Fund Research

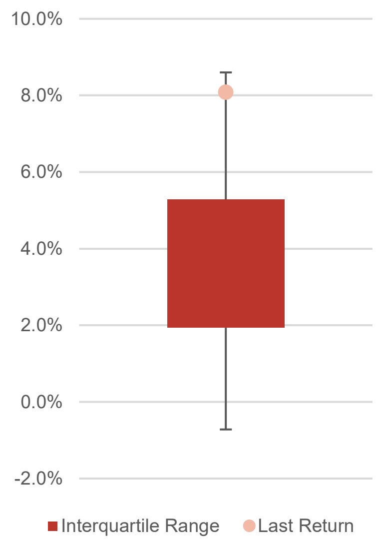
Epsilon Direct Lending Fund

Overview

The Epsilon Direct Lending Fund (the "Fund", "EDL") is an unlisted open-ended unit trust, domiciled in Australia, which provides wholesale investors exposure to the Australian and New Zealand private credit markets. The private credit sub-asset class is a major part of the Australian corporate debt market that has historically been exclusively occupied by financial institutions or large institutional investors. The Fund therefore offers investors unique exposure to a segment of the market that is typically inaccessible. Through active loan origination, the Fund aims to **exploit market inefficiencies in funding gaps within the underserved middle market space**. These inefficiencies have resulted from an **increased regulatory burden on traditional bank lenders** and the **preference of borrowers for bespoke and timely financing**.

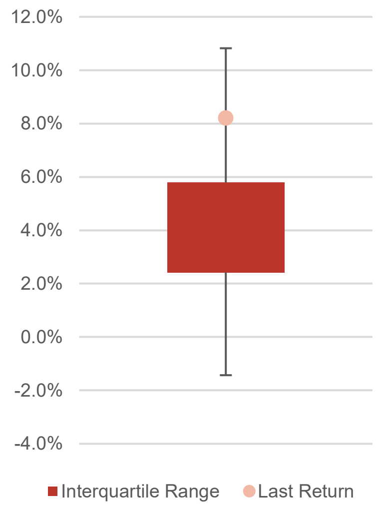
The Fund has a **target net total return of 3mBBSW +6.00% p.a.**, and a **target net distribution of 3mBBSW +3.25-4.00% p.a. paid quarterly**. The Fund offers two unit classes: Class A; which charges no management fees, while Epsilon retains all transaction fee benefits, and Class B; charging 0.75% p.a. of NAV, while transaction fee benefits are paid to the Fund. The **Fund also charges a performance fee of 20% on returns in excess of the hurdle of 3mBBSW +3.25%**, although fees will accrue, they will not be paid to the Manager until 31 May 2024.

Figure 1. Class A Net Returns Box Plot



Source: BondAdviser, Epsilon. Annualised monthly returns, after fees since inception. Based on Class A returns. Data as at 31 October 2022.

Figure 2. Class B Net Returns Box Plot



Source: BondAdviser, Epsilon. Annualised monthly returns, after fees since inception. Based on Class B returns. Data as at 31 October 2022.

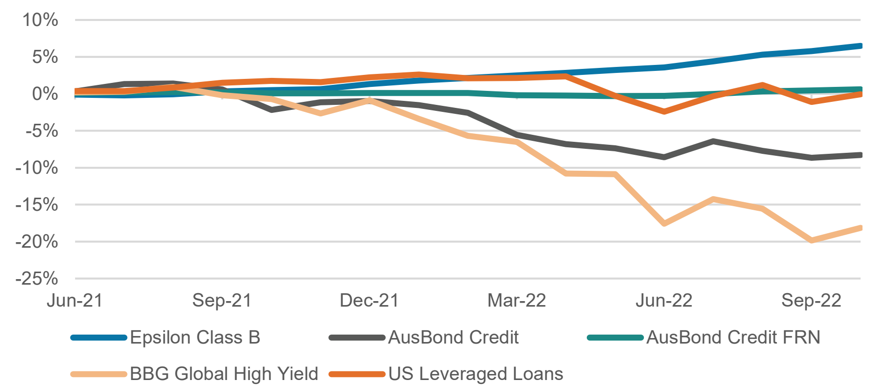
Figure 3. Monthly Net Returns* (%) – Class A & B

