Fund Research

Perpetual Credit Income Trust (ASX: PCI)

Overview

The Perpetual Credit Income Trust ('PCI' or 'the Trust') is an ASX-listed investment trust (LIT) designed to provide investors with exposure to credit markets with a focus on Australian dollar high-yield bond, syndicated loan, and securitised asset classes. PCI is actively managed by Perpetual Investment Management Limited, an established fixed income team that manages over $7 billion across multiple strategies. 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 more than $23 billion of assets as at 31 March 2021.

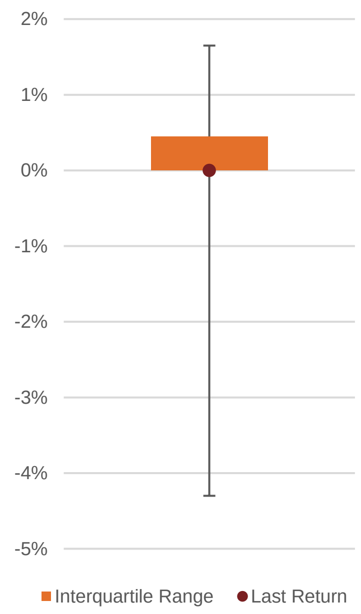
The Trust targets a return of the RBA Cash Rate + 3.25% p.a. (net of fees) through the economic cycle. The Trust is designed to deliver consistent monthly cash distributions while limiting capital drawdowns. Foreign currency exposure is limited to 30% of gross asset value (GAV) but risk is typically hedged into AUD. Leverage is permitted due to 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 2. Monthly Net Investment Returns (%)**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.50	0.80	0.30	0.70	0.30	0.40	0.20	0.20	0.50	0.10	0.00		**4.00**
2020	0.5	0.00	-4.10	-0.40	1.10	1.10	1.00	0.80	0.20	0.60	1.40	0.80	**3.00**
2019					0.10	0.40	0.60	0.10	0.30	0.30	0.30	0.40	**2.50**

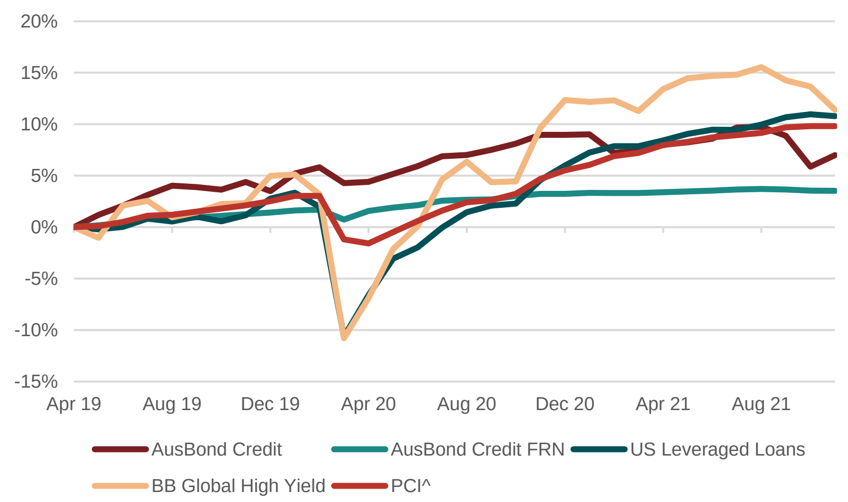
Source: BondAdviser, Perpetual. As at 30 November 2021.
*** Monthly investment return net of fees and operating expenses since inception based on growth of NTA and assuming all distributions are reinvested on the ex-date.*

Figure 1. Monthly Returns* Box Plot



*Source: BondAdviser, Perpetual. As at 30 November 2021. * 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 30 November 2021.
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

A proven investment strategy, alongside first-class systems, coupled with an experienced and stable team, forms our expectations of continued outperformance from a risk-reward lens.

