"Metrics Credit Partners interview by Livewire I Webinar: Portfolio update and market outlook"

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# Edited Transcript

**James Marlay:** Okay, well let's get things underway. Could I get you to share some of your views on the current COVID-19 situation? What are the companies that you lend to saying and what are some of the implications for Metrics?

**Andrew Lockhart:** Thanks James and thanks everyone for joining today. It's been an interesting process over the last several weeks and months, I guess seeing this flow through the market as a whole. I guess when we look at it, obviously there were clearly some industries and sectors that were impacted as a result of this and they most clearly are hospitality, tourism, education, student accommodation, airlines, retail and event management.

But you've seen it spread beyond that and the flow-through impacts have now gone into the healthcare, retail property and commercial property sectors. And appropriately, given the impact in the market, it's clear to see the government needed to and has provided a response in terms of market support.

The initial reaction appeared to be the government sort of almost saw this as being a stimulus measure and both the first and second announcements made by the Governor seemed to indicate they were looking to provide stimulus but certainly from my perspective being cash flow based lenders, we have a clear understanding in terms of cash flow requirements and we saw the impact of what was happening as a result of the market and the government's response to dealing with the virus as a liquidity issue.

So I guess now when we look at it, we've got a situation where you've got rising government debt, you've got an increased requirement for corporates to increase their level of leverage, unemployment is clearly under pressure, market volatility, and potentially an impact in terms of how the market responds once we get through this period. But certainly, the impact for shareholders and equity investors have been both in terms of material market impact, in terms of valuations, volatility, and clearly, you're now seeing a situation where some companies are moving quickly to restore their balance sheets. Some are doing deeply discounted equity raisings, impacting existing shareholders to use those proceeds to do two things: 1) Effectively restore equity buffers and provide a buffer for continued operation and trading, or 2) Raising capital to restore balance sheets.

The way we look at it is some businesses have been impacted, some have not been impacted, and others have been beneficiaries of what's gone on. But you certainly see this as being a widespread liquidity issue for companies and certainly the way we have looked at this has been to sort of stress test our portfolios in terms of understanding the impacts. What were the impacts on the supply side? What were the demand impacts to companies? And clearly what's been the impact on liquidity? And so, when we look at the companies that we're dealing with on the supply side, for instance, we originally saw some clear supply chain issues. Others are being impacted on the supply side as a result of the businesses are in strong demand, they're say in the food supply chain and as a result of that they're concerned about the availability of employees because people are now not required or not able to move around as clearly as they would or as a result of potential school closures and

those sorts of things impacting on their availability of employees.

You've seen issues across the demand side. Hotels, hospitality, airlines, healthcare, elective surgery being terminated, all being impacted on the demand side again. We've seen companies that we have exposure to that are on the food supply chain where demand has been strong. And so, it really has been a feature of different industries, different companies performing and behaving differently. But then we look at the real driver now as being clearly liquidity and companies are clearly saying to us that debt collections are becoming harder outside I guess government and sort of healthcare related type sectors. There's been a real push to gather cash.

Companies are looking at their availability of committed and un-drawn credit facilities. They're making plans and there's been announcements to the market where people have reduced or cut dividends. They're seeking to differ debt amortisation, requesting the capitalization of interest, looking to inject equity to give companies the availability of liquidity to work through this temporary liquidity squeeze that's been impacted on various companies in different sectors.

So the sorts of things we're being asked to look at and the flow through impact on companies I would say is one of the more severe shocks in terms of large, well established businesses that are being impacted as a result of the cash flow squeeze and liquidity squeeze. Often when you look at credit and you look at the analysis you undertake of companies, you don't necessarily expect large well diversified companies that have operations not only in Australia, but have geographically diversified in other markets as well, put into a situation where revenue has been materially impacted and you are now almost assisting companies on the basis of them being start-ups and looking at the assessment around available liquidity, cash available to sustain material cash burn in a number of cases.

**James Marlay:** Could you give people an update on the portfolio make up in terms of the credit ratings and the different sector exposures? And maybe talk in a bit more detail to some of those sectors that have been making headlines and how you're reacting?

**Andrew Lockhart:** Yeah, sure. In terms of credit rating, I think we certainly moved some time ago to really assist the root cause of potential concerns around the companies that you're lending to. And that, as I said, really focused in on - and we actually made an announcement today to the ASX for both MXT and MOT where we've outlined some of the views in terms of how you go about assisting and managing credit risk through this period of time. And clearly, what we've had to do is sensitise our portfolio on the basis of those that have got available cash and undrawn liquidity lines. You look at and need to understand what are the reductions that companies can make to their fixed costs? So we've seen that clearly in terms of companies laying off or requiring employees to be stood down, you're seeing a range of non-essential, non-operating type expenses being cut and reduced. Rent's being renegotiated to lower their fixed operating costs. We've seen companies approaching the ATO looking to defer tax payments, raising equity all designed to give them sufficient cash to be able to operate through a period of time where their business is impacted.

When we look at our portfolio, one of the things that is pleasing for us is that we do have a well-diversified portfolio across MXT and MOT. And certainly in MXT for instance, you've got a well-diversified spread. You've got probably around 43% of the portfolio exposed to

commercial real estate where we hold mortgage security in addition to security over the companies themselves, and often personal guarantees and those are often for project-related financings. And we've seen a situation where obviously the retail sector, the hospitality sector, aviation for instance, have all been impacted with material layoffs of employees. Those industries have effectively shut down. But in the construction sector, I think there was at one point two million people in Australia were employed in that sector and the government appears to be very keen to preserve and keep those people on sites. It's having an impact though on those projects, the projects are slowing the rate of construction as people are having to deal with increased workplace safety requirements and a slowdown in terms of availability of materials and the like. And so those sorts of things start to impact more broadly as well.