A	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	0.43	0.34	0.35	0.35	0.36	0.35	0.62	0.69	0.54	0.65			**4.68**
2021						-0.06	-0.03	-0.01	0.16	0.22	0.15	0.27	**0.70**

B	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	0.44	0.35	0.32	0.35	0.39	0.34	0.79	0.86	0.47	0.66			**4.97**
2021						-0.12	-0.09	0.14	0.38	0.20	0.13	0.70	**1.34**

Source: BondAdviser, Epsilon. As at 31 October 2022. May not sum due to rounding.
** Return is monthly net total value price movement plus distributions. Assumes no compounding of distributions.*

Figure 4. Relative Cumulative Performance



Source: BondAdviser, Epsilon, Bloomberg. As at 31 October 2022. Calculated from cumulative net monthly returns of the Underlying Fund. Based on Class B returns.

Product Assessment

Approved

The Investment Team has a significant breadth of experience in managing middle market financing, having managed $1.7 billion across >50 total loans with no loss of capital.

The Epsilon Direct Lending Fund provides wholesale investors with unique exposure to **domestic middle market lending**. Although the credit quality is sub-investment grade, the Fund provides **primarily senior secured loans**, offering security over borrower assets, seniority in the capital structure, as well as protective covenants which mitigate credit risk and improve the probability of capital recovery in the event of default.

The Founding Partners at Epsilon have worked together at other top bracket firms for many years, across which they have originated and **managed billions of middle market financing**. Through dozens of collective years of industry experience, the Investment Team has the ability to leverage its deep relationships across the industry to provide an ongoing source of new loans. Unlike other lending markets (namely real estate and SME lending), middle market direct lending is not a heavily intermediated market. Deep and abundant industry relationships are key to accessing broad and attractive investment opportunities. We view validation to this opinion in the fact that the Manager has arranged two loans for the Fund under a club structure, with the other pari-passu lender in both instances being separate leveraged financed divisions of global banks.

The Fund consists of private corporate loans, which typically have historically experienced low correlations to traditional asset classes. This can provide diversification benefits to investors holding equity and traditional fixed income securities in their portfolios.

A **deteriorating bank appetite for middle market lending creates a capital scarcity** that results in more attractive pricing. Whilst corporate lending in Australia is still dominated by traditional bank lenders, the ability to provide finance is being squeezed by: (1) capital requirements which make sub-investment grade lending less attractive from a return on equity perspective for banks; (2) inflexibility on loan products that are non-vanilla in terms of capital structure, covenants, and loan structure; and (3) timeliness – bank processes are cumbersome, which is not ideal for borrowers with time-sensitive event-driven lending opportunities.

Given the underlying assets of the Fund consists of private corporate loans, **the Fund exhibits lower correlations with traditional asset classes**, providing diversification benefits to investors holding portfolios of equity and traditional fixed income securities. Given the Fund is composed solely of private loans, mark-to-market volatility is limited, **suitable for investors seeking low capital volatility**. Although the Fund currently consists solely of senior secured loans, the Fund has the ability to provide subordinated, stretch senior and unitranche loans, as well as minority equity participations where appropriate. Duration risk is also currently negligible, considering the portfolio consists wholly of floating rate loans. This is beneficial to investors in the present environment where rates are uncertain and seek an income stream aligned with the direction of interest rates.

Figure 5. Estimated Risk-Adjusted Comparison

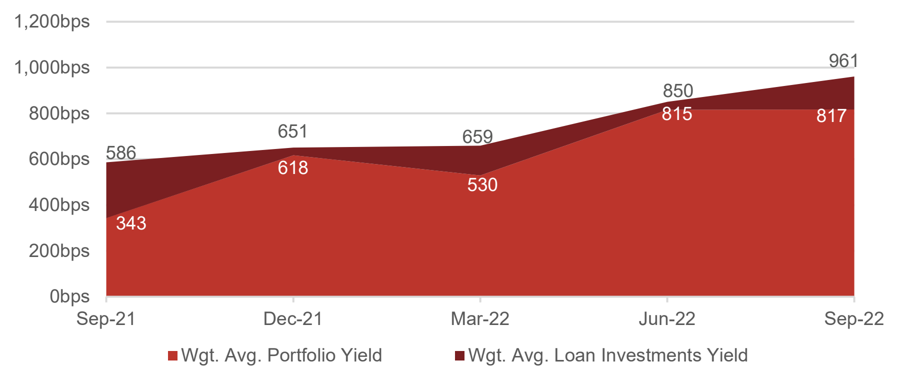
** All returns for indices calculated using annualised monthly returns for the past five years. ** Credit Ratings based on BondAdviser Estimates. *** Calculated based on annualised monthly returns data for past five years for indices and since June 2021 for Epsilon Direct Lending. Source: BondAdviser, Epsilon, Bloomberg as at 31 October 2022. Based on Class B returns. ^ Average return for Epsilon Direct Lending calculated since June 2021. ^^ **Orange box indicates trajectory without first three months of performance over the launch of the Fund, while the red box indicates BondAdviser's expectation of future volatility after 5 years of performance.***

