Fund Research

Perpetual Credit Income Trust (ASX: PCI)

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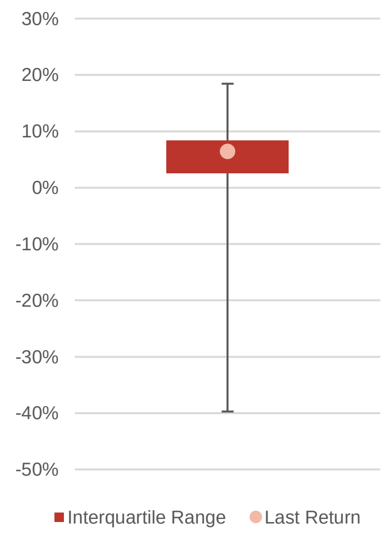
Overview

The Perpetual Credit Income Trust ('PCI', 'The Fund' 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, investing across a combination of investment grade and high-yield bonds, syndicated loans, and securitised asset classes. The Manager, Perpetual Investment Management Limited, is an established credit and fixed income team that manages ~$7.3 billion across multiple strategies as at 31 March 2024. PCI is a retail-accessible investment portfolio managed by specialists in niche credit markets not directly available to its investor base. The management team is comprised of experienced and skilled investment professionals with a proven track record of managing credit investments across cycles. The team is supported by Perpetual Asset Management's broader investment network that together manages $21.4 billion of assets as at 31 March 2024.

The Trust targets a return of the RBA Cash Rate + 3.25% p.a. (net of fees) through the economic cycle. PCI 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



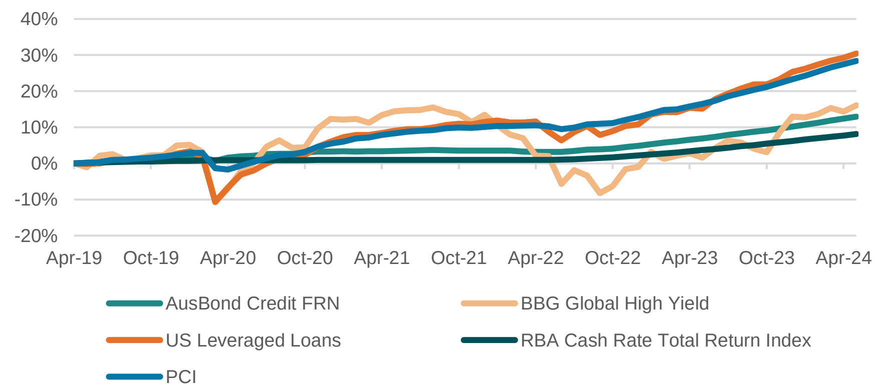
Source: BondAdviser, Perpetual. As at 31 May 2024. Monthly investment return net of fees and operating expenses since inception based on growth of NTA.

Figure 2. Monthly Net Investment Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2024	0.80	0.89	0.90	0.76	0.68								**4.03**
2023	0.89	0.86	0.14	0.70	0.58	0.76	1.11	0.69	0.77	0.65	0.87	0.90	**8.92**
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 May 2024.
** 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 May 2024.
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 | Improving

Following a period of recovery after the market-wide rout in 2022, the Fund's returns now exceed its target at every major timeframe.

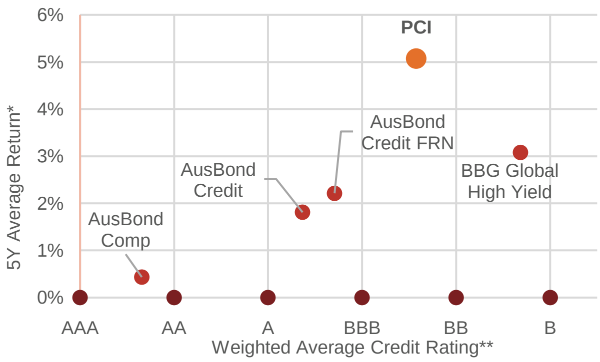
PCI aims to offer investors access to a diversified portfolio of credit investments, targeting consistent and reliable income with a target return exceeding the RBA cash rate by 3.25%, aligned with its risk profile. Following a period of marketwide underperformance that PCI was somewhat protected from due to its defensive nature and low duration exposure, the Fund as at 31 May 2024 **exceeds its target return on a 1-year, 2-year, and since inception basis**. Annualised investment returns (excluding returns in unit price) for PCI over those respective timeframes have been 10.23%, 7.88%, and 5.04%, beating the target by 250, 100, and 14 basis points per annum, respectively. As at 31 May 2024 the portfolio's running yield is 8.1% which is also ahead of the target return on a forward basis.