When I look at our portfolio, we've seen the impact for instance, we're a lender to a number of private hospital groups, large private hospital groups, the government required obviously those groups to cease their elective surgery arrangements and those groups have been in negotiation with the government now in terms of some changes to make available their facilities to the public hospital system. So, across the spectrum, you have to look at each individual company, each individual industry and just determine what is the level of risk that you're exposed to against all of these. But as a lender, it's also very important that people understand where you sit in the capital structure. It’s important from our perspective to ensure that equity interests are aligned with our interest as a lender, and that means that equity shareholders need to incur the risk of loss. So when we look at the companies that we're exposed to in the way in which we lend, we should have and we do have a material equity buffer in the companies that we lend to or a material lower LVR in terms of loan to valuation ratio against to projects in property related assets that we have exposure to. We've got appropriate covenant controls, we've got short dated exposures, and as a result of that we believe we're in a good position.

So, again, ensuring there is a continuation of alignment between the interest of equity and the interest of debt. And what I mean by that is, effectively through this period of time, cash flows might be squeezed. Companies might have to cut costs and they may be increasing their rate of cash burn and their level of leverage might be increasing. So, the position for us is when you get through this period of time, this temporary sort of liquidity squeeze that might go for six months, it might go to 12 months. One thing that I think we're all clear on is that there's a degree of uncertainty as to the time period. And so from our perspective as a lender, what we have to look at is ensuring that the companies that we lend to have the capacity to manage through this liquidity squeeze and cash flow issue and impacts to their business to ensure that when the get through the other side, the level of leverage that they have and the projected future earnings of their businesses are not materially impacted to the extent that we believe that the value or the going concern of the company has destroyed equity value and is destroying debt value.

So, from our perspective, what we look through is the rate of cash burn, the rate of increase in leverage, and then we run stress tests in relation to the likely bounce back in earnings. There are some sectors that we think the bounce back in cash flows and generating cash flows and earnings will be more significant. There will be other businesses that the rate of re-establishing their operations and the demand for their products and services will be delayed and as a result of that you have to take a different view in terms of the ramp up of recovery of earnings once you get to the other side of this. So certainly, from our perspective what we look at is liquidity today. At the other side, what is the level of leverage that's required?

What's the level of cash burn? What will companies need to do in terms of raising additional equity to restore liquidity buffers and restore their balance sheets? And then running sensitivities around the future prospects of the earning forecast, because that will have an impact in terms of their route to be able to deliver once we get through this process.

**James Marlay:** Andrew, obviously the last month or so we've seen a lot of volatility in asset classes, equities, and investors are really trying to get an understanding around the potential downside risks in their investments and with Metrics. How should people be thinking about this with respect to their investments with Metrics. How should investors view the potential downside?

**Andrew Lockhart:** Clearly, we are focused on the fundamental credit risk assessments that we undertake. Our view is, through all that process, people hopefully can understand that we not only manage the position today, but we take a long-term view in terms of the risk of any potential impairment or loss. And so one of the things that's really important is to think about it in the context of where you sit in the capital structure, what is the risk that you've got today, how can you manage through this process? So part of the process that we're going through with a number of borrowers is effectively looking at requests to temporarily waive or not determine an appropriate covenant position while they're being impacted in the current quarter. And so we've got requests from companies that are asking to set aside the testing of their leverage ratios. We've got requests from companies looking to capitalise interest and defer amortisation. There's no concept in our market where borrowers are given an interest free period or an interest holiday. The end of it interest accrues, companies are required to pay the interest and they pay at a higher rate where the risk is applied or falls back to our lender.

But from our perspective, we need to see and understand that the quality of the companies and the counterparties that we deal with have the financial wherewithal to support the company through difficult times. And that is a risk for equity and equity needs to move and provide capital to sustain companies, otherwise they potentially fall into the hands of creditors, and lenders, and others seek to trigger enforcement action to recover their debt. We're not in that position. Right at the moment we have no companies that are in default of their exposures. We have no covenant breaches. We have no interest or principal arrears in our portfolios. And what we're finding in the market more generally, is the willingness of the banks and other lenders to support companies through this by making appropriate allowance to defer cash payments.

So the liability continues to accrue. That's why I would say when we look out over the course of the next six to 12 months, the potential requirement for some companies to have to go back to market and raise additional equity and or to sell assets to pay down debt, if their earnings don't restore to the prior levels, may become more evident. So the issue for us right at the moment is understanding what does it look like going through this trough period, but importantly what do balance sheets and earnings look like as businesses start to re-establish themselves and seek to restore normal activities? And so what we don't want to see as a lender is a temporary deferral of interest or payments and then see decline or deterioration in earnings outlook. And so the policies that are being implemented by the government are important in the context of what stimulus and support we believe might be available to the economy and what companies and industries are exposed to.