The ability to originate and structure privately negotiated loans with Private Equity Sponsors and private business owners gives greater visibility over borrowers and superior structuring control.

Epsilon differentiates itself with other managers in private debt through its ability to **structure and originate privately negotiated loans directly with private equity sponsors** and owners of middle market businesses. Providing bilateral (and small club) loans to capable borrowers allows Epsilon to impose favourable structuring terms, protecting the Fund in the event of default. Epsilon is also provided with monthly reporting from its portfolio companies, allowing for close monitoring. Access to data on a monthly basis allows for frequent stress testing and scenario analysis of forecasts, which Epsilon use to dynamically assess the credit fundamentals of each borrower.

Origination fees are *in essence* passed through for either Class A or B – **which we view as best practice** compared to others who monetise origination fees plus management fees. Class A has the origination fee benefits paid to the Manager but benefits from a nil management fee, whereas Class B sees origination fees pass through but pays a higher management fee. We view this as relatively zero sum, in terms of a solution in tailoring for different asset consultant constraints, but we would preference the Class B units given the significance of origination fees which can be 1-4% of the loan value. The Fund also charges a 20% performance fee in excess of 3mBBSW +3.25% (below the Target Return), which is creative in the sense that if the Fund achieves its target return, **the total net fee would still be typically lower than comparable funds but still provides incentive for the Manager to achieve returns in excess of the Fund's target**.

Figure 6. Time Series of Wgt. Avg. Loan Investments Yield and Portfolio Yield



Source: BondAdviser, Epsilon. Data as at 30 September 2022. Based on Class B.

The Fund currently has some **concentration risk** given the relatively small number of loans in the Fund. On the contrary, **this implies a strong conviction strategy** is required, demanding high levels of due diligence to ensure the borrower has the capacity to make timely repayments. As the Fund scales to its estimated target size ($500 million), concentration risk will fall. Nonetheless, with protection afforded by seniority in the capital structure, the prevalence of a customised covenant package to ensure capital preservation, as well as the breadth of capital markets experience across the Investment Team, **we are comfortable with the credit profile of the Fund**.

We have reviewed Epsilon's internal due diligence, including credit papers, and see it as being completed to first class standards. This is in addition to the use of top-tier service providers (i.e. lawyers, accountants, valuers, administrators). Other funds of similar size may not be willing to use such service providers because of the costs (borne by the management entity or the borrower), which comes at the expense of first-class governance. We note that Epsilon achieves this while still maintaining modest management fees. This aligns with our expectation of best practice among private credit managers.

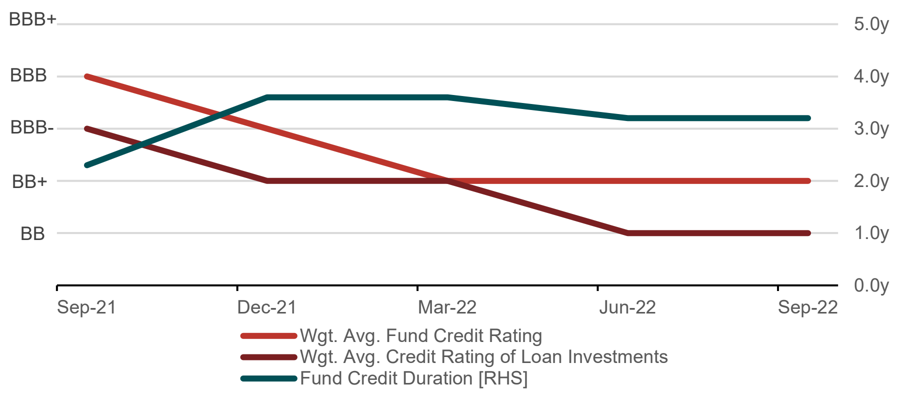
The Fund contains a three-year lock-up period, presenting liquidity risk in the early stages of the Fund's life, which we view to be entirely appropriate given the illiquid nature of the underlying assets.