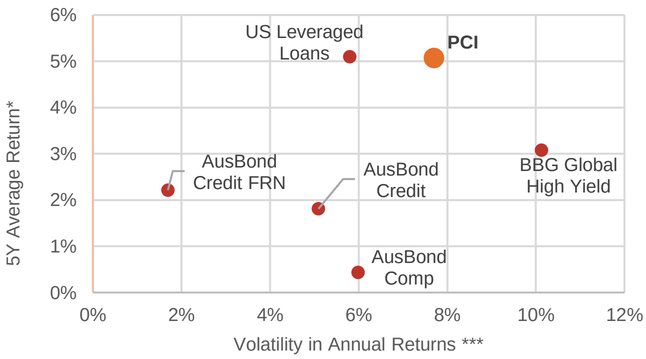
PCI provides investors with an actively managed, diversified portfolio of best ideas designed to provide attractive risk-adjusted returns through the cycle.

The Fund as at 30 April 2024, inclusive of cash, is comprised of a 41.1% allocation to syndicated loans, 18.9% to securitised assets and the remainder (~36.2%) is allocated to bonds – predominantly investment grade and Australian dollar-denominated. We therefore contrast the Fund's returns to both a loan index (SPBDAL / US Leveraged Loans) and a bond index (BACR0 / AusBond Credit). US Loans have returned 9.51% p.a. over the past two years while the AusBond Credit has returned 3.79% annualised. Given PCI's net return of 7.88%, the Fund's returns are again favourable. This is especially the case when considering the consistently stable net asset value of the Fund along with its credit quality that borders on investment grade (leveraged loans are sub-IG while BACR0 is A-band).

As a function of the Fund's weighted average credit rating being around BBB+/BB-, PCI sits at the limit of our **Upper Medium** Risk Score designation. A material weakening in the credit quality of its borrowing counterparties or allocation to riskier borrowers would likely trigger a deterioration in our Risk Score to High.

Figure 4. Estimated Risk-Adjusted Comparison*





** All returns for indices calculated using annualised monthly returns for the past five years to 31 May 2024. ** Calculated as at 31 December 2022. Excludes equity holdings, BondAdviser estimate per unrated assets. *** Calculated based on annualised monthly returns data for past five years to 31 May 2024.*

Positively, from the September 2023 quarter onward, the Fund moved to independent loan valuations which are conducted externally by S&P Global on a quarterly basis and can be requested out of cycle if there has been a material change in market conditions or performance of a particular credit.

The Fund's Responsible Entity and investment manager are not independent of PCI at the parent level, however as part of Perpetual Limited's strategic review, the Manager expects the Responsible Entity will become independent following the completion of the announced sale of the Perpetual Corporate Trust business (expected in February 2025). We would view such change as a material positive.

As a listed investment trust, PCI is subject to the volatility of other instruments listed on the ASX (predominantly equities) and, despite the daily updates reassuring investors of the stable NAV, traded at a discount to its net asset value for over four years. There was no intermediation undertaken by PCI such as a buy-back over this period whereby the discount was consistently greater than 10%. We would view the implementation of a mechanism whereby the Fund bought back units upon a certain discount threshold being broken to be a best-in-class governance measure to mitigate the risk of another extensive discount. Mechanisms such as this or the inception of an unlisted fund with the same investment strategy that can also invest in units of the listed version have been utilised by other managers. Such strategies have had more rapid success in recovering the NAV discount following the market-wide selloffs.

On 9 July 2024, PCI announced a capital raising across a wholesale Placement and a Unit Purchase Plan at a new issue price of $1.10 per unit. PCI's net asset value on 8 July 2024 was $1.102 and over the past four years, there have only been 41 trading days where the PCI unit price has exceeded its NAV. The new units are not being offered at a discount to the Fund's NAV and the raise comes immediately after taking four years to close a discount to NAV. While there may be diversification benefits to the capital raise, we would have preferred a more sustained period of trading at a premium to NAV to illustrate secondary trading confidence in the price.

Positively, following the departure of key person Anne Moal in June 2022 who was both the Head of Corporate High Yield at Perpetual for eight years and fundamental in the creation of the loan sleeve, the Fund has continued to operate smoothly and PCI's allocation to its loans capability has grown. We note this has further increased the key person risk to Michael Korber.

The Fund now has a track record of just over five years and BondAdviser have covered PCI since its inception with no issues pertaining to access to data or management wherever necessary. The Fund's returns are satisfactory and we view the risk profile of the Fund as relatively consistent for a fund with an actively managed dynamic allocation strategy. There have been no allocations to aggressive assets over the five years in a bid to increase returns even during periods of underperformance of the benchmark. We view the consistent adherence to a risk profile that is inline with the returns target of the Fund as a material positive for investors as this is an illustration of a Manager investing with a perspective of beating the target through the cycle, aligning with longer horizons of investors.

