Fund Research

Epsilon Direct Lending Fund

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Overview

The Epsilon Direct Lending Fund (the "Fund", "EDL") is an unlisted open-ended unit trust (note the Fund is yet to be incorporated), domiciled in Australia, which provides wholesale investors exposure to the Australian and New Zealand private credit markets. The Fund will provide bespoke capital solutions to a select portfolio of middle-market borrowers, supporting growth and event-driven strategies.

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 specialised financing.

Whilst the Fund has no track record, the Investment Team all have greater than 20 years' experience across loan funds management, leveraged finance and banking at the middle market corporate lending level. Additionally, the Investment Team have a strong transactional record (~50 loans, >$1.6 billion) from when they previously worked together at CBA.

Contents

Key Characteristics

Fund Size^	$500 million	**BondAdviser Risk Score**	High
Initial Offer per Unit Price	$1.00	**Product Assessment**	Approved
Minimum Investment	$500,000	**Outlook / Asset Classification**	Improving / Level 3^^
Fixed / Floating	Floating	**Structure**	Unlisted Open-Ended Unit Trust
Distribution Frequency	Quarterly	**Sub-Asset Class**	Private Credit
Target Net Return	3mBBSW + 6.00%	**Trustee**	Perpetual Trustees (The Trust Company Limited)
Hurdle / Benchmark	3mBBSW + 3.25%	**Administrator / Registrar**	Alter Domus Australia Pty Ltd
Distribution Rate*	3mBBSW + 3.25 - 4.00%	**Auditor#**	KPMG
Mgmt Fee / Perf. Fee***	0.00% - 0.75% / 20%	**Valuation Services##**	Big Four

*^ Fund size is an estimate and subject to change dependent on capital raised. ^^ Largely Level 3, however also may include Level 1 & 2 assets. * Target Fund distribution rate provided by Epsilon. **Class A units pay zero management fees, and the manager retains all upfront loan and any ancillary fees. Class B unitholders pay a 0.75% fee per annum on the Net Asset Value of the Fund with upfront loan fees and other ancillary fees paid to the unitholders. *** **Performance fee is 20% of returns above the hurdle of 3mBBSW + 3.25%.** Performance fees will accrue but will not be paid to the Manager until 36 months after the first close. #Not yet appointed given the Fund is yet to be incorporated. ##Epsilon is in discussion with Big Four accounting firms to provide independent Valuation Services.*

Product Assessment

Approved

A deteriorating bank appetite for middle market lending creates a capital scarcity that results in more attractive pricing.

The Epsilon Direct Lending Fund provides wholesale investors with unique exposure to **domestic middle market lending**. The Fund will primarily consist of **senior secured floating rate loans** to companies that would typically have a stand-alone credit profile that is **sub-investment grade**.

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**. However, we note this will be Epsilon's maiden Fund.

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 prohibitive 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.

The avoidance of real estate lending is a considerable positive for diversification in a market that is oversaturated with direct or indirect real estate exposure.

Epsilon differentiates domestically across two pillars, the first is the **avoidance of real estate lending** – a considerable positive for diversification in a market that is oversaturated with direct or indirect real estate exposure. The second is the ability to originate and structure privately negotiated loans **directly with Private Equity sponsors and private business owners**, compared to participation in broadly syndicated lending – this gives **greater visibility** over borrowers and **superior structuring** control.

Origination fees are *in essence* passed through for either Class A or B – **which we view as best practice** compared to others whom 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.

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.

In its infancy the Fund will contain **some concentration risk** but as the Fund scales this will become less pertinent. Nonetheless, we remain comfortable with the credit given the lending is secured with a customised covenant package to ensure capital preservation. Additionally, we note there is a liquidity lock-up for three years, however this is entirely appropriate given the illiquid nature of the assets.

Positively, in addition to extensive due diligence, third-party valuations separate from the auditor will be sought at regular intervals (at least annually). We view this as best practice given the subjective nature of impairments and valuation of illiquid Level 3 assets. Whilst leverage is not anticipated we note leverage is capped at 30% of Gross Asset Value.