In these situations, we always come back and say, "Okay, is there fundamentally a situation where any company that we lend to, their business model or their operations are it's a broken or flawed business model as a result of this situation?" And across our portfolio, we don't believe that we're exposed to those circumstances. People have probably heard us over the years talk about the fact that generally we've avoided the retail sector, for instance. We've avoided the education sector, the student accommodation sector and others. We've avoided the media sector, because we felt that the risks associated with lending to those industries or companies in those industries was not something for a lender to take risk on. We should look at it and say those risks can be borne by equity, and shareholders can provide the capital from our perspective as a lender as they're not attractive industries that we particularly want to lend to. Because the risk of loss is greater. And so that's an equity risk.

Similarly, if it's a cyclical industry or a resources-based industry, the degree of cyclicality around cash flows and the like become more problematic, and so as a result of that, lending structures would usually be more conservative. And I think that what will come out of this at the back end will be banks and lenders will probably require companies to have greater levels of equity buffer, greater levels of liquidity, which will probably push down future equity type returns I would expect.

**James Marlay:** Andrew, looking forward, what are your expectations around a potential for loan restructures or defaults and the flow on in terms of potential for capital loss for investors?

**Andrew Lockhart:** That's a very interesting question, because at the moment lenders are probably prepared to work with companies to provide some sort of temporary cash flow relief in terms of requiring a number of the companies for instance that we lend to would be required to make a half yearly or quarterly debt repayment. Lenders are probably prepared at this stage to agree to a deferral of those and a catch up at a later time. You might be prepared to capitalise interest. But you only do that when you believe that there's fundamental equity value still in the capital structure. I think if we got to a position where we thought that this was going beyond a temporary impact, and companies or shareholders refused to contribute additional capital, and it meant that you got to a position where equity value was wiped out, then I think you'd see that lenders would tackle this lenient approach and would move to protect their interests. And so at this point in time, there's considerable going concern around value within the companies that we lend to not withstanding the temporary build up in leverage and the impact in terms of short term impacts on balance sheets and earnings.

The issue is equity holders are very determined to maintain control of it because they see value. If it got to a position where the value had been destroyed for equity, then you wouldn't see the alignment, and then as a result of that you'd probably see lenders move to take control. So if you think about it from our perspective, in a simple case of a property transaction, so the loan-to-value ratio's 60%. The value of the asset falls 40%, equity is wiped down to zero. But it doesn't mean that you as a lender have lost a cent. The enterprise value or the value of the entity that you take security over is then comprised of 100 cents in the dollar of debt. But it doesn't require you to lose a cent in terms of that situation, nor as a non-bank lender that doesn't have leverage and we don't ever want to be put in a position where we're a forced seller, it wouldn't be in our interest to then turn around

and sell or dispose of the asset in the same market cycle.

And our view would be we would look to negotiate a consensual arrangement with the borrower, seek to take control of the asset, and then at a particular point in time in the future of our choosing where we think we can maximise the recovery and return for our investors, then we might look to exit the position. So, it's the same in companies. As a lender, if you're in a position where you have to enforce your securities and negotiate an arrangement whereby you effectively enter into a debt for equity swap, so if you look at it and say, "Okay, the average company that's being acquired might've had a EBITDA multiple over the last period of time ranging sort of between eight to 12 times," at the time, the transactions are completed and our borrowers would be required to contribute not less than 50% cash equity. And lenders would generally not want leverage to sort of be above 4-4.5 times debt to equity in terms of the structure.

And so as a result of that, there's essentially a sort of equity cash buffer within the companies you lend to that is at risk to equity. If the value of the business falls, then equity is wiped out, but for you as a lender you haven't lost a cent. You then enter into say a debt for equity swap, take control of the company, trade the business on, and look to exit. So having flexibility in recovery and having flexibility in terms of the way in which you manage credit is very important and I think covenants are there designed to give you an early warning signal, and to give you a means to negotiate. Triggering of the covenant or a potential event of default doesn't actually crystallise a loss for a lender. And so when we think about it you have to have a default that then triggers a change or an impact on existing equity. But from a lender's perspective you're moving to protect and preserve your position. And as a result of that you then move to minimise any potential loss and then the future actions or the actions you take through a work out or a corporate restructure may determine whether or not you as a lender actually incur a loss or actually succeed in not only maximising your recoveries but potentially providing gains.

**James Marlay:** Andrew, has the current situation impacted your ability to meet your distribution objectives over the next 12 months?

**Andrew:** No, the position for us is the minimum target return that we seek to deliver in MXT is the RBA cash rate plus 3.25% net of fees and cost. And on MOT we're looking to deliver a minimum cash coupon of 7%per annum with potential upside gains. The portfolio is largely locked in, so people might recall that we were looking to raise additional capital recently for MXT. So the portfolio and the capital of the funds are fully invested in the portfolio of assets. And so the returns are known to us. We don't believe at this stage that we have any situations where we're exposed to the risk of downside loss across our portfolio, however we may see a situation where some of our borrowers seek to defer or capitalise interest.

In those circumstances, we have sufficient available cash to be able to capitalise those through our accounts and continue to pay distributions to our investors. We announced the distribution to the end of March, which again, exceeded the minimum target returns for both funds. The portfolios are performing well, and as a result of that, we're confident around our ability to make the minimum target returns.

**James Marlay:** A common question is around the NTA and right now there's a disconnect

between the report of the NTA and the share prices of MXT and MOT. Can you give some comment on how that NTA figure is reached and why we haven't seen the NTA decline given the widening of credit spreads and the deterioration that we're seeing in all the economic environment?