We are pleased by the Fund's ability to have successfully navigated a transitionary phase following the departure of key person, Anne Moal, coupled with an extended period of market weakness during 2022. Returns have bounced back from the 2022 selloff, and forward expectations exceed that of the benchmark. As a result of PCI's track record now being greater than five years, the Fund is eligible for consideration to be upgraded from a Product Assessment of Recommended to a rarely issued Highly Recommended. However, as there are some material areas of the Fund's key person risk and governance that we consider to not be at the extremely high benchmark of best-in-class, the Product Assessmemt remains at **Recommended**. That said, improvements have been made via the engagement of an independent valuer and the Manager expects for the Responsible Entity to soon be independent. We previously had a Deteriorating Outlook on the Fund's Product Assessment due to performance and key person risk but we now move our Outlook to **Improving** following the positive developments for PCI since our last report.

Investment Process and Portfolio Composition

There have been **no material changes** to PCI's portfolio construction and investment process.

Portfolio Risk Management

Following the ramp up of investments in the portfolio following the capital raise in early 2019, the Fund has consistently operated at a meaningful level of individual counterparty diversification (80+) and continues to target low interest rate duration via hedging fixed rate exposures to floating – as is in line with its investment strategy. At this point in the cycle, PCI has a meaningfully lower weighted average tenor, reflective of the defensive stance the portfolio currently holds. In spite of this, the running yield of PCI at 8.1% is in excess of the target return (7.6% at the current RBA cash rate).

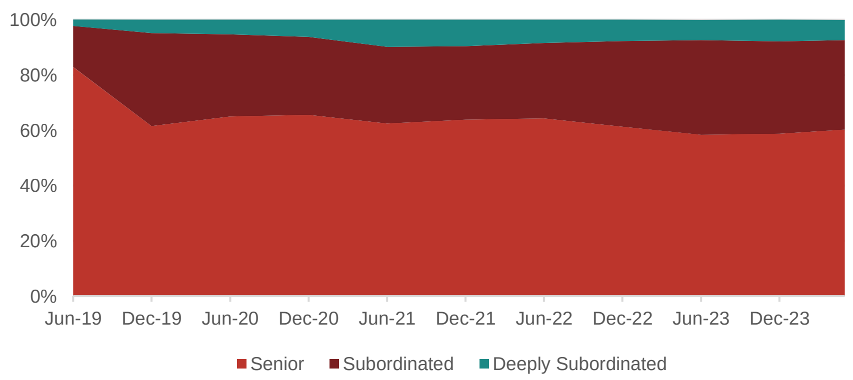
Figure 4. Portfolio Characteristics Over Time

	May-19	May-20	May-21	May-22	May-23	May-24
Market Capitalisation	$444m	$384m	$414m	$405m	$387m	**$433m**
Number of holdings	30	101	120	118	127	**121**
Number of issuers	26	73	88	93	89	**82**
Running yield	2.3%	4.3%	3.5%	4.0%	7.5%	**8.1%**
Portfolio weighted average tenor	1.7 years	4.6 years	4.1 years	2.5 years	3.0 years	**2.7 years**
Interest rate duration	~37 days	28 days	15 days	23 days	25 days	**35 days**

Source: BondAdviser, Perpetual. As at 31 May 2024.

The Fund is well established now and has clearly found a steady state in terms of allocation across the capital stack as is illustrated by Figure 5. That said, the economic backdrop is beginning to turn, and the Manager has stated that it stands ready to take advantage of relative value opportunities as they arise. This ability to take advantage of cheap offerings coupled with the portfolio's defensive positioning are positive for the investor.

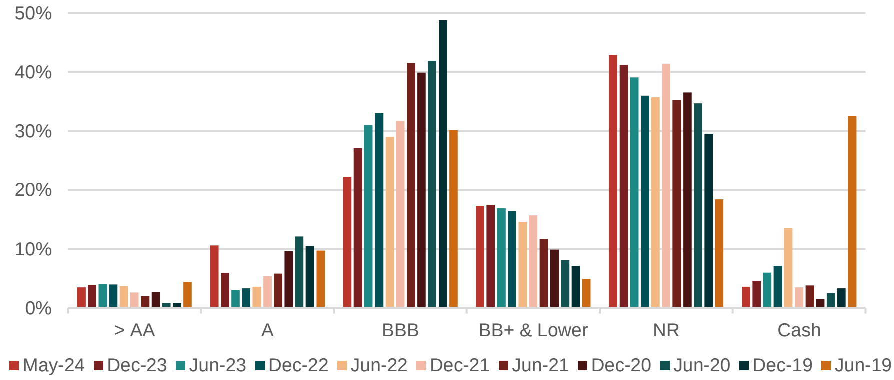
Figure 5. Portfolio Seniority Mix*



*Source: BondAdviser, Perpetual. As at 31 May 2024. * Excluding cash and derivatives.*

The portfolio remains defensively positioned with 17.3% of the portfolio BB rated or lower. We note that 44.5% of the portfolio is not externally rated as a function of the Fund's 42.7% exposure to syndicated loans. Each of these loans are senior secured and 95.1% of these loans are at a mid-single digit margin over the swap rate. Such yields are in line with the upper end of the sub-investment grade universe and thus we view the portfolio as having an estimated weighted average credit rating around the BB band. Given the significant portion of non-rated securities in the portfolio, it is difficult to quantify if the credit quality of PCI has changed over time. Our quantitative analysis suggests that there has been a slight weakening in the credit risk of the portfolio versus the prior report which was based on the Fund's portfolio as at 31 December 2022.