We expect the Fund to have **low correlation to other asset classes**, providing investors a valuable diversification tool. Would it not be for the lack of track record at the Fund level, we would consider upgrading our recommendation. In light of this, we have assigned an **Improving** outlook. Forming the basis for our **Approved** assessment was: (1) a commitment to **industry best practices**; (2) a **unique investment narrative** and **seasoned investment process**; (3) a **long track record of collective performance** by the Founding Partners; and (4) **robust structural protections** as tested in our *Quantitative Analysis*.

Investment Strategy & Performance

The Epsilon Direct Lending Fund aims to provide bespoke senior secured, bi-lateral and small club loans, to high quality middle market companies, which require financing for growth and event-driven strategies. The Fund aims to deliver attractive risk-weighted returns with low correlation to other asset classes throughout the market cycle by building a portfolio of directly originated loans. Downside protection is prioritised with emphasis to capital structure seniority, security and tailored covenants.

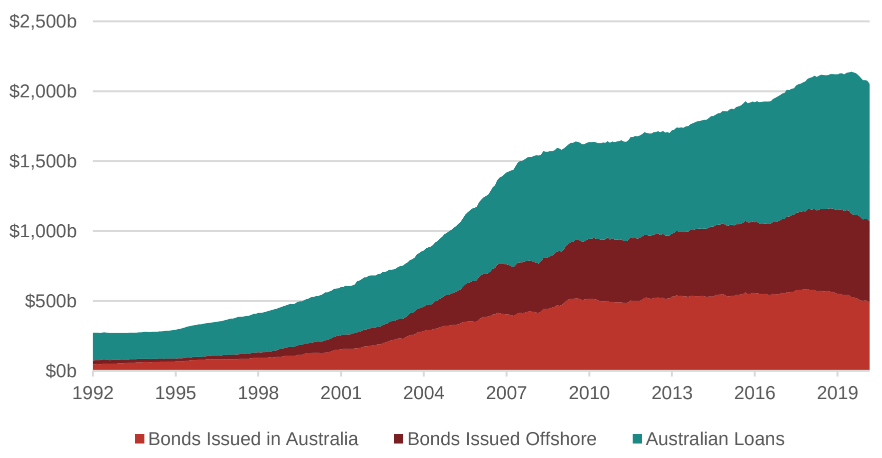
A middle market company typically has revenue of $25-500 million and a minimum EBITDA of $5 million. The Fund is targeting a portfolio of 15-20 loans to middle market companies domiciled in Australia or New Zealand that meet their strict borrower characteristic requirements. These focus on the sustainability of the company's business model through the cycle, manageability of capex requirements, market position, growth potential and competence of management. This strategy seeks to take advantage of market imperfections in the underserved middle market corporate lending universe.

Epsilon expects to convert 15-20% of opportunities proposed by companies into completed loans. Generally, the demand of middle market financing far exceeds the capital available to them, allowing Epsilon to select from a significant number of opportunities.

Private credit in the middle market space is a flexible financing solution provided to companies requiring debt capital. Due to increasing regulation for banks and the diverse needs of lenders, this market space has become increasingly unattractive to traditional banks. In recent years, non-bank lenders, who are less burdened by the regulatory restructuring and open to more complex transaction structures, have been able to capitalise on this supply deficiency and fill this capital vacuum at an attractive premium.

We see Epsilon as being exposed to robust lending opportunities in all market conditions. In better conditions, there is a greater need by middle market companies to finance growth, providing Epsilon more opportunities to lend. Conversely, during poorer market conditions such as throughout the COVID-19 pandemic, companies still require debt capital but typically, bank lending appetite reduces, especially to new clients. This creates a larger opportunity set for non-bank lenders, such as Epsilon.