**Andrew Lockhart:** So in MXT, the fund flows down into two funds, which are not open-ended funds, they're closed ended vehicles where the investors have no rights to redeem other than through portfolio run off. And so the portfolios are valued on the basis of a hold to maturity portfolio assessment. Part of the portfolio is held in the Diversified Australian Senior Loan Fund. That fund is a mark-to-market fund. The fund is independently reviewed and assessed each month by an independent party and we make the comment in our PDS in relation to both MXT and MOT that the valuation, market price and the credit risk assessment is undertaken by an international major accounting firm; to verify the market pricing and to verify any risk of impairment, both current and future risk of impairment across the portfolio.

Market volatility across other asset classes doesn't really translate to the Australian market. So for instance, if I look at the Australian market in terms of banks and others that we're involved in in terms of lending, we haven't seen a material adjustment to credit spreads. So what you're seeing at the moment is banks tending to not be open or not really looking to do a whole lot of new lending transactions and that's certainly consistent with ourselves and others in the market where market conditions remain quite uncertain and volatile and as a result of that from lender's perspective we want a degree of certainty in relation to the forward outlook to be comfortable to lend new money.

And so what you've got is a situation where the banks have got sufficient liquidity, access to funding through what the government's done with the RBA, and as a result of that you've not seen any material widening in credit spreads in relation to the transactions that they undertake with their borrowers. We're involved in negotiation across our portfolio with a number of banks and we're not seeing them look to increase pricing across the portfolio where borrowers are looking to renegotiate terms or conditions as a result of this virus situation. So when we look at it, you might see a gradual step up in margins, but you're not getting the extreme volatility that you get in public market asset classes. It's a private market where lenders still compete to provide funding. So importantly, our vehicles reflect a couple of things and sort of compare it and contrast it with some of the offshore vehicles that operate in the Australian market or the vehicles that operate in the Australian market giving investors to exposure in US high yield or European high yield asset classes.

And certainly, when I look at some of those vehicles, you've got a situation where you've got low credit quality, often triple C or greater credit risk. You've got longer maturities, you've got weaker covenants, weaker controls around increased levels of leverage or distribution, and as a result of that, you get a far greater level of correlation in the asset class between a lowly rated credit and equity. And so, it's not unreasonable to assume that the asset class will be more highly correlated to other riskier asset classes such as equity.

When you look at our asset class and you look at the quality of the credit, and you look at

the short dated exposures, you look at the covenants, you look at the controls that are held and the security and the protection of Australian corporate and solvency laws and you look at the absence of foreign currency risk, all of these things get to an absence of market risk. And so you've also got a situation in loan agreements where credit margins migrate higher, reflecting any change in the underlying credit quality of the borrower. So in circumstances where borrowers are looking to renegotiate or defer covenants or defer interest payments, often the margin that's supplied across a margin grid increases. And so as a lender you've already got some in-built protections to provide you for an increased margin to reflect the potentially higher risk. And so unlike other markets where you get the volatility in mark-to-market movements, in the loan agreement negotiated in advance, you should have some flexibility across the margin pricing grid to cater for some volatility of credit quality as well. So the fundamental driver of the NAV across our funds is primarily credit quality and the risk of impairment.

**James Marlay:**
Andrew, we've got a lot of questions coming through, so I'd like to allow a good amount of time to get to those. I'm going to finish up with two questions here if we can try and get through these. The first one: discounts between LIC vehicles and the NAV, has Metrics taken steps or looked at taking steps to close these gaps?

**Andrew Lockhart:** Yeah, look, I think it's pretty early to sort of make comments around that. So, at this stage, what we have done, and we made an announcement on the 12th of March and today in relation to the ASX announcements, where we've noted that the enterprise trading on the ASX is at a discount to the NAV and that Metrics had acquired units on market and where it is below the NAV and we have sufficient liquidity available to us to be able to do that then we will take advantage of that for investors in our other funds. So, from our perspective, we think there's a very strong governance process in relation to the oversight in the system of the enterprising that we quote in the NAV. We think it's appropriate, we think it's of the highest level, it's independent of themselves, and as a result of that, we take comfort that the NAV quoted on the market each day is an appropriate valuation for the portfolios that we hold. And where we see a dislocation in the market as a result of liquidity issues or a disconnect between the underlying fundamental value of the assets we hold in our portfolio, and we see value for other investors we will act.

And quite frankly, we've been pretty disappointed to see the disconnect because we’re not happy that our investors are seeing a situation where the traded value of the unit prices is now below the NAV. And so from our perspective, we don't want that to continue. It's a clear sign that the market's looking for liquidity and as a result of that we'll continue to assist it with the ongoing performance of their funds.

**James Marlay:** Andrew, a final question. Just in terms of the current situation, are there any opportunities that arise if you step back and look at a big event like this? Are there ways that Metrics can be opportunistic in this environment?

**Andrew Lockhart:** It's actually really interesting James because as a lender, in lots of ways these are actually market conditions that are very attractive to equity values being impacted, people are nervous and concerned, capital becomes scarce, and as a result of that, as a lender, you tend to find the terms and conditions tightened as capital tightens and pricing

becomes more elevated and companies defer going and raising equity because they're not happy with the current market price of their equity. Whole range of reasons sees them rely more on alternative sources of funding. And so particularly in MOT and also MXT, we are seeing opportunities, we've been selective in terms of those opportunities, certainly completing the transactions where we had given prior commitments to borrowers, but certainly we're alert to the opportunity that is there.