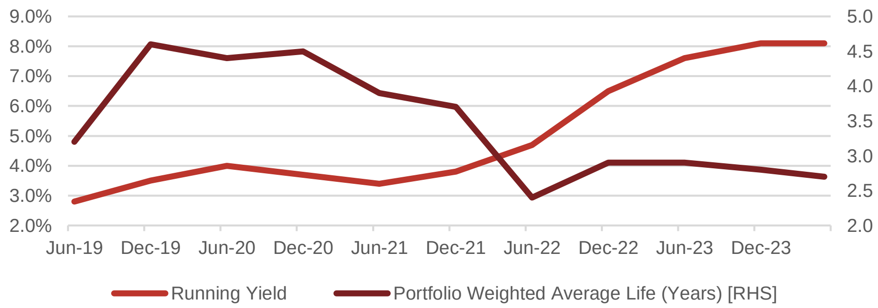
Figure 6. Portfolio Credit Rating Mix



Source: BondAdviser, Perpetual. As at 31 May 2024.

While the underlying risk of the portfolio has not changed materially, the Fund is now earning a significantly higher running yield. This is a function of the floating-rate nature of PCI whereby as rates have risen, the returns on underlying investments have risen too. The running yield on PCI at 30 June 2021 was 3.4% when the cash rate was 0.1%, equating to 3.3% above the RBA and inline with the target of RBA +325bps. The running yield still exceeds the target and as a function of the portfolio being well structured to capture sufficient returns, the credit risk of being a longer-term lender to a single party has been reduced by the weighted average tenor falling from around 4.5 years to 2.7 years as at May 2024. The reason this reduction in tenor is beneficial to investors is that the shorter timeframe until you are repaid as a borrower, the lower the chance of something going wrong and subsequently not being repaid. The Manager has gradually increased its allocation to loans, which are typically shorter tenor and at higher spreads, allowing the Fund to achieve its target return with shorter exposure.

Figure 7. Portfolio Running Yield versus Weighted Average Life*

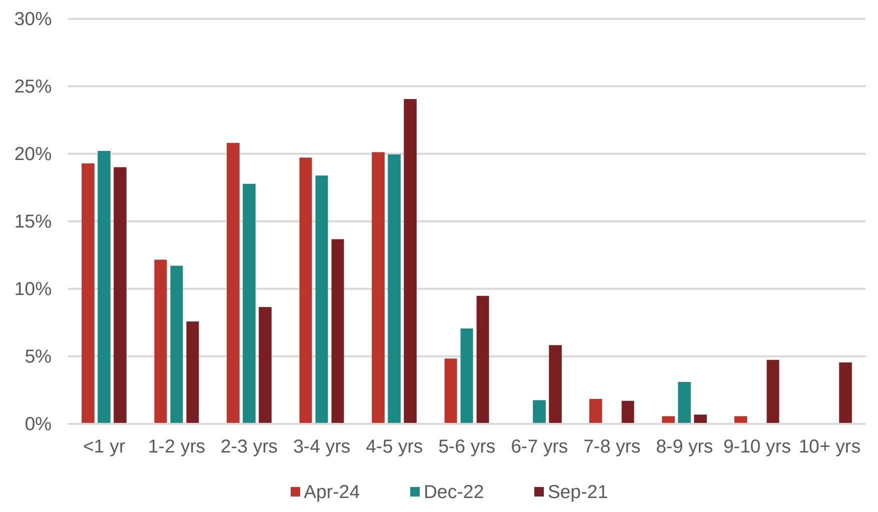


*Source: BondAdviser, Perpetual. As at 31 May 2024. * Excluding cash and derivatives.*

The prior two reports on PCI performed analysis on the portfolio as at 31 December 2022 and 30 September 2021. In September 2021, the portfolio constituted of 27.0% (excluding cash) in the 5+ years bucket. This fell to 11.9% at December 2022 and then 7.8% at 30 April 2024. This again speaks to the reduction in weighted average tenor for PCI. Notably, there has been de minimis change in the portion of the book rolling off in less than 12 months. This is a positive for investors given that nearly half of the book is invested in private loans which are typically more difficult to redeploy capital into.