Figure 1. Australian Corporate Debt Outstanding



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

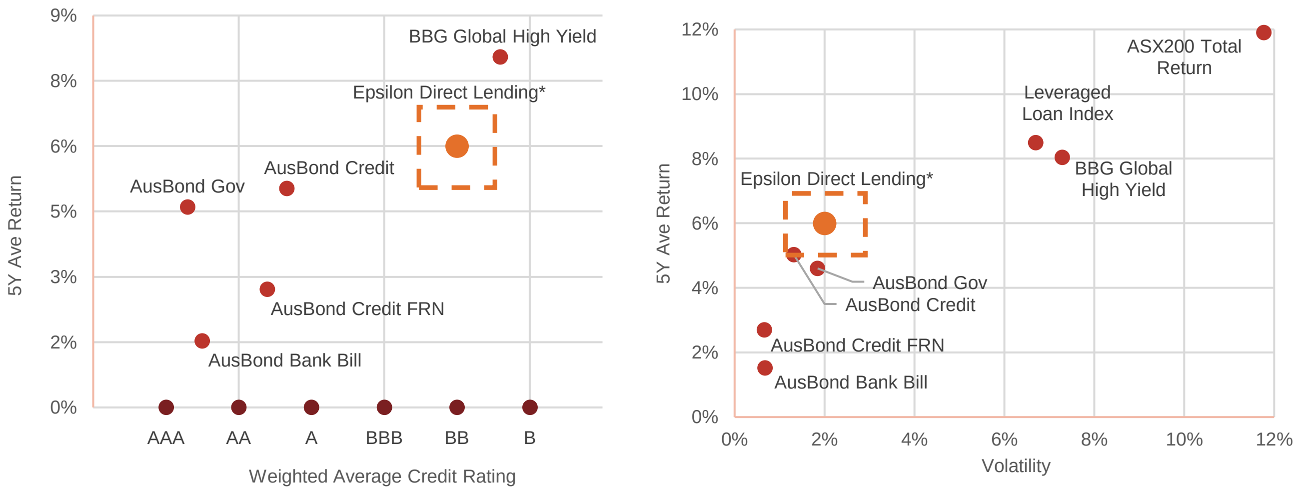
Epsilon Direct Lending Fund has a net target return of 3mBBSW + 6% (pro forma 6.01% as of 13 January 2021). This target return is net of all fees and taxes incurred by the

Fund. It is expected that the Fund's returns will be primarily generated from loan fees and margins.

The ramp-up phase of the Fund is expected to be fully complete 18-24 months after first close. This gradual ramp-up may prevent Epsilon from reaching target returns until this phase is complete. We expect the target return to be exceeded post-ramp.

Based on a range of expectations for return and volatility, Epsilon Direct Lending Fund has the potential to offer strong risk-adjusted returns relative to the fixed income asset class, as illustrated in Figure 2. A private credit strategy can result in higher risk-adjusted returns than are available when restricted to traditional, investment-grade fixed income opportunities. This is due to two specific premia: illiquidity and complexity. We note the strong duration performance present in the Bloomberg Global High Yield, AusBond Gov and AusBond Credit indices. Figure 2 uses historical returns and we recognise in the future that traditional fixed-income returns will likely fall with a continuing decline in yield.

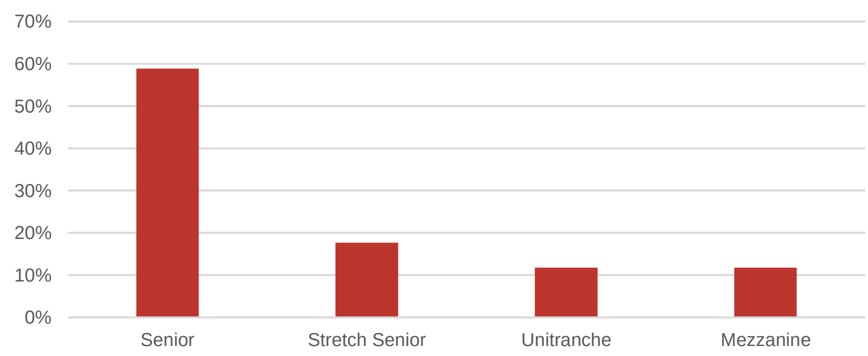
Figure 2. Estimated Risk-Adjusted Comparison



*[1] Calculated using annualised returns since 2016. * Returns based on provided expected return; Credit rating based on BondAdviser estimates.*
Source: BondAdviser Estimates, Epsilon Direct Lending, Bloomberg. As at 8 January 2021.

As shown in Figure 3, the Fund will predominantly be comprised of senior secured loans with relatively small allocations to lower traches of debt. Although it is expected that the borrowing companies in the Fund will not have a public credit rating, Epsilon is targeting firms with an estimated "BB" rating.