And so I think from our perspective one of the questions you asked before was, "How do we see the market in terms of our return profile?" One of the things that we would see is from the risk adjusted perspective, when I think about what's going on in offshore markets and the impact on banks from regulators where they're impacting the dividend distributions that are being paid by banks to shareholders and when I think about the way in which existing companies will need to restore their balance sheets, the fact is that companies will no doubt be restricting or terminating their dividend distribution simply because they'll be needing to restore their balance sheets. And so as a result of all of those things, I think that we've got a good position in terms of market opportunities for new transactions, we think that in the companies that do defer going and raising equity will be more receptive to working with lenders and potentially giving us opportunities to secure greater equity in businesses that we lend to across MOT.

We certainly feel that the general uptick in margins may flow through. It just depends how we go through this over the course of the next few months. But certainly we've had a number of companies come to us for instance, wanting to put in effectively insurance to ensure that they've got sufficient liquidity to get through this process and they're often prepared to pay for that. And so as a lender, there are opportunities unfortunately where companies are impacted that do provide opportunities for our investors.

**Q&A session**

**James Marlay:** Okay Andrew, I'm going to take us into the Q and A session. We do have a lot of questions lined up people on the call. We'll try and get to as many of them as we can. First one, thoughts on the impact on returns from MXT in an environment where it's competing against banks that have cheap funding underwritten by the RBA? Does this mean low returns to MXT going forward?

**Andrew Lockhart:** No, it doesn't. I think what ends up happening is I think we've got a highly skilled and professional team and we've got good relationships with borrowers that have got a good market presence, got extensive networks with banks, borrowers, and corporate advisors and others, and as a result of that I think we can move and respond quickly. We've got a range of flexible mandates that makes us very viable and very needed in the market. When I compare our capacity to transact versus some of the other competitors, I think we're at a very strong position. So from that perspective, I think our ability to negotiate outcomes, acknowledge the value of the capital that is provided by our investors and ensuring that our investors are appropriately rewarded for the risk is what we'll be seeking to do.

**James Marlay:** Next question. Currently there isn't a concern surrounding the NTA or current capacity for business to repay their loans, it's the concern that in a month's time when the lack of revenue takes its toll, that the businesses will start to close down and be unable to repay their debt. The question is, are the loans in your portfolio able to hold up over an extended period of time?

**Andrew Lockhart:** We have gone through our entire portfolio and ranked every borrower according to liquidity availability, and that goes 3, 6, 9, 12 months out and beyond. And we're comfortable with our position and the way in which we have appropriate plans in place to manage those exposures.

**James Marlay:** A follow on question to that. Is it possible to get any more detail on loans that may require some level of management or could be in default risk?

**Andrew Lockhart:** Look, unfortunately, we operate in a private market where borrower confidentiality is required. I would just simply say to people we have an obligation for continuous disclosure of any materiality issues across our portfolio. If there was anything material, it would be disclosed to the market. And I will say is just to inform everyone that we have appropriate governance and processes around the independent verification of our daily NAV. And so hopefully between those two things we are keeping the market informed, but we're not in a position to disclose individual details around individual negotiations with specific borrowers.

**James Marlay:** Andrew has there been any back testing that you can share indicating the potential or likely outcome in periods such as the one we're experiencing now?

**Andrew Lockhart:** I guess people will say, and we referred to it at the time of the capital raising for both MXT and MOT, we showed back in March of 2009 the lag effect between default and the net write-offs experienced by the banks through the GFC I think was around 0.67 of 1%. I think we're in very strong position given the fact that we are not a regulated bank and that we have a range of tools that are available to us to manage credit. So for instance, in a bank if credit quality deteriorates the level of regulatory capital held against that asset is required to increase. And often it becomes punitive for the banks to hold those assets on their balance sheet. For us, we've got the flexibility to hold those assets on the balance sheet, work with borrowers. It would be reflected in an adjustment in terms of the credit quality disclosed to the market in terms of the ratings outcomes, but certainly we think that we've got the full ammunition available to us to be able to work through and restructure credit even to the extent that if we have to take control of the company and do a debt for equity swap, then we have the capacity to do that, which is all the more reason why you need to be very comfortable that the underlying business model isn't flawed or broken and that it presents good value.

So we believe that in this situation, companies' equity values might be under a little bit of stress, but we believe fundamentally that the businesses have going concern value and as a result of that, going concern value will be on the level of debt. So if there was a situation where a borrower was to default, and we had to take more proactive action to manage our exposure, then potentially that would provide for some upside gains to our investors in future periods.

**James Marlay:** Andrew, a few questions about your funds. Could you just clarify the

relationship between the list of products, MXT, MOT, and your wholesale funds? And also, if the entry and exit prices for those wholesale funds have changed?

**Andrew Lockhart:** No, the prices for MXT and MOT disclosed to the market each day. Flow from the underlying wholesale funds, so the way the funds are priced, the underline wholesale funds are priced each day. And as a result of that, MXT and MOT's respective interest in the underlying wholesale funds have been priced and disclosed to the market. So the way the funds are brought, you've got MXT, that feeds capital into the MCP Wholesale Investments Trust. That feeds capital 60% into their diversified fund, 20% into our secured private debt fund strategy, and 20% into our real estate strategy. MOT blends funds into the MCP Wholesale Income Opportunities Trust, which allocates capital across our secure private debt fund, real estate fund, and our credit trust vehicle.