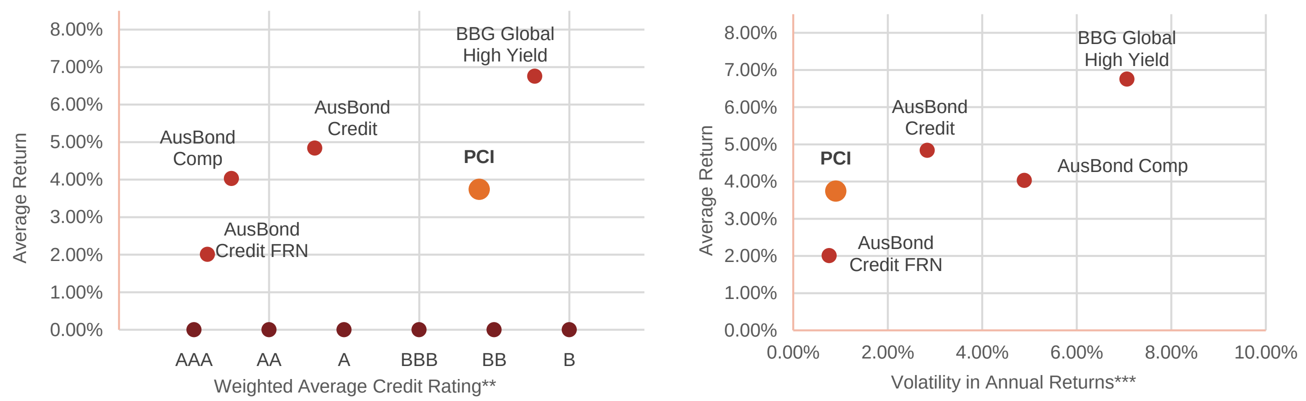
PCI gives investors exposure to a diversified portfolio of credit investments to deliver consistent and reliable income with a yield over the cash rate that is commensurate with its risk profile. Since inception, on an investment return basis (excluding movements in unit price), the portfolio has outperformed its target of the RBA cash rate + 3.25%, returning 3.70%. In line with broader credit markets, PCI's performance suffered during the onset of COVID in 2020. Positively, in the last 12 months the portfolio returned a stronger 5.0% and the overall performance through hostile market conditions and subsequent rebound supports confidence in Perpetual's ability to execute its strategy in the long-term.

Performance in the past year has been driven by a slight shift in the portfolio's composition towards a return profile which can help deliver target returns in the long-term, albeit with an increase in credit risk. The majority of the portfolio is now non-investment grade, with significant HY bond, syndicated loan and ABS assets contributing to yield. Positively, PCI's security and borrower diversification continues to improve, a major benefit given the asymmetric nature of these underlying assets.

PCI offers exposure to a well-diversified portfolio of credit and fixed income assets not usually available to retail investors.

From a shortcoming perspective, PCI sits at the limit of our Upper Medium risk designation. Should credit quality continue to deteriorate, our risk rating could fall to High. From a governance perspective, for the unrated portion of the portfolio, particularly with respect to illiquid assets, we prefer external valuations. PCI currently has valuations reviewed by an independent internal team. Additionally, the RE and the investment manager are not independent at the parent level, this is not in line with our preferred structure.

Figure 4. Estimated Risk-Adjusted Comparison*



All returns for indices calculated using annualised monthly returns from May 2019 to 30 November 2021.
*** Calculated as at 30 November 2021. Excludes equity holdings, BondAdviser estimate per unrated assets. *** Calculated based on annualised monthly returns data from May 2018 to 30 November 2021.*

PCI's performance when accounting for change in ASX-traded unit price is weaker – 2.1% (net p.a.) since inception. In March 2020, PCI – as did all comparative LITs – traded at a substantial discount to NAV. Although most of the discount has since recovered, PCI continues to trade at a marginal discount and below the premium at which it priced in the period preceding COVID. Whilst ASX pricing is subject to market dynamics exogenous to the control of Perpetual, unfavourable unit pricing presents a risk to investors. Moreover, unlike some high-yielding LITs, PCI 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). Thus, whilst we view the likelihood of PCI trading at such a severe discount to NAV as seen in March 2020 as unlikely, unit price volatility continues to present hurdles for PCI’s total unitholder return.

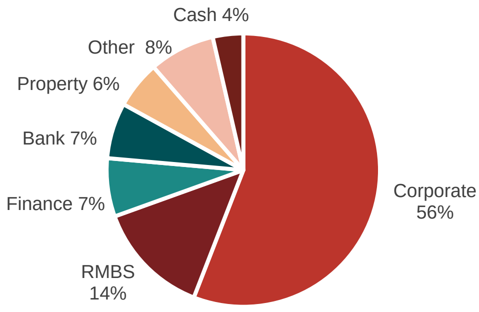
BondAdviser has covered PCI for several years, across which, it has consistently exceeded our expectations. Whilst credit risk has increased, performance has been strong and counterparty diversity has continued to improve. A proven investment strategy, alongside first-class systems, coupled with an experienced and stable team, forms our expectations of continued outperformance from a risk-reward lens. This has warranted an upgrade to our product assessment, which improves to the infrequently issued status of **Recommended**.