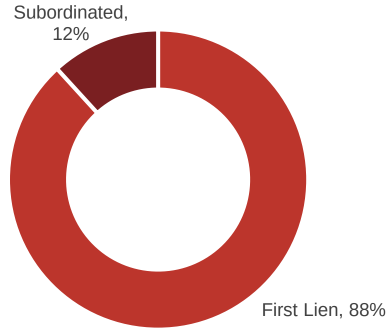
Figure 3. Indicative Transaction Structure as Percentage of Portfolio



Source: BondAdviser, Epsilon Direct Lending.
BondAdviser estimates based on fully ramped portfolio.

For a Fund of this nature, that is, an active manager in largely private, non-investment grade credit assets, perhaps more important than the credit rating profile of the portfolio is the seniority composition. This is because, as detailed further in the *Risk Management and Construction and Investment Process* sections, despite a lower credit rating, investor capital is protected through senior claims to the security of the investment. As is shown in Figure 4, the majority of the Fund is expected to be invested in first lien loans. In the event of default, first lien loans must be paid in full before a subordinated lender is repaid. Due to the riskier nature of subordinated loans, they carry a risk premium.

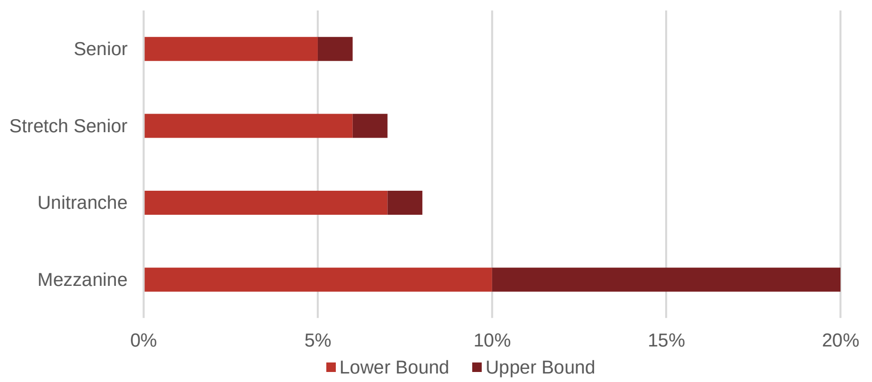
Figure 4. Indicative Lien Type Distribution (% of MV)



Source: BondAdviser, Epsilon Direct Lending.
BondAdviser estimates based on fully ramped portfolio.

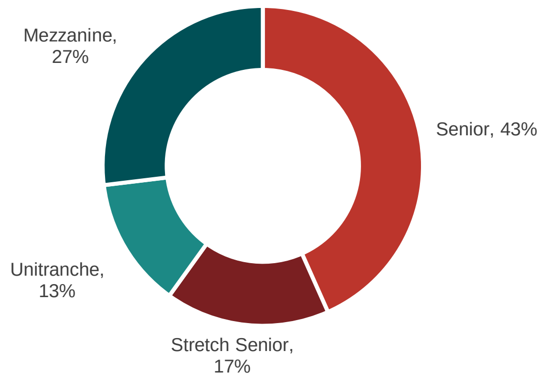
The compensation for subordinated risk can be seen in Figure 5, where the average expected yield for Mezzanine financing is more than triple that of senior secured loans. This heightened yield contributes heavily to the Fund's expected return, illustrated in Figure 6. Although Epsilon's indicative weighting to Mezzanine loans is around 12%, this exposure accounts for 27% of the Fund's expected returns. Without the mezzanine loans, the expected yield for the Fund would drop by approximately 1.25% per annum. The presence of such investments in the portfolio naturally increases risks for investors, however, the performance of the Manager in previously mitigating credit risk in addition to the Fund's investment processes, discussed in *Risk Management*, means we are comfortable with a minority exposure in exchange for a robust return. Notably, Epsilon will generally not lend at the mezzanine level unless it has a blocking vote in the senior portion of the lending capital structure. In infancy, whilst the fund is relatively concentrated, this may amplify counterparty risk, nonetheless we are comfortable with this strategy compared to the alternative.