Although the Fund provides private bilateral/club loans to middle market businesses, Epsilon has assigned Moody's to provide private loan rating services. We view external valuations and credit opinions to be a best-in class feature that is comparable to what happens in more developed offshore markets.

Including cash, the Fund currently has an estimated weighted average credit rating (on a drawn basis) of BB. As shown in Figure 5, the Fund provides more attractive risk-adjusted returns on a credit rating basis than the Bloomberg Global High Yield Index, albeit not necessarily yet on a volatility basis as a result of fund ramp-up. **We expect the volatility of annual returns will fall over time** as the initial returns at launch become less prominent. To this point, we emphasise that **the unit price of both classes has remained stable across each quarterly report at $1.00 per unit since inception.**

On an inception and last twelve-month basis, the Fund is lagging its target return, which is a function of cash drag that is typical of private asset ramp-up. The Fund has recently introduced a new working capital facility, which will aid in reaching its target return and help in managing cash drag on a forward basis. Notably, barring the first quarter after inception, the Fund has met its quarterly cash distribution target – a distinct positive for income orientated investors.

Figure 7. Time Series of Wgt. Avg. Credit Rating and Credit Duration



Source: BondAdviser, Epsilon. Data as at 30 September 2022.

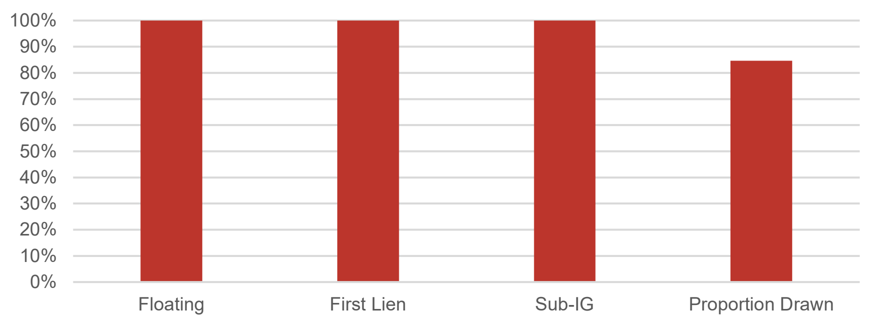
The Fund does not have a track record that is long enough to warrant a Product Assessment upgrade under our methodology. Besides this preclusion, we view the Fund offering the processes, governance, and structure as being of upgrade status. Accordingly, we maintain our **Improving** Outlook, on expectations that an upgrade could be provided when the track record and outperformance record exceeds two years per our methodology. We expect as the Fund continues ramping, that returns will begin to outperform the Fund's target – wider credit spreads will only assist here.

Forming the basis of our **Approved** assessment was: (1) our **comfort with the expertise of the Investment Team** having decades of collective experience in originating, structuring, and managing loans; (2) our review of the underlying portfolio and the associated: (i) **embedded structural protections**, and (ii) **extensive diligence** undertaken by the Investment team; and (3) the **Manager's proof and commitment to industry best practices**.

Portfolio Risk Management

The risk profile of the Fund currently slightly differs from our initiation report in January 2021, where the indicative portfolio specified that the Fund would contain subordinated loans and transaction structures differing from containing solely senior loans. This is largely a function of Fund ramp-up, and we would expect that as the Fund ramps up to its target size ($500 million), a higher allocation could be made to subordinated loans (compared to October 2022 portfolio data) where the Manager sees attractive risk-adjusted opportunities that meet the Investment Objectives of the Fund. As a result, we would expect the risk profile to change on an individual loan level, and on a whole-of-fund basis as the Fund becomes diversified across numerous counterparties. In Figure 5 of our Initial Report, we illustrated our expectations that for the target yield to be reached, more aggressively leveraged positions in unitranche and mezzanine loans would be required. However, we positively note on a forward basis, the Fund is now achieving its total target return with exclusively senior positions. We view this to be a positive reflection of the Manager's value-add proposition in providing bespoke and timely financing.