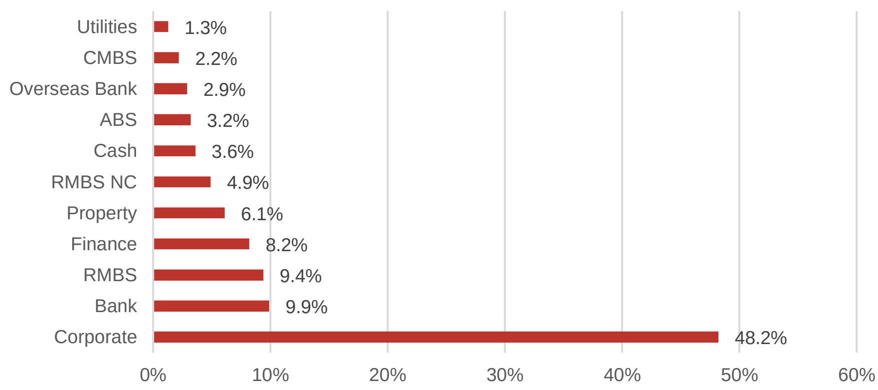
For public assets such as bonds and securitised vehicles, this is not much of an issue as the Manager is able to buy assets that trade daily in open markets. Loans do not trade in open markets and require a far longer lead time to be able to reinvest the cash into appropriate assets with a similar risk-return profile. As such, we view the lack of a significant increase in the less than one year maturity wall as a positive. The manageable reinvestment task alleviates concern of cash drag on returns if the Manager were unable to originate/participate in loans. Also offsetting this concern is the unconstrained strategy of the Fund whereby if the Manager can't find loan opportunities at that point in time, public securities can be bought to avoid cash drag while more appropriate loan opportunities are sourced.

Figure 8. Portfolio Tenor to Expected Maturity Mix*



*Source: BondAdviser, Perpetual. As at 30 April 2024. * Excluding cash and derivatives.*

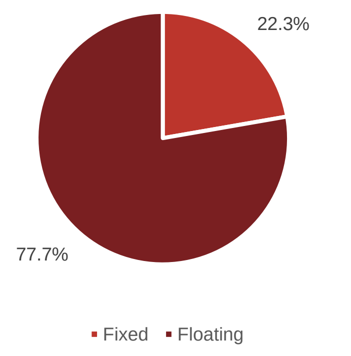
Figure 9. Portfolio Sector Allocation*



*Source: BondAdviser, Perpetual. As at 31 May 2024. * Excluding cash and derivatives.*

The portfolio is 22.3% exposed to fixed-rate as a function of a large portion of the Australian bond market being predominantly fixed-rate. As already discussed, the interest rate exposure taken on by investing in these instruments is hedged back to floating rate to keep duration risk at a minimum. We view this as both appropriate risk mitigation and also suitable given it provides alignment of the Fund's underlying holdings' returns to the floating rate target.

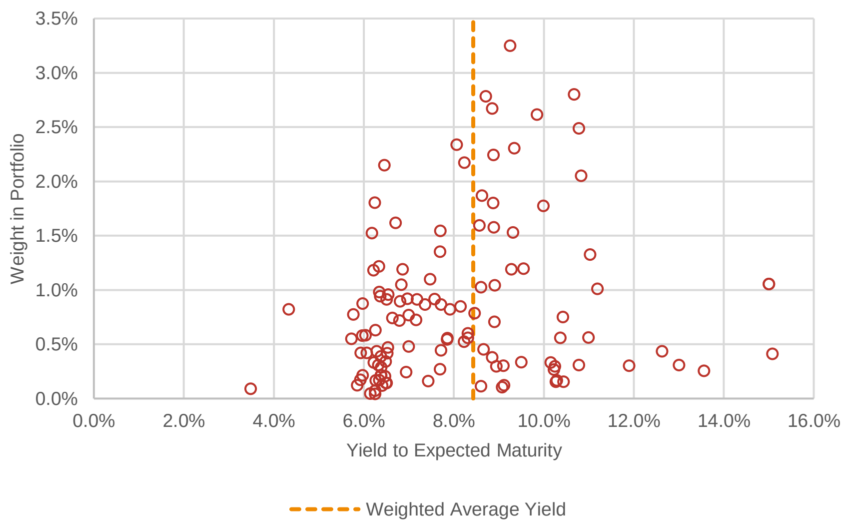
Figure 10. Portfolio Loan Interest Payment Mix*



*Source: BondAdviser, Perpetual. As at 31 May 2024. * Excluding cash and derivatives.*

The portfolio is structured with a large number of lower yielding, higher credit quality investments that predominantly each constitute a small portion of the deployed funds. Of the Fund's 121 individual holdings, 58 are exposures that represent less than 1% of the portfolio excluding cash and have a yield less than the weighted average of 8.43%.