Investment Process and Portfolio Composition

There have been **no material changes** to PCI's portfolio construction and investment process, although changing market conditions have driven slight shifts in the portfolio's composition. As Figure 5 shows, in line with marginal growth in Trust NTA, the number of individual holdings and respective counterparties has increased in the last 12 months. The portfolio remains overwhelmingly comprised of AUD denominated securities (94%) issued by Australian domiciled entities.

Figure 5. Portfolio Sector and Country Mix

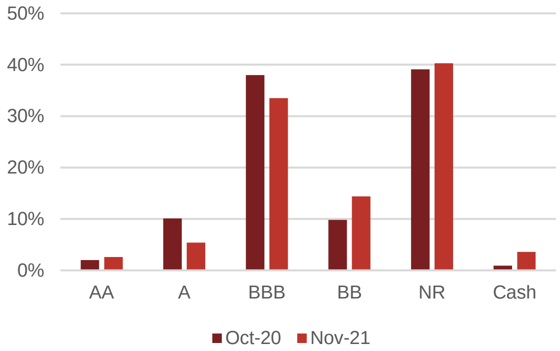
	Oct 20	Nov 21
NTA	$432m	$444m
Number of holdings	103	117
Number of issuers	78	89
Running yield	4.0%	3.8%
Portfolio WA tenor	4.5 years	3.5 years
Interest rate duration	31 days	56 days

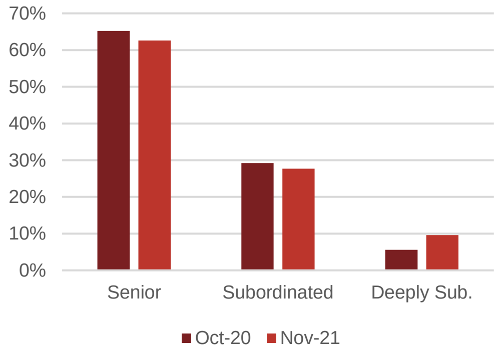


Source: BondAdviser, Perpetual. As at 30 November 2021.

A notable shift in the portfolio's composition over the last 12 months has been a slight transition away from longer-dated, investment grade (IG) securities toward shorter-dated, non-IG assets. As shown in Figures 5 and 6, the IG portion of the portfolio has lowered to 45% whilst the weighted average tenor of the portfolio has reduced by 12 months to 3.5 years. This is partly a function of PCI's natural development: as the Trust has gradually ramped up and matured, Management have relaxed initial conservatism in portfolio construction. It has also occurred in response to changing market conditions, which, following significant tightening of IG and financial spreads, Perpetual now views as positive for HY and non-rated assets, especially those issued by non-financial corporates. Mezzanine RMBS assets continue to comprise an integral part of PCI's HY portfolio, despite an outlook for pressure on RMBS spreads in line with widening senior financial spreads. In addition, PCI has maintained an almost-zero duration exposure (through hedging) in line with its investment strategy, a notable feature of the portfolio as inflation becomes a paramount macroeconomic concern.

Figure 6. Portfolio Credit Rating Mix





Source: BondAdviser, Perpetual. As at 30 November 2021.

Portfolio Risk Management

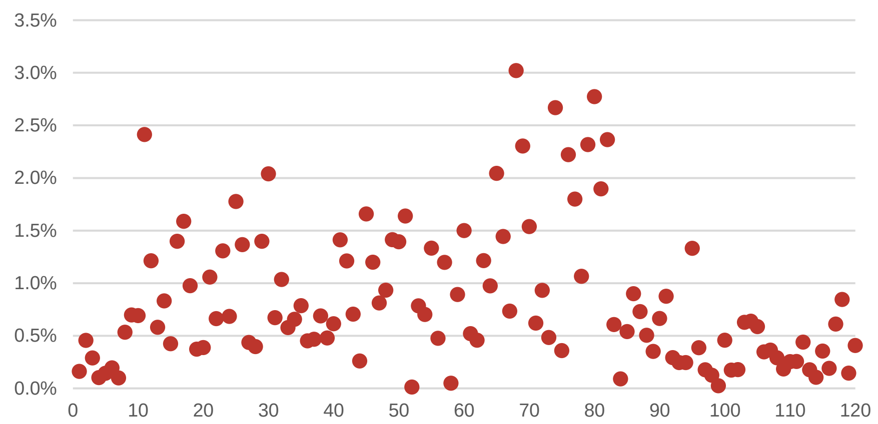
There have been **no material changes** to PCI's portfolio risk management.

