an investors' individual liquidity preferences due to price volatility.

We view the Manager's efforts to reconnect the unit price to the NAV as being underwhelming. Currently, raising investor education is the approach taken and while this can only be beneficial, this strategy is clearly not enough to comfort investors. This is evidenced by the persistence of a NAV discount for nearly the past three years. It is our opinion that it is time for a change in tack, especially when the discount has recently widened back out to as much as -18.7% on 27-Sep-22.

As is the preferred strategy of some other listed funds when faced with a NAV discount, we continue to view buy backs as both a robust form of unit price support (preventative of trading at a larger discount), and also a way to narrow the bifurcation. It is also logical from an opportunity cost perspective. Currently the yield on the portfolio is 6.5% while the NAV discount is -10.3% as at 24 March 2023. By not buying back units in the Fund at a discount greater than the portfolio yield, the Manager is implying that it should be able to earn larger returns than the discount – in order to be accretive to all unitholders.

Figure 11. Net Asset Value Against Unit Price



Source: BondAdviser, Perpetual. As at 24 March 2023.

Fund Governance

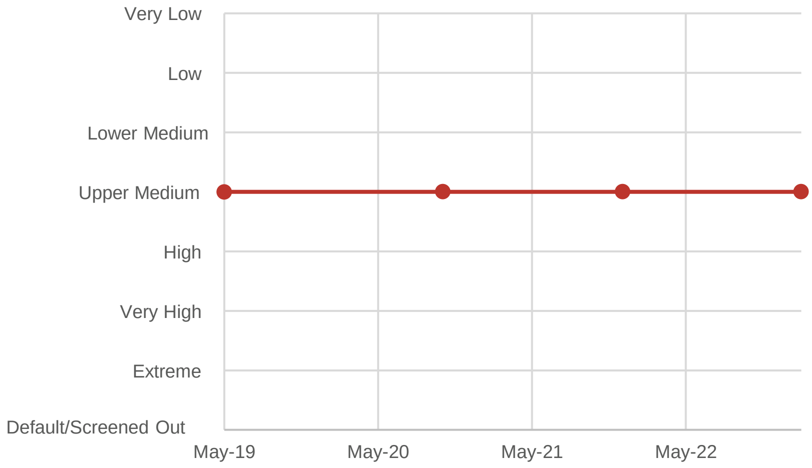
On 10 June 2022, Portfolio Manager for the Perpetual Loan Fund and key person for PCI, Anne Moal, left the Fund. She was instrumental in the creation of the loan sleeve for this Fund. Management have since restaffed this team to ensure its continuity. However, Ms. Moal's level of expertise was superior to the new staff, and any such impact remains to be seen. We do not expect but remain wary of any potential downside risks during this transitionary period.

We do highlight in page 8 of our January 2022 report that on 21 September 2021, the Manager announced PCI would be **transitioning its custody and administration services from RBC Investor Services Trust to State Street Australia**. This was purely a function of RBC altering its custodial services and the change had **no impact on the Fund's governance assessment given the like-for-like replacement**.

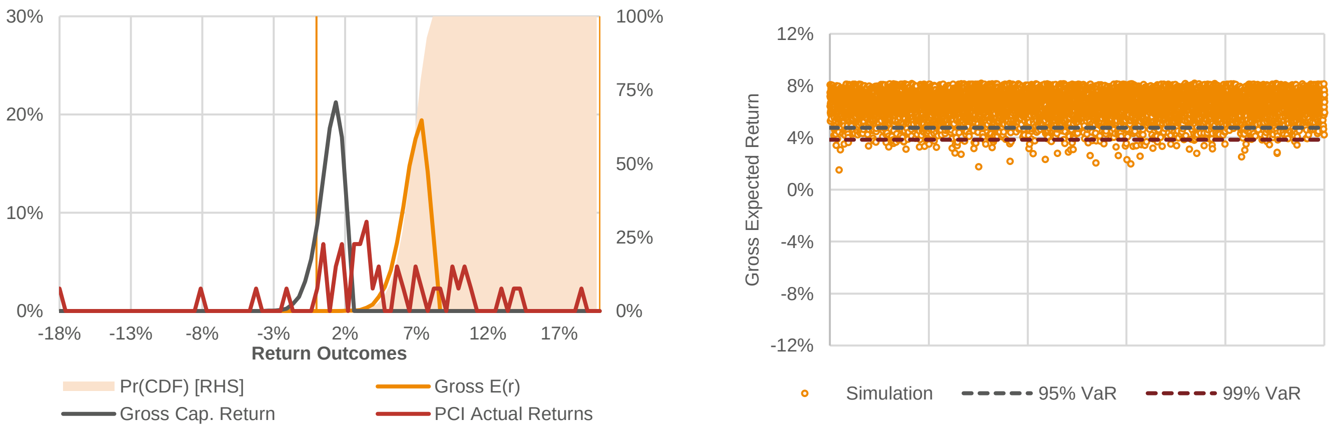
Perpetual provides daily updates on the NAV and monthly reports on the portfolio performance with insights into portfolio composition. The structure of the Trust is detailed in the Figure 9 of the January 2022 report.