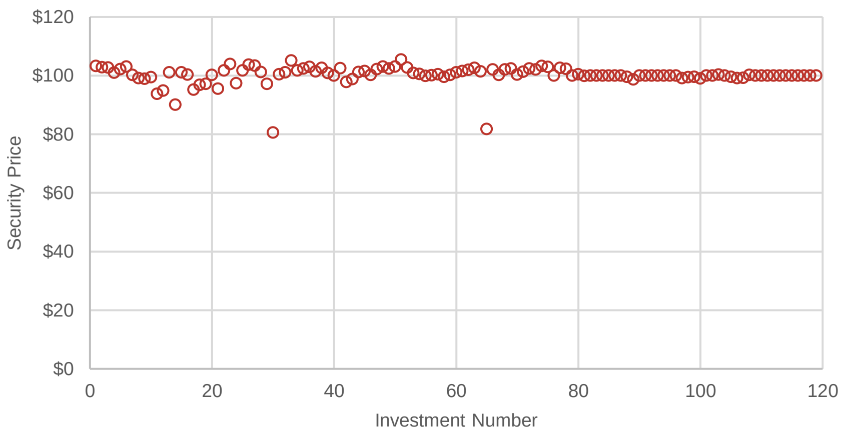
Figure 11. Individual Holding Yield versus Weight*



*Source: BondAdviser, Perpetual. As at 30 April 2024. * Excluding cash and derivatives.*

The portfolio has two holdings that are trading meaningfully below par. Both of these holdings are fixed rate bonds with a maturity in 2031, and therefore we do not see these assets as stressed. The credit spreads are well below +1,000bps, the levels above which we consider distressed.

Figure 12. Individual Holding Security Price*



*Source: BondAdviser, Perpetual. As at 30 April 2024. * Excluding cash and derivatives.*

Perpetual ensures stringent governance oversight and robust risk controls throughout the investment process. The Manager couples bottom-up fundamental research with a top-down credit scoring process to identify the best relative value opportunities. The portfolio is actively managed and consistently monitored to adhere to investment guidelines across asset types, credit quality, maturities, countries (typically hedged into AUD), and issuers.

We understand that a broad mandate can bring risk to a fund, but it is also this lack of restrictions that allows for the benefits of an actively managed fund to be captured. The Fund is able to leverage the expertise of its experienced investment team headed by Michael Korber (42 years relevant experience) to, unlike a passive strategy, actively allocate into superior risk-adjusted investments as they present. Given the asymmetric nature of returns in credit, single security selection, subsequent active monitoring, and appropriate diversification is critical in both achieving market-beating returns and managing credit risk at the portfolio level.

It is worth noting that the Fund's 62.4% weighting to non-IG excluding cash is approaching the upper threshold for the Fund's guidelines of 0-70% investment guideline. Given most loans are unrated, this places a limit on the ability to allocate further to loans without selling sub-investment grade bonds and securitised vehicles. As at 30 April 2024, the Perpetual Loan Fund comprised 47.1% of PCI.

Fund Governance

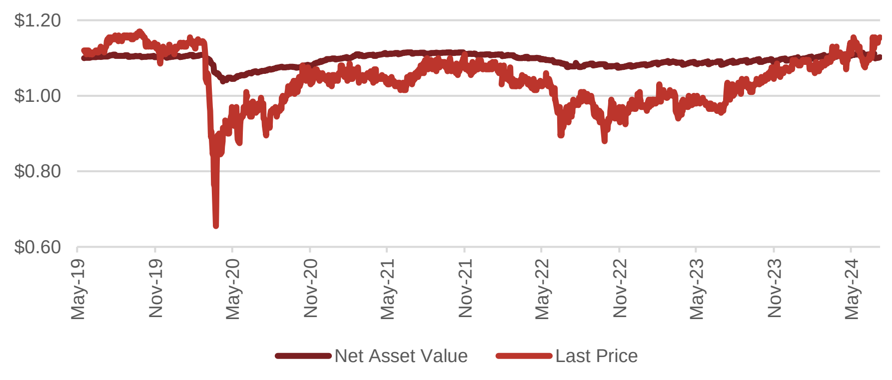
There have been material changes to the PCI's fund governance since our last report.

S&P Global has been engaged to perform independent loan valuations from the September 2023 quarter onwards. These valuations were previously done by an internal team separate from the Fund. Additionally, as part of Perpetual Limited's strategic review, the Manager expects that the Responsible Entity of the Fund will become independent to the extent that it will not be a subsidiary of Perpetual Limited. These are both positive from a governance perspective, however we still highlight that the Responsible Entity is not yet independent until the announced sale of the Perpetual Corporate Trust business is complete (expected in February 2025). We consider investment management oversight at arm's length to be preferred and therefore view the Fund's governance in its current state as improved but not being best in class.

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. This team was restaffed to ensure its continuity and there have been no issues over the past two years.