Perpetual maintains strong risk controls throughout the investment process along with strict governance oversight. 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 monitored for compliance with investment guidelines - 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 proprietary **risk management system, which has recently been upgraded**. Given the asymmetric nature of returns in credit, single security selection and appropriate diversification is critical in managing credit risk at the portfolio level.

Figure 7 shows that the portfolio is well diversified. As shown in Figures 5 and 6 (Page 4), **diversification has improved further** with the number of holdings and names increasing on a year ago. The **exposure to non-investment grade has increased from 50% to 55%** and is reflective of the respective investment opportunities in each of these categories. Importantly, this is within the Fund's guidelines of 0-70% non-investment grade and 30-100%. These bands are wide but give the Manager flexibility to move between various segments of the credit markets as opportunities arise. It does bring risk, but it is also one of the reasons for investing in an actively managed fund over a passive strategy as it allows investors to leverage the expertise of an experienced investment team and potentially get a superior risk-adjusted outcome.

Figure 7. Portfolio Individual Investment Mix*

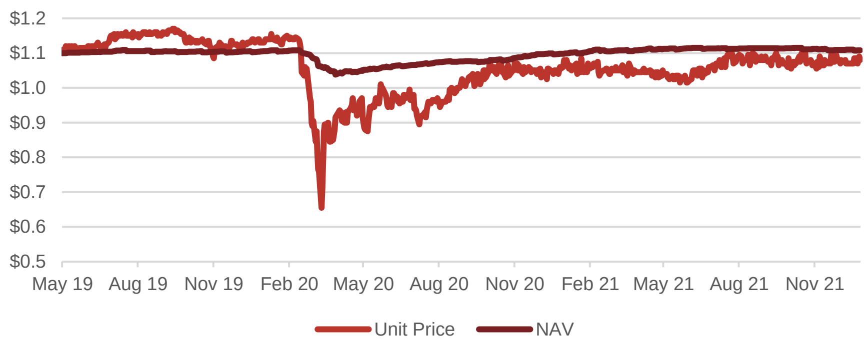


*Source: BondAdviser, Perpetual. As at 30 September 2021 * Excluding cash and derivatives.*

As a listed, product PCI provides investors with relatively better liquidity than unlisted funds (in terms of the ability to trade intraday). However, given it is listed, the unit price is determined by the market and as such may not reflect intrinsic value of the Trust as measured by NAV. Consequently, investors' individual liquidity preferences are vulnerable to adverse capital movements as a function of price volatility. As illustrated in Figure 8, PCI suffered a severe sell-off at the onset of the pandemic in line with broader credit markets. Most of the price to NAV gap has since been closed, however PCI continues to trade at a slight discount to NAV versus the consistent premium seen prior to March 2020. PCI's unit price is partially a function of news flow, market sentiment and other factors extrinsic to the Trust itself. As such, this aspect of liquidity risk is unable to be fully mitigated by the Manager.

Buy-backs are employed by some listed funds to narrow the price to NAV discount. The Manager has not gone down this path but rather has taken the approach of raising investor education about the attributes of PCI to support demand. As investors become more knowledgeable about this relatively new asset class (LITs) and are comforted by the performance of sophisticated portfolios like PCI over the COVID disruption, we view severe NAV dislocations as less likely, although not impossible. Over the longer-term, Fund performance will be a key driver of investor demand.

Figure 8. Net Asset Value Against Unit Price



Source: BondAdviser, Perpetual. As at 7 January 2022.