Quantitative Analysis

Figure 12. Risk Score

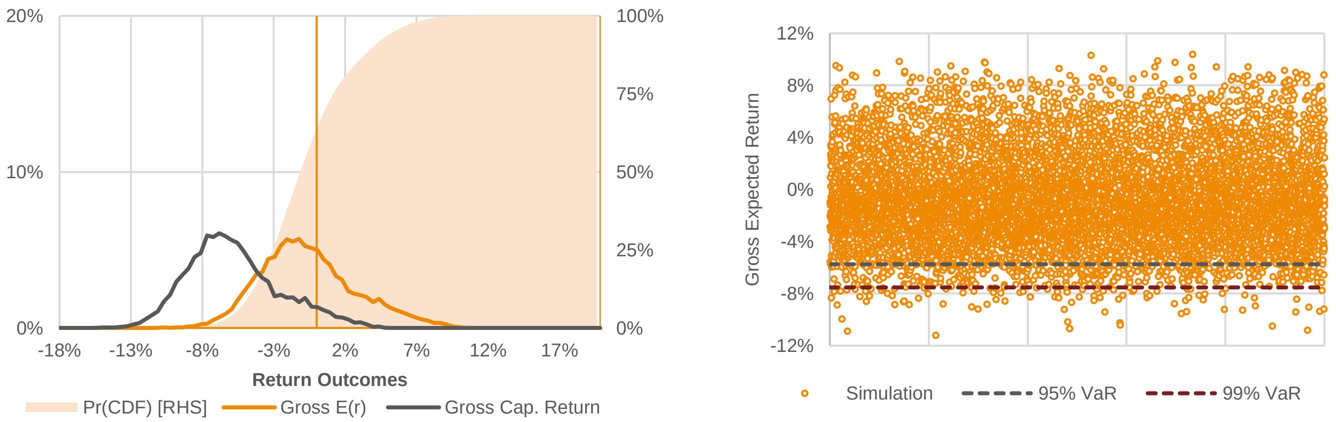


Scenario 1. Baseline Asset Assessment



Source: BondAdviser Estimates as of 31 December 2022 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated. For a more detailed explanation of the methodology, please contact BondAdviser.

Scenario 2. Stressed Asset Assessment



Source: BondAdviser Estimates as of 31 December 2022 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

Investment grade securities perform significantly better in distressed scenarios than non-IG, whilst loss given default outcomes are better the higher up the capital stack. The largest factor for a credit portfolio from a risk mitigation perspective is diversification, which also remains relatively unchanged with the Fund's mandate targeting ~100 individual holdings. As such, versus a year ago, there are minimal changes in terms of portfolio risk improvements. In spite of this, modelled returns have shot up versus the Dec-21 portfolio as a result of higher base rates reflecting the positive impacts of floating rate exposure in a rising rate environment.

In our baseline assessment, the median expected return and 99% VaR have risen from 3.14% and -0.90% a year ago to 6.72% and 3.84%, respectively. Expected returns are also considerably improved in the GFC-like scenario whereby the 99% VaR has risen from -12.84% at Dec-21 to -7.53% at 31-Dec-22. The primary driver behind this massive delta in Scenario 2 is again the higher base rates, however the Dec-21 portfolio's securitised vehicle exposure (15.4% in Dec-22, 11.9% in Dec-21) was of a drastically lower weighted average credit rating. Higher credit rated securitised vehicles saw substantially better LGD results during the GFC, driving a portion of the 5% uptick in VaR versus the prior year despite the higher weighting to the asset class.

PCI is currently eligible for a Risk Score upwards notching due to average counterparty weighting of 1.0% being below our threshold of 2.0% and no single counterparty being above 5.0% (largest is 3.1%). As the portfolio's weighted average credit rating is on the border of BBB- and BB+, we view an upgrade from the "Upper Medium" or the "BBB" band, to "Lower Medium" or the "A" band as excessive. As such, our **Risk Score for PCI remains unchanged at "Upper Medium"**.

Reporting History

PCI Report – 11 January 2022

PCI Report – 20 October 2020

PCI Report – 8 March 2019

Important Information

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Report created on 30 March 2023.