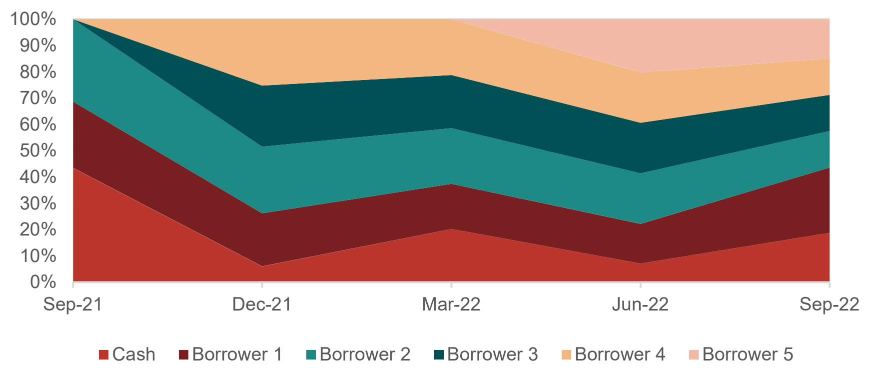
Figure 8. Current Portfolio Metrics*



*Source: BondAdviser, Epsilon. Data as at 31 October 2022. * Excluding cash.*

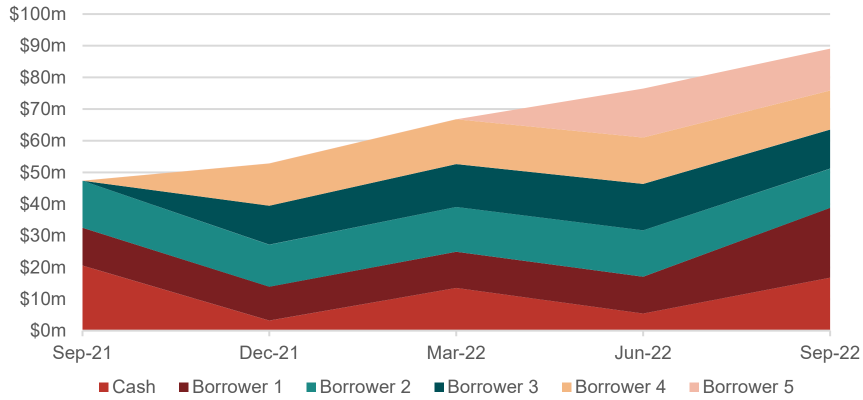
Concentration on an individual borrower level has diversified since inception (see Figure 9) and is expected to continue as the Fund scales to its target size, with a sixth loan having been funded in December, and Epsilon having been contractually mandated to a seventh loan. Diversification in private assets takes time compared to public assets, due to the nature of custom bilateral transactions that require significant investment and due diligence.

Figure 9. Borrower Concentration - % Net Trust Value



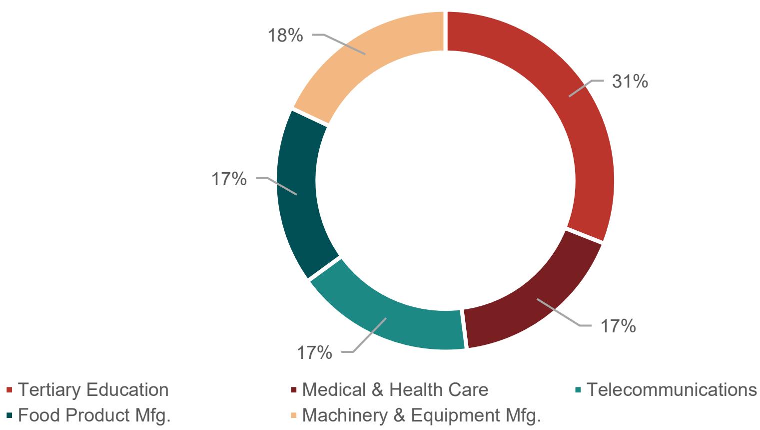
Source: BondAdviser, Epsilon. Weighted by net trust value. Data as at 30 September 2022.

Figure 10. Borrower Concentration - A$ Net Trust Value



Source: BondAdviser, Epsilon. Weighted by net trust value. Data as at 30 September 2022.

Figure 11. Portfolio Industry Allocation



Source: BondAdviser, Epsilon. Weighted by commitment value. As at 30 September 2022.