Prior to March 2024, PCI traded at a discount to its net asset value (NAV) since the initial COVID-19 market rout that began in February 2020. Across this four-year period of being faced with a NAV discount regularly in the double digits, the Manager did not buy back units of PCI with the only accretive form of unit price support being daily NAV publishing and detailed portfolio performance discussion released monthly. We viewed this strategy as insufficient as is reflected by the four-year delay until the unit price traded at a premium again. This was especially disappointing given that yields on the portfolio have not reached double digits and that a buy-back would have theoretically outperformed the portfolio itself. Therefore, investing in itself would have increased the returns for PCI unitholders.

Figure 13. Net Asset Value Against Unit Price



Source: BondAdviser, Perpetual. As at 5 July 2024.

PCI is listed on the ASX and is as a result subject to equity market volatility. It is unfortunately natural that the ASX will eventually have another market-wide sell off which would potentially impact PCI. Based on the lack of action over the past four years, we do not expect for units in PCI to be bought back in such an instance. We do not view this fund policy as best in class and see it as one of the few limiting factors for the Fund. A change to this policy for future drawdowns would be viewed positively and also likely mitigate the risk that a severe drawdown happens again given markets would view there as being a discount floor.

On 9 July 2024, PCI announced to the ASX a capital raising across two offers, a placement to wholesale investors (Placement) and a unit purchase plan (UPP). The proceeds of the offers are intended to be used to pursue additional investments in line with the Trust's investment strategy and approach. The Responsible Entity proposed to issue up to 60.2 million new units at $1.10 via the Placement which represents a 4.8% discount to the closing price on 8 July 2024 but is on par with the net asset value of $1.102 as at 8 July 2024. On 10 July 2024, it was announced that the Placement raised $66.2 million. The UPP is also being offered at a price of $1.10 per unit whereby existing eligible unitholders can apply for up to $30,000 worth of new units. The maximum number of new units that can be issued under the UPP is 120.4 million.

Over the past 1,119 trading days since 1 March 2020, PCI has traded at a premium to its NAV for 41 total days and has traded above $1.10 for 55 total days. We would prefer to have seen a longer period of consecutive trading above NAV prior to a capital raise.

Whilst greater scale in the Trust benefits unitholders via allowing for further diversification and reducing the fixed expense base per unit, it may place pressure on the unit price, given a potential lack of secondary demand.

The structure of the Trust is detailed in the Figure 9 of the January 2022 report.

Quantitative Analysis

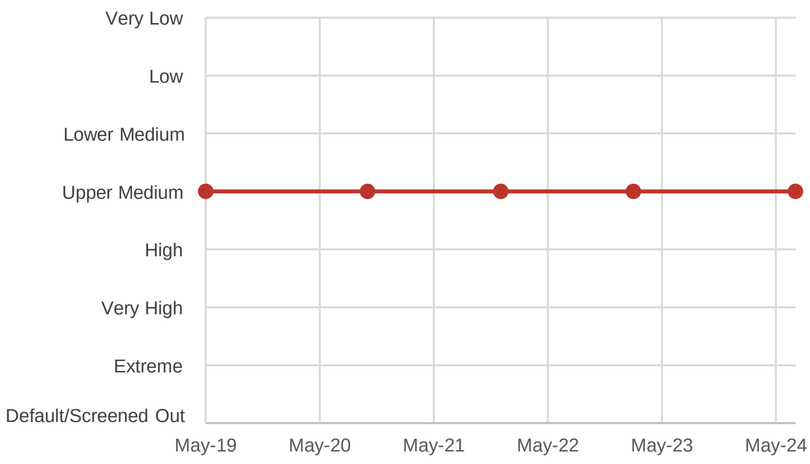
The Fund has benefitted from rising rates since we last performed analysis on PCI's underlying portfolio as at 31 December 2022. Since then, the RBA cash rate has risen 125bps to 4.35% which is reflected in the median expected gross returns for our benign scenario being 1.36% higher than the prior comparable period. Over this time, there has been growth in the portion of loans in the portfolio which are unrated. This adds an element of uncertainty to our modelling given we need to arrive at an estimate of credit quality for such instruments based on pricing, tenor, seniority and other factors.

We model the portfolio through both a benign scenario and a GFC-like scenario and analyse how PCI would perform in a 12-month period with such an economic backdrop based on how assets with the same characteristics performed historically. In the benign scenario, the median gross expected return is 8.08%, which aligns with the running yield of 8.1%. The median expected return in December 2022 was 6.72%, a 136bps difference, reflective of the impact of 125bps in rate rises on income for the portfolio. On a capital basis, the 99% VaR has fallen from -1.73% in Dec-22 to -2.42% as at Apr-24. This reduction in the benign scenario is a reflection of the slightly riskier credit profile than last modelled.