Figure 5. Average Expected Yield for Loan Type



Source: BondAdviser, Epsilon Direct Lending.

Figure 6. Contribution to Expected Portfolio Yield by Loan Class



Source: BondAdviser, Epsilon Direct Lending.
BondAdviser estimates based on fully ramped portfolio.

The Fund Manager does have some formal limitations on the type of companies Epsilon can lend to. Epsilon Direct Lending is seeking opportunities outside of the real estate sector, which is a significant positive, given the typically heavy weighting to real estate in most Australian investment alternatives. This further helps Epsilon achieve its target of providing investors with a product that is lowly correlated with the broader market.

Based on the composition of the Investment Team's portfolio during their previous lending experience, we expect the Fund, post ramp-up, to be an industry agnostic, diversified portfolio. The Manager will also exclude sectors that do not meet the Fund's ESG requirements, including but not limited to weapons, tobacco, alcohol, gambling, fossil fuels and nuclear power. We note **Epsilon is a signatory of the United Nations Principles for Responsible Investment** (UNPRI).

Loan terms will typically be between 3-5 years, but this is ultimately dependent on the underlying credit quality of the borrower and the terms agreed upon. As indicated by Epsilon, the average expected tenor is 3.5 years with expected liquidity of the Fund illustrated by Figure 11 in *Portfolio Risk Management*. This aligns well given the initial 36-month lock-up. Additionally, Epsilon will provide amortising loans, which typically run-off on a 10% p.a. basis, providing a steady inflow (in addition to term loan roll-offs) of capital to manage redemptions as required.

Positive Risk Factors

Structural Protection. With at least 80% of the portfolio allocated to senior secured loans, all of the portfolio will be secured against assets of the borrowers and will benefit from senior ranking positions which preference the Fund ahead of other junior creditors in an event of default.

Origination Pipeline & Expertise. Most middle market financing opportunities are privately arranged, meaning a strong origination pipeline, obtained through relationships with financial sponsors and corporates directly, is critical. Epsilon's Investment Team has extensive experience in the lending space, through which they have developed a broadly diversified origination network.

Complexity/Illiquidity Premium. The private debt market is niche, with an expanding opportunity set available for competent operators. This expertise drives profitability and a significant expansion of assets under management given the progressive regulatory tightening and pull-back by traditional bank lenders.

Established & Repeatable Processes. Management has set up a formalised, multi-stage investment process which is repeatable across transactions and manifests a commitment to preserve investor capital. This includes maintaining close engagement with borrowers to enable Epsilon to undertake adequate due diligence as well as appropriately manage non-performing assets when required.

Alignment of Interests. The Investment Team will invest in the Fund directly and are also committed to reinvesting at least 50% of their entitlement to distributable profits from Epsilon into the Fund (or later Epsilon funds) for at least three years. This has the effect of more closely aligning the Manager's interests with those of the unit investors.

Negative Risk Factors

No Fund Record. Given Epsilon is a new Manager, it has no track record of performance. However, this is partially mitigated by the fact that the Investment Team has worked together previously, through which time they achieved considerable success together.

Concentration Risk. The Fund aims to build a portfolio of between 15-20 loan investments, each of a value of $10-62.5m. At the least diversified, this leaves the Fund's largest exposure at 12.5% of the Fund. This leaves investors exposed to considerable capital loss if a single loan investment deteriorates.

Operating Infancy. Risk of operational error is always a threat to portfolio performance. This includes the failure of internal processes and includes human error, misjudgment and fraud. This is notable given Epsilon is a recently established lender, with its internal processes largely untested. We recognise Epsilon is partnered with the largest services providers for private credit and the Founding Partners have operated in new fund environments previously.

Liquidity Risk. Direct bi-lateral lending is illiquid and in a stressed scenario, underperforming or defaulted investments may be difficult to liquidate, given there is no real secondary market. The liquidity risk of the Fund is mitigated by the natural run-off afforded by the size of the portfolio.

Credit Risk. Weakening credit profiles of counterparty exposures in the Fund's portfolio could result in a decline in the Fund's net value. This is partially offset by protective structural features of the loan arrangements. Notably the Founding Partners all have extensive experience in handling a portfolio's credit risk during downturns.