**James Marlay:** Have you put a cap on redemption from the wholesale funds?

**Andrew Lockhart:** No. The funds have different redemption terms. The Diversified Australian Senior Loan Fund provides for investors to redeem on a quarterly basis subject to providing 90 days prior written notice. The other funds, the secure private debt fund, the real estate fund, and the credit trust provide for investors to redeem in asset run off.

**James Marlay:** Would Metrics consider to use cash from maturing loans to purchase units on market with the view to close discounts?

**Andrew Lockhart:** We have and we disclosed that in the ASX announcements made today and also on the 12th of March.

**James Marlay:** Okay, moving to questions that have been submitted by the webinar. Why aren't NTAs mark-to-market when everyone can see MOT is not a true reflection of the current market conditions?

**Andrew Lockhart:** I don't accept that, and I guess the issue for people is that with having independent oversight of our valuations, it's an appropriate policy for the assets that are held. It's not inconsistent with the way in which banks hold and value their own assets.

**James Marlay:** Okay, have the mark-to-market values of debt behaved as you expected it would in this type of environment?

**Andrew Lockhart:** Yes. When we think back to the GFC, so in terms of at the time of the GFC, bank loan margin pricing effectively moves gradually over about a two-year period. We would expect, if conditions were to remain tight, and we don't believe that they will, we think this is a sort of a temporary crisis and eventually market conditions will be restored. But if it was to be something similar to the GFC, where it extended over a period of time, you would effectively see a gradual movement in pricing reflecting the constraints on liquidity available to the banks and the increasing cost of funding. At the moment, the banks' cost of funding isn't being increased or passed through, and as a result of that it's actually probably been lower in some parts, and as a result of that you're not seeing any upward buys in terms of margins in the Australian market.

I'll just point out too, primary issuance in other public markets effectively gets closed during

these periods of time. In periods of market stress, it's pretty difficult to see too many new corporate bonds being issued in the Australian market. It's just not an environment where issuance can come to market. So you've got an untested primary market pricing. So as a result of that, most of the movements that you see in public markets are a disconnect from the fundamental values of the assets and largely of equity driven.

**James Marlay:** Andrew, a quick question again on defaults. Are there any likely defaults in your loans?

**Andrew Lockhart:** We made the comment in the ASX announcement today in relation to defaults. At this point in time we have no borrowers that are in default, there are no borrowers that have breached covenants. There are no bad debts and there are no arrears in terms of principal or interest payments form any of our borrowers across any of our funds.

**James Marlay:** Okay a few questions coming through on prices for the NTA valuation on a daily basis. How are the external experts valuing the loan book and how do investors in MXT get comfort and more clarity that the NTA updates are real and accurate?

**Andrew Lockhart:** Okay, so we've disclosed in the PDS when we launched MXT and MOT that the valuation process is in line, it's overseen, so I think at the end of it we need to sort of sit back and say, "What's the governance process that we operate under?" One, we have an independent trustee that over sees our fund activities. We secondly have just completed a process in terms of issued a PDS to the market where we had an accounting firm that undertook an investigative accounting report and that was lodged in the PDS for MXT. To be able to do that, you have to look at the underlying loan assets across each of the underlying wholesale funds. Each half year, we have an auditor come in to do that process that's completed by KPMG. Their processes are extensive and they review the current values of the assets in accordance with appropriate standards. Each day, we have a process whereby we're receiving income and interest. And then at the end of each month, there's a major four international accounting group that reports the current value, assesses it against other market participant carrying values and reviews for impairment and tests for future impairments and reports that separately to the trustee.

I think it's important for people to understand, a loan is a contractual obligation between a company and a lender. There's no subjectivity as to the valuation. At the end of it, I think we reported when we raised capital for MXT and MOT as a team we've completed well in excessive $8 billion of transactions and over 300 loans being repaid at par. All of the loans are short dated. They run down the term curve. The majority of the loans have pricing grids where the margins move to reflect the changes in credit quality of the underlying borrowers, and evidence of repayment is clear as you recycle and are repaid. And the fact that there are no impairments across the portfolio give an indication as to also the fact that we would expect to be repaid. And I think the other thing that's important to note, unlike other instruments where people take a facility through to the term or the maturity date, in a loan transaction the borrower will generally look to repay you between 6-12 months or longer in advance of the maturity date. Recognising the fact that they don't want their liability to become a current liability nor do they want to take a refinance risk against a lender.

And in this environment where companies are concerned about their liquidity, we would expect that they would also start to think about early refinance of existing exposures as they did in the GFC. And so companies will most likely look to move in advance to the state of

maturity date which again gives the lender the ability to reset terms, conditions, and pricing to market as in when those facilities are repaid or refinanced.

**James Marlay:** Andrew, what share of the portfolio is in property development? Development, not established property, and can you talk through the LVR and the property loans?

**Andrew Lockhart:** We quoted today that there's about 43% of MXT is exposed to the commercial real estate sector. That is comprised of a mix of development funding and also investment related facilities. We have no commercial office exposure. We have no retail exposure. We have some industrial exposures where they are also exposed to the food and supply chain and logistics. We have a range of development funding projects where we're exposed to land subdivisions, residential and industrial developments. Interestingly we continue to see good sales being achieved across our portfolio where borrowers continue to achieve sales across their projects, and in some where we hold residual stock funding lines, we're being paid down as stock is sold. So across our development portfolio, again the important thing for people to understand is the individual exposure to have to any one individual counterparty, and so whilst there might be exposure to a sector, it's also very important to understand the quality of the borrowers and the sponsors involved in those transactions. And so we're comfortable across our portfolio where the average hold is less than 1%. Across our portfolios, we believe that that's giving our investors a good appropriate level of diversification across projects and the like.