Fund Governance

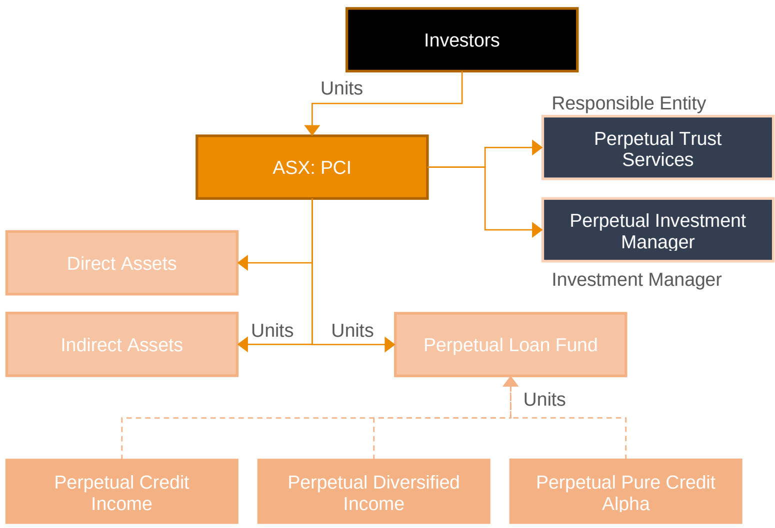
On 21 September 2021, the Manager announced PCI will be **transitioning its custody and administration services from RBC Investor Services Trust to State Street Australia**. This was purely a function of RBC altering its custodial services and the change has **no impact on the Fund's governance assessment given the like-for-like replacement**.

There have been **no other material changes** to PCI's governance policies or structure.

Perpetual Limited is a domestic asset manager that operates across a spectrum of asset classes. Given this, firm wide governance is crucial to ensure internal controls are developed and updated. These functions are independent of portfolio construction and are comprised of dedicated committees and internal audit functions providing oversight. Perpetual Limited has Audit, Risk, and Compliance committees that are independently chaired and have mostly independent members. **We remain comfortable with PCI's governance structure and policies.**

Perpetual Trust Services Limited is the Responsible Entity (RE), which acts at arm's length as required by the Corporations Act 2001 (Cth) and company policy**. The Manager and RE are both subsidiaries of Perpetual Limited**. We note a point of potential conflict arising from a management fee cap of 3.0% of portfolio value (exclusive of GST) pursuant to the Trust's constitution, and which can be altered by the RE at its discretion. However, this is a commonplace feature in the LIT/LIC market.

Figure 9. Legal Structure



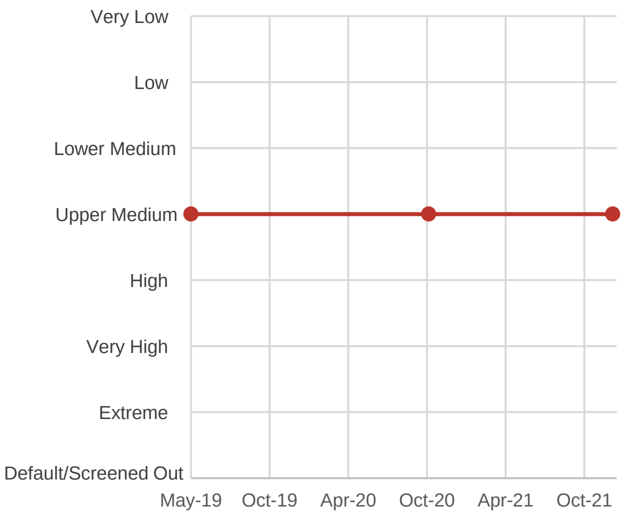
Source: BondAdviser, Perpetual Ltd

At a product level, PCI is a closed-ended LIT domiciled in Australia (issued by Perpetual Trust Services Limited) with a single class of unit on issue. The LIT is registered with ASIC as a Managed Investment Scheme with Perpetual Trust Services Limited being the Responsible Entity (RE) acting in the best interests of unit holders. Perpetual Investments Management Limited is the Investment Manager of the Trust. The Product Disclosure Statement, Trust Deed, Unit Sale Agreement, Offer Management Agreement and Investment Management Agreement are the key documents governing PCI.

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 diagram above (Figure 9).