Construction and Investment Process

Portfolio construction is conducted within the investment guidelines with oversight and approval from the Investment Committee. The investment guidelines are outlined in Figure 7 and are consistent with the investment strategy. The portfolio process is largely three-step, namely origination, execution and portfolio monitoring.

Figure 7. Investment Guidelines on $500m Fund

Target Number of Investments	15-20 individual loans
Max / Min Loan Size	$62.5m (12.5%) max, $10m min
Sector Concentration	$100m to any one sector
Currency	Max 20% to non-AUD currencies
Subordinated	Max 20% to non-senior secured investments
Equity Investments	Max 5% to equity or equity-like investments
Payment-in-kind	Max 10%
Domicile	Max 10% outside of ANZ

Source: BondAdviser, Epsilon.

Origination & Execution

The network of operators in the space is limited due to the prior dominance of the major domestic banks. This naturally imposes a barrier to entry and emphasises the importance of relationships to operate in the middle market.

Middle market financing opportunities are primarily growth based or event driven. These are typically privately arranged and completed. We view ‘on the ground’ presence as critical in this space, as it manifests in access and completion of a broader transaction set.

The Founding Partners have deep experience in this space and expect to source loan investments from these key areas:

- Financial Sponsor Coverage

  Private equity sponsors or otherwise high net worth investors / family offices typically fund the equity proportion of transactional, event-based deals. Lenders build relationships with these sponsors over several years. Repeat business for a lender is common in this space, as sponsors preference knowing the key decision makers. The Investment Team have a national coverage model, allocating individual responsibilities with respect to relationship management. We expect a large proportion of deals to flow from this area and note that Epsilon has a deep connection with a broad array of domestic private equity participants.

- Direct-to-Corporates

  Middle market companies are typically privately owned. This makes access to capital markets limited, in turn, making growth capital difficult and expensive to access. Epsilon has extensive relationships with this cohort, cultivated over years of personal interactions as customers or prospects.

- Intermediary Networking

  Intermediaries generally refer to professional services, including accounting, legal, business brokers, corporate advisers and bankers. The Investment Team understand which individuals are responsible or involved in the majority of transaction flow and have long standing, co-aligned relationships.

- Stapled Financings

  Stapled financing is usually arranged by an adviser to the vendor company on an M&A transaction. This is a pre-arranged finance package offered to potential bidders in an acquisition process. This is used to solicit bidder interest in a sale process. Epsilon maintains close relationships with advisers responsible for managing M&A processes and expect to be able to leverage those relationships to source compelling investment opportunities.

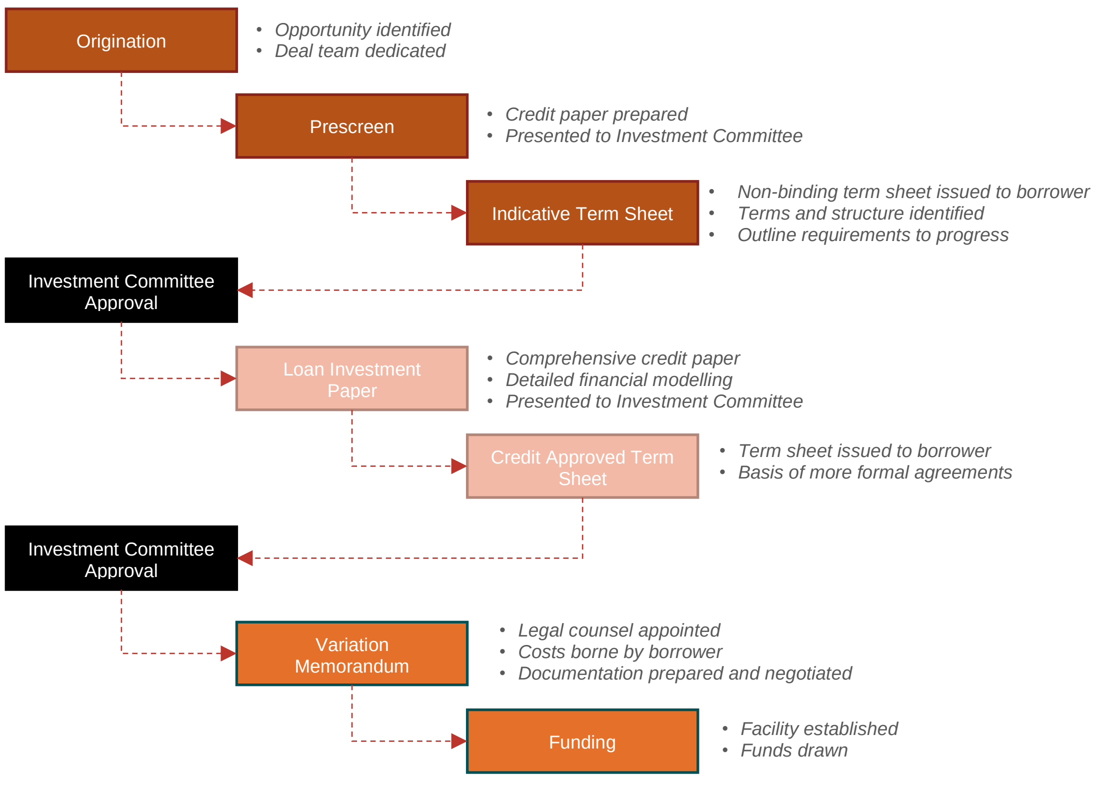
- Opportunity Creators / Opportunity Database