The Fund currently holds exposure exclusively to industries that are non-cyclical in nature. This is especially beneficial as operating conditions tighten as a result of higher inflation and interest rates impacting disposable income, which could see a slowdown in spending across discretionary industries.

Figure 12. Investment Guidelines – Fully-Ramped Fund

Target Number of Investments	15-20 individual loans
Max Loan Size	$62.5 million / 12.5% maximum
Max Sector Concentration	$100 million to any one sector
Currency	20% maximum to non-AUD currencies
Max Subordinated Allocation	20% maximum to non senior-secured investments
Max Equity Allocation	5% maximum to equity or equity-like investments
Domicile	Maximum 10% outside of Australia & New Zealand
Max PIK Allocation	10% maximum PIK allocation

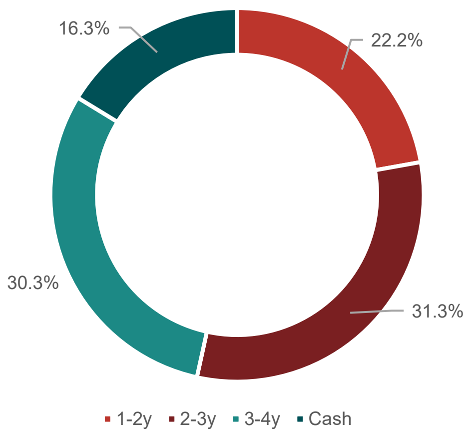
Source: BondAdviser, Epsilon Direct Lending.

Figure 12 above lists the guidelines surrounding limits to investment characteristics of the Fund when fully-ramped. We would expect as the Fund ramps up, there will be further allocations towards subordinated instruments, which may contribute to a minor deterioration in credit quality (albeit within our expectations).

The Fund held five loans as at 31 October 2022; however, is aiming to build a portfolio of 15-20 individual loans (ranging from $10-$62.5m per loan). As previously stated, this presents moderate concentration risk. Whilst we do have fundamental confidence in the Manager's investment process, we would view further diversification on an individual loan basis to be a credit positive.

The Manager specifically does not lend to distressed borrowers, property developers, start-ups, or infrastructure borrowers. Whilst it is reasonable for all managers to conduct extensive due diligence in the selection of credits across all sectors, we view the exclusion of real estate exposure to be a positive considering recent headwinds faced across the sector have led to widespread insolvencies – based on recent ASIC data.

Figure 13. Portfolio Maturity Distribution



Source: BondAdviser, Epsilon Direct Lending. Weighted by commitment value. Data as at 31 October 2022.

Loans are typically provided with maturities up to six years (on average between 3-5 years), though this is ultimately dependent on the underlying credit quality of the borrower and the terms agreed upon during structuring.

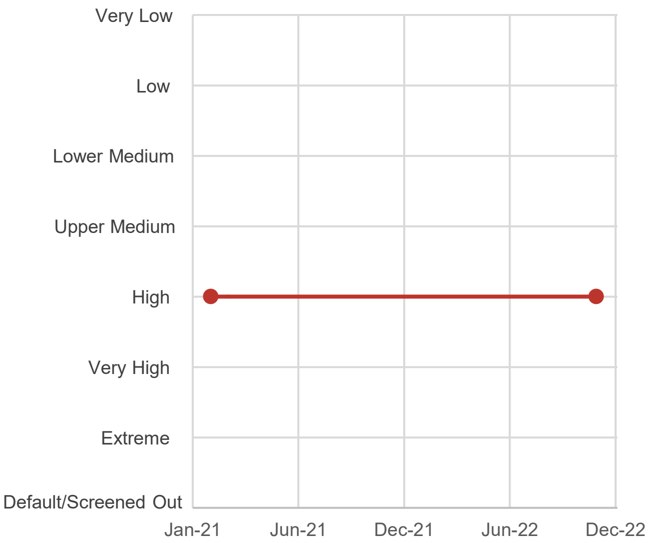
Fund Governance

There have been **no material changes** to the Fund's governance, however we note that since launch, KPMG has provided an unqualified opinion on the Fund's financial statements, signalling that the financial statements produced are presented in a fair manner in all material respects.

The structure of the Trust has not changed and is outlined in a prior report (see page 15 of Epsilon Direct Lending Fund Initial Report – 27 January 2021).