**James Marlay:** With regards to MXT, can you give a ballpark or a percentage of borrowers that have asked for some kind of relief on loan repayments?

**Andrew Lockhart:** I think across our entire business at the moment we have about 150 exposures, 150 borrowers, there's around about 8-10 that have sought to negotiate. We've negotiated a number of those that have been completed, so I think as of yesterday there were about three of those borrowers where agreements have been reached and there were a number of others that were still in negotiation in terms of their requests. So for instance, to give you an understanding, if a lender seeks to agree to a waiver of a covenant we also require some additional requirements being imposed on borrowers.

So the process of negotiation of these is not simply a process whereby you're sitting aside a covenant with a borrower without a process of ensuring that you've appropriately managed the risk assuming that conditions restore. You need to think through not only the immediate requirement that the borrower is looking to achieve but also think through the issues assuming we go through this period of time and borrowers are up and running again. Just ensuring that the interests of a lender are protected and put in place to ensure that our interests are protected through both good and bad times.

**James Marlay:** Andrew do the funds have leverage loan exposure with private equity funds, and if so what is your view on private equity backed companies and how these companies are dealing with this?

**Andrew Lockhart:** It's interesting, I think certainly our private equity sponsor clients have done all of the appropriate things. They've stood by their companies, they've sought to do appropriate things to manage their cash reserves. Some of them have injected further equity capital into companies to preserve their rights and their value. So across our portfolio, we're

not seeing any borrowers where there's a misalignment between their and our interest. There's a clear interest on the part of shareholders and equity to preserve their value and to preserve their rights and as a result of that we're seeing a very good alignment from both private companies and public companies and also private equity sponsored companies.

**James Marlay:** Can you talk through the weighted average credit rating or an estimate for the MOT portfolio? And are those lines externally rated?

**Andrew Lockhart:** No, most Australian companies are not externally rated. You tend to find that only large investment grade companies that are publicly listed tend to have credit ratings where they're looking to access alternative sources of capital. Most Australian companies are not required to be rated and most of the companies are reliant on non-banks or banks for financing. And so the majority of the ratings that we undertake across all of our business are internally generated. Having said that, people will be aware that the MCP or the Metrics Credit Partners Diversified Senior Loan Fund is rated by S&P and in that rating report they reference the fact that we rate and asses credit in line and in accordance with S&P's ratings methodology and so the average credit rating in MOT would be a double B flat.

**James Marlay: T**here's a lot of questions still coming through just in terms of how Metrics will respond to the discount to the NAV, along the lines of why would you lend out money if there's such a big discount why wouldn't you support the vehicles on market, why don't you give us an update on your policy going forward on supporting the discount?

**Andrew Lockhart:** I think that's a really interesting comment because at the end of it, we have made the comments before that it's a long lead time to originate a transaction and close. So, we're obviously obligated to finance companies where we've entered into commitment arrangements and documentation arrangements to complete those transactions as you would expect a good lender to do. When you're not in the habit of withdrawing commitments in the middle of transactions and leaving borrowers exposed. Now having said that, where facilities mature and repay, we've got a mechanism within the vehicle to provide for that.

Interestingly, people want to ensure that our returns and yields are holding up and part of that process is ensuring you don't have a cash drag on your funds. So from our perspective we have sought and we did at the time when we came to market for MXT we sought to ensure that we were invested and there was minimal cash drag and we were looking for additional capital to continue to lend. As a result of what's occurred in the market and the fact that we cancelled the MXT capital raising, a number of transactions have been terminated that might have proceeded. Some of those are for transactions where borrowers had negotiated to our companies and as a result of the market movements they've triggered material adverse change clauses in contracts allowing acquirers to walk away from those transactions and as a result of that we continue to monitor and manage our capital.

I think it's fair to say that the movement and the dislocation between the NAV and the traded price has only really occurred in the course of the last two a half to three weeks. And so I don't think that we will be making any rash decisions in relation to this. I think at the end of it, we get through all of this period of time, I think people will then start to look at what's appearing in the market, potential decreases in dividends that are being distributed by equity. Pretty ordinary return that's available in cash and other asset classes and I think that

when people are comfortable with the stability of the NAV, the stability of our performance, the fact that we've managed credit risk through an extreme and stressed environment and continued to give a consistency of income and returns that are attractive compared to other alternative asset classes. I'd expect that we'll hopefully continue to gain investor support and that's obviously what we're working to do which is to deliver for our investors.

**James Marlay:** Did you say that MXT, to clarify, that MXT could end up with equity in a borrower rather than debt? And I think a good follow in question to this is how many workouts is your team capable of handling at any given time? And what experience does your team have?

**Andrew Lockhart:** Like I said my team has an awful lot of experience across this. We've been doing this sort of thing for over 30 years, myself and my other partners. And we've got a highly skilled quality team that support us. So from our perspective we're obviously going through our portfolio on a daily basis. We're all working remotely, which is fine, and we communicate across our team through this process so we know exactly what's occurring, what's going on. We've had one on one discussions with every borrower across our portfolio. We have appropriate plans and processes in place. We have close on 60 people in the business now and all focused on portfolio risk management across all of our funds. So I think from that perspective we're very comfortable with our capacity to work through and manage corporate restructures, renegotiations of terms and conditions and the management of credit risk is what we do.