  The Investment Team members have been able to introduce business owners and/or management teams to sponsors in facilitating a corporate transaction. In addition to goodwill, this can be leveraged to position for a financing opportunity.

- Dedicated Prospecting / Opportunity Database.

  Keeping up to date with corporate transaction opportunities that are either rumoured or pending completion allows for opportunistic prospecting. It is not uncommon in M&A transactions that only equity is utilised – but subsequently a debt recapitalisation occurs.

Figure 8. Origination and Execution Process



Source: BondAdviser, Epsilon

In terms of pipeline, Epsilon expects to review $1.5-2.0 billion of potential financing per annum and currently have opportunities in excess of $1.0 billion. This $1.5-2.0 billion is estimated to be around 10% of all transactions in the targeted middle market segment. Conversion is 15-20%, which amounts to $225-400 million executed loans per year.

Time, in terms of the underwriting process, is variable and depends on the circumstances of the transaction. Generally, the origination process ranges from a few weeks to a few months.

Portfolio Monitoring

Post transaction analytics and monitoring involves both the internal Investment Team and several external parties.

As a predominately bi-lateral lender, monthly management financials from borrowers are reported, received and reviewed by Epsilon. This access is superior to the syndicated market, which despite reporting more commonly than public markets, is distributed by the agent on a quarterly basis (i.e. less access to management). This frequent interaction with company management, sponsors and owners allows Epsilon to better understand credit fundamentals and thereby proactively manage distress or special situations to optimise outcomes for Fund investors. Epsilon have proven restructuring expertise and have dedicated processes to preserve capital at risk. Return of capital takes priority over return on capital for this direct lending strategy.

Epsilon utilise IHS Markit's iLevel monitoring system for central processing, independent review, accuracy and completeness. For each borrower, key financial and operational drivers are mapped at origination and regularly examined and tested. Cash flow performance is the key determinant of Epsilon's view on credit quality.

Internally, Epsilon conducts monthly team meetings to review each borrower. The monitoring philosophy of EDL is that of "no surprises". By this, efforts to monitor the portfolio should result in transparency, independence and thoroughness. The Investment Committee expect to be able to continuously assess underlying credit quality of borrowers.

Portfolio Risk Management

Our assessment of risk management considers credit and liquidity risk. However, we also recognise operating risk is always present and this is considered throughout the report. We view effective risk management as underpinning success, due to the asymmetric nature of credit investment. In *Quantitative Analysis* we simulate scenarios to test the credit profile of the portfolio, contrasting with this qualitative assessment.

While each individual asset has its own risk profile, we believe Epsilon has the competence and the Fund will have the scale required to isolate and control risk at a portfolio level. The structural and fundamental elements of each individual asset underpin Epsilon's investment strategy and allow the Fund to operate within its target at an aggregate portfolio level.