Quantitative Analysis

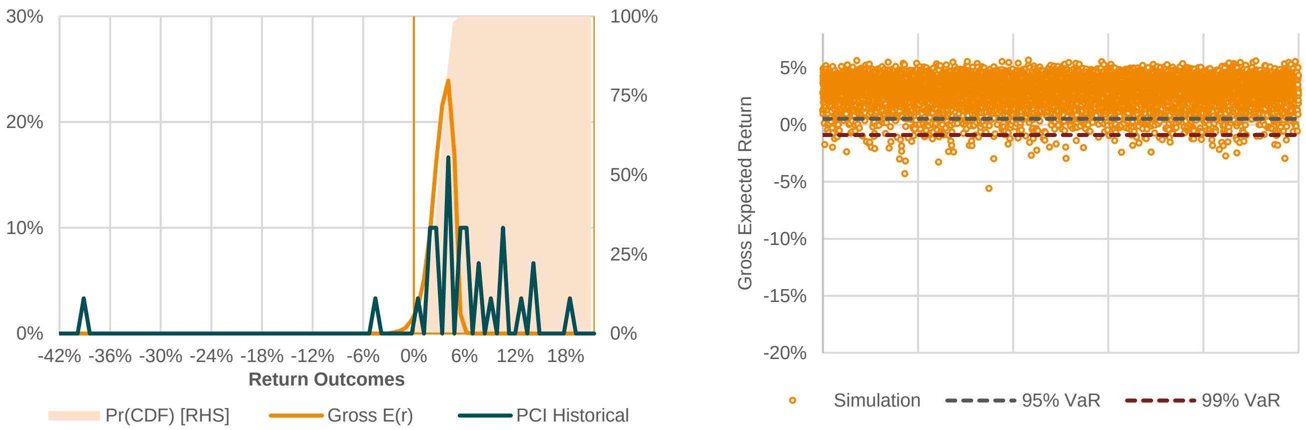
Figure 10. Risk Assessment



PCI has a 45% weighting to investment grade securities which perform significantly better in distressed scenarios than non-IG. That said, the Fund does have a 14% exposure to Australian RMBS which were heavily impacted during the subprime crisis. On balance, the portfolio continues to perform well under our simulation of a GFC-like scenario, however, further increases in the weighting towards securitised investments would drastically impact our modelling.

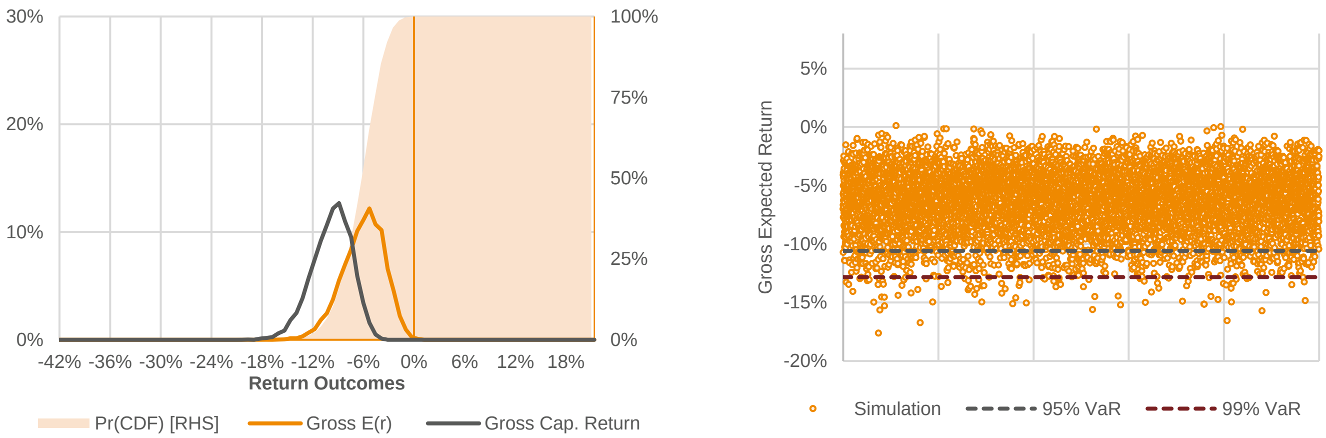
The weighted average credit rating of the portfolio has slightly deteriorated in the last 12 months in line with strategy adjustments. However, these are partially offset by diversification improvements on an individual security and borrower basis. **Our Risk Score for PCI remains unchanged at "Upper Medium"**.

Scenario 1. Baseline Asset Assessment



Source: BondAdviser Estimates. Excludes impact of fees.

Scenario 2. Stressed Asset Assessment (GFC)



Source: BondAdviser Estimates. Excludes impact of fees.

Reporting History

PCI Report – 20 October 2020

PCI Report – 8 March 2019

Important Information

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Report created on 11 January 2022.