All of our funds have been designed to ensure that we were never put into a position where you're a forced seller. And so one of the key issues is just ensuring that you have the ability to manage credit and that if you have to take a particular course of action to not only preserve but manage the risk of loss and actively manage that and if that results in a situation where you have to take a more proactive stance and convert part of your position into equity then it's always been our view that you should do that because if you're doing that you're doing it because you believe that the fundamentals and value are there. Equity at a particular point in time might be destroyed but doesn't mean that you as a lender have been subjected to any loss.

It just means that the capital structure needs to be reworked. And the reworking of a capital structure may be that you hold debt and equity. But it's important that you as a lender have the flexibility to do that. Unfortunately given the banks are levered and highly regulated, they don't have the ability to do that in a workout scenario because if a bank was to hold an equity position they end up holding it at a 400% risk weight. And so from a bank's perspective it's not really a viable option, which sees them effectively become forced sellers in the market to others. And we think it's not in our investors' interest to be put into a position where you can't maximise the recoveries if you have a situation where you've got a defaulted line and you need to work through the credit risk.

**James Marlay:** Could you touch on the average maturity of a loan book?

**Andrew Lockhart:** The maturity process is all over the funds so depends on which fund. So in the Diversified Australian Senior Loan Fund, it's around by 2.6 years. In our secure private debt funds strategy, it's around about three years. In our real estate fund, it's just over one year, and in the credit trust it's just around three years. So, the average time to maturity is quite short considering they are to the contracted maturity dates. Which doesn't cater for any

early repayment or refinance by a borrower.

**James Marlay:** Does a high unemployment pose a threat to your residential property developments?

**Andrew Lockhart:** Look, it does to the extent that it heightens the risk of potential settlement defaults. And so we are aware of some developers where they had negotiated contracts previously and were coming up to settle those transactions and the purchasers have failed to settle because they've lost their jobs. We think that the government's response in terms of the job keeper payments does a bit to potentially restore unemployment levels post this situation but certainly we would have expected unemployment levels to rise. We're in a position where we are seeing across our portfolio today continuation of sales and settlements for those projects that were sold and marketed prior to construction. We're also in a position where borrowers are achieving sales or presales now for projects that might complete for later in eight months to two years.

And so as a lender you will always look at it in terms of what is your market risk, what is your construction risk and what is your settlement default risk on completion because it's your source of cash flow and repayment. And certainly from a lender's perspective you would ordinarily build in buffers to cater for heightened levels of settlement default and you do that by way of requiring a level of over cover on the settlement pre sales or the presale contracts that are achieved. And you also build in buffers associated with this by lending at a lower LVR. And so what we would expect given the potential uncertainty in the market. Loan to valuation ratios might adjust lower and the level of over cover on market risk will be increased.

**James Marlay:** We're going to finish up just two final questions before we wrap things up. Andrew, do you have a view on what happens to the hybrids in this market?

**Andrew Lockhart:** No. I have no view on hybrids other than our view is that we've consistently said that we think that they are mis-priced. Our view is that where you sit in the capital structure as a hybrid would not, for us in a risk adjusted basis, if a corporate was to require funding on the same terms and conditions as you would entered into with a hybrid, the return that we would expect would be materially higher.

**James Marlay:** Given the likely potential opportunities over the next six to 12 months, what is the thought process of the recently cancelled capital raising and revisiting that in the future?

**Andrew Lockhart:** I think from our perspective, we see strong demand for us and our team's ability to lend. I think all we can simply do is continue to demonstrate to investors that we manage their capital appropriately, that we seek to ensure that we minimise any risk of loss, that we take proactive action to manage risk, and that we seek to maximise the returns to ensure that our investors are receiving an appropriate risk adjusted return for their capital. Assuming we do that and investors are supportive of our activities and what we do, and compared to alternative asset classes, if MXT and MOT are attractive and we have investor support, and we feel that we can deploy the capital that doesn't change the risk or return profile for our investors, then we would hope to be able to raise capital in those listed

vehicles.

**James Marlay:** Okay, ladies and gentlemen we've gone quite a bit over time so I'm going to wrap the call up there. I apologise that we haven't been able to get to every single one of the questions. We've done our best to cover the majority of the topics raised. I will let you know that a recording of this call and a transcript will be made available via the Metrics website, and you can send additional questions through to the team at Pinnacle. Andrew, I might just hand it over to you for some final comments and perhaps some just, I guess remind people about the availability of that ASX announcement that has quite a bit of detail from today.

**Andrew Lockhart**: Thanks James. I think the most important aspect of our activities is for people to always think where do we sit in the capital structure and what should be the appropriate risk return outcomes for our lending? You'll see a lot of volatility in different asset classes, particularly equity. It doesn't flow that we as a lender should be exposed to that level of market volatility and I think the other things that's important is that we believe that we've got appropriate systems and controls in place to manage risk for investors and as a result of that we believe that we continue to report and continue to keep the market up to date in terms of our activities and what we see. But certainly, we think that we get through this and there'll be future opportunities for us in terms of the demand from our borrowers that we believe will be attractive for investors. I'd just like to thank everyone for their time and appreciate your interest in the webinar today.