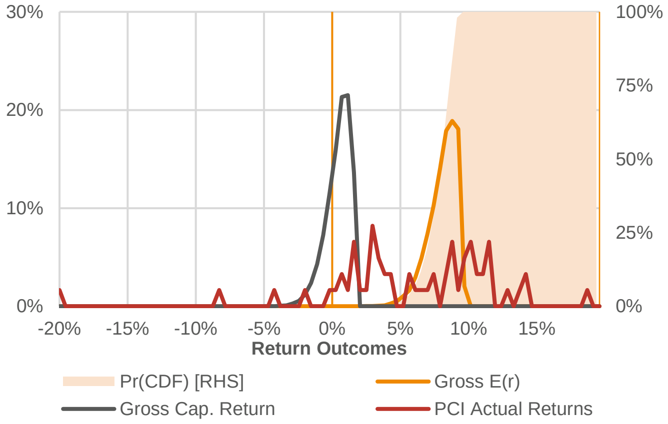
When assessing the modelled outcome in a GFC scenario, the incremental risk in the portfolio versus Dec-22 is highlighted. The median gross expected return is -1.12%, 6bps improved on the Dec-22 portfolio's experience. This is despite the higher cash rate flowing onto higher income for the majority of the assets. In the GFC-like scenario, the 99% gross (including income) return is -7.65% and the 99% VaR capital return is -13.83%. This is a 152-basis point fall from the Dec-22 modelling, but it is significantly improved on the December 2021 experience (-16.20%) due to now being invested in securitised assets with higher credit ratings. This is impactful due to the default experience for securitised assets in the GFC whereby higher credit rated securitised vehicles saw substantially better LGD results.

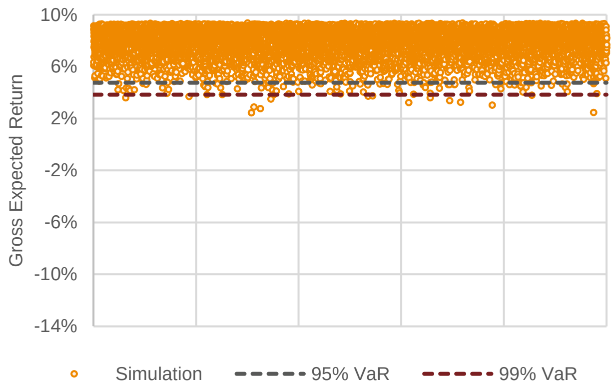
PCI's average counterparty weighting is 1.45% and the largest counterparty exposure is 4.53%. This is below our thresholds of 2.0% and 5.0% respectively for a fund to be eligible for an upwards notching of our Risk Score due to diversification. That said, our estimated credit rating for the Fund is around BBB- and BB+ and we would view an upgrade in our Risk Score from Upper Medium (BBB band equivalent) to Lower Medium (A band equivalent) as excessive. Subsequently, our **Risk Score for PCI remains unchanged at "Upper Medium"**.

Figure 14. Risk Score



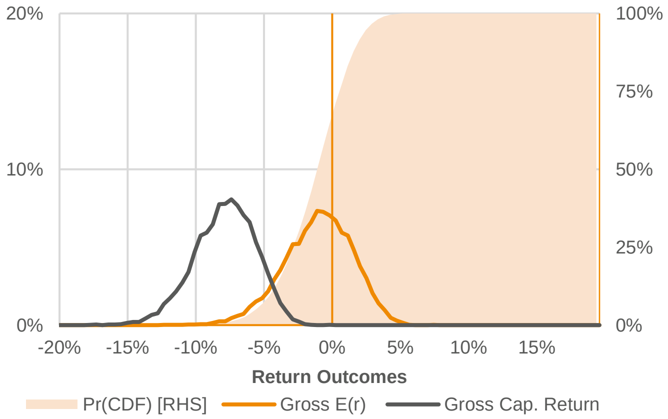
Scenario 1. Baseline Asset Assessment

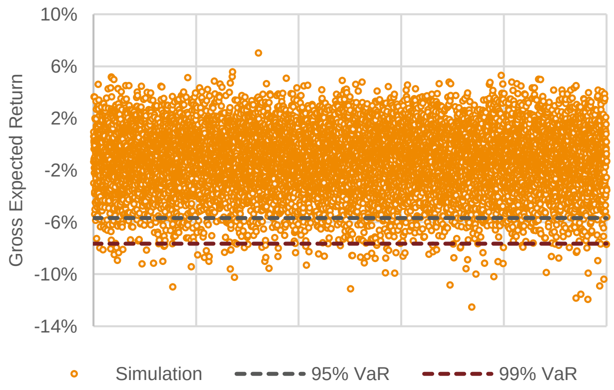




Source: BondAdviser Estimates as of 30 April 2024 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated. For a more detailed explanation of the methodology, please contact BondAdviser.

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates as of 30 April 2024 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.

Reporting History

PCI Report – 30 March 2023

PCI Report – 11 January 2022

PCI Report – 20 October 2020

PCI Report – 8 March 2019

Important Information

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