Quantitative Analysis

Figure 14. Risk Score

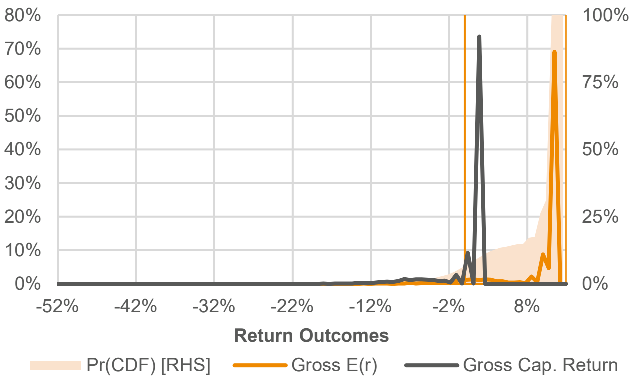


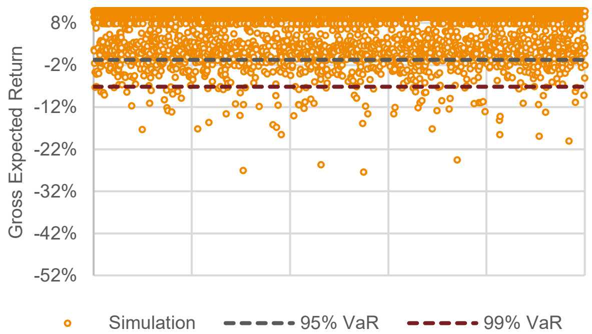
Our baseline assessment of the Fund indicates reasonably strong performance in the absence of materially adverse credit migrations. Given the concentration of single loan exposures, there is bimodality in the return distribution profile. For our baseline scenario, the mean gross expected return produced in our modelling is 9.03%, with a 99% VaR of -7.13%. Our stressed scenario produces a 5.02% gross expected return, and a 99% VaR of -20.72%. This is a function of US GFC-like conditions on a highly concentrated portfolio and does not account for manager skill.

Our previous quantitative analysis was based on an indicative portfolio consisting of over a dozen loans. Given the Fund now consists of five unique loans, outcomes are materially worse than our previous modelling in our stressed scenario - a function of concentration risk. Contrarily, with risk free rates rising significantly, the baseline scenario performs considerably better than our initial modelling in 2021.

We also note that our modelling does not assume origination fees are paid to the Fund, nor management or performance fees. With origination fees often ranging from 1-4%, this would be supportive of even stronger Class B returns. **Our risk score for the Fund remains at "High" or "BB"**.

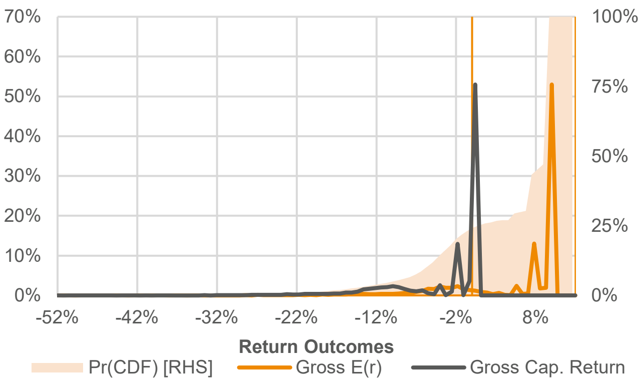
Scenario 1. Baseline Asset Assessment

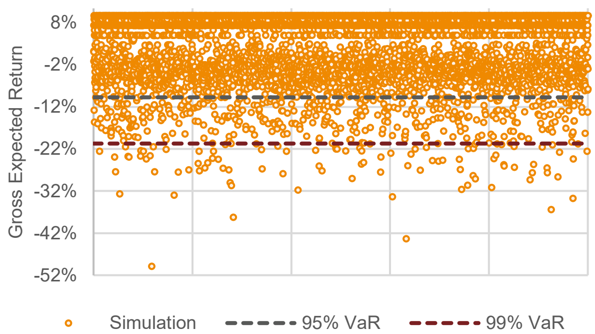




Source: BondAdviser Estimates as of 31 October 2022 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is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

Scenario 2. Stressed Asset Assessment





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

Reporting History

Epsilon Direct Lending Fund Initial Report – 27 January 2021

Alternative Investment Fund Research Methodology

Click here to view

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Report created on 20 December 2022.