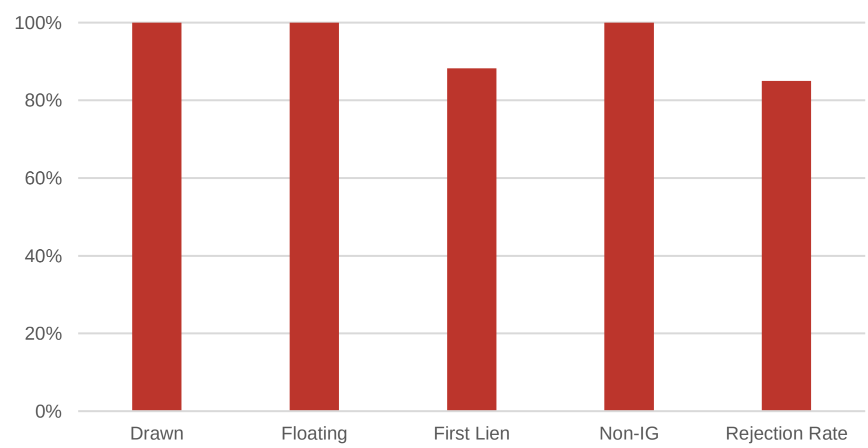
Credit Risk

Investors' exposure to credit risk is predominantly from credit migration risk (i.e. deterioration in the credit quality of an investment) impacting loan valuation which flows through to lower net trust value. Given the Fund targets non-investment grade, middle market borrowers, mitigating this risk is especially important for the Fund relative to investment grade alternatives.

Epsilon's credit risk management is predicated on a thorough investment process which emphasises credit fundamentals with the goal of identifying and avoiding marginal credit quality borrowers. Epsilon seeks lending opportunities to companies with profitable, verifiable and robust financial histories. Further borrower considerations for the Investment Team include manageable capex requirements, limited exposure to cyclical business models, strong and stable cash flows, and experienced management with appropriate alignment of interests. Credit risk management is supported in the case of PE sponsored transactions, in which case the PE sponsor can provide additional depth and expertise to the due-diligence process.

In addition to mitigating exposure to poor quality borrowers, Epsilon manages credit risk through minimising potential loss in the event of default. Given most of the Fund's investments will be private, bilateral loans, which are generally held to maturity by the lender and have limited mark-to-market volatility, default risk will be a key determinant of investment value.

Figure 9. Indicative Portfolio Metrics (% GAV)



Source: BondAdviser, Epsilon.
BondAdviser estimates based on fully ramped portfolio.

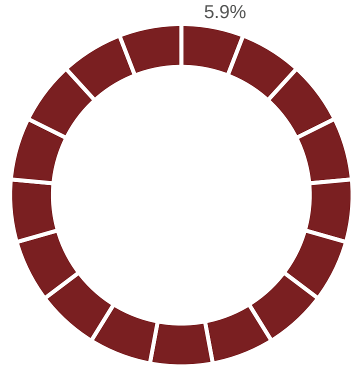
Epsilon aims to outperform the market in relation to portfolio loss for middle market corporate loans through its rigorous assessment and construction process (detailed in *Construction and Process*).

Positively, the Investment Team's considerable experience in corporate lending will assist in delivering to the Fund a broad origination network in a sector (middle market corporate lending) to which exposure is highly dependent on relationships and 'on-the-ground' presence. These relationships should enable the Investment Team to draw an extensive universe of possible investment opportunities from which it can funnel and build a portfolio which suits the Fund's risk and yield appetite.

From this position of scale, Epsilon is in a position to further protect default risk through embedding loans with structural protections. The Fund will seek to predominantly provide loans as the lead arranger and manager, acting as either the sole lender or in a small club structure. This provides Epsilon with greater influence over loan structure, terms and conditions, fees, pricing and recovery mechanisms, which together can **mitigate loss given default and improve recovery rates relative to traditional bank lending or syndicated loans**. In addition, this degree of control gives Epsilon greater access to the borrower through the loan period, include monthly accounts and regular contact and possible input into management.

In addition, most (at least 80%) of the Fund's investments will be senior secured loans, with various forms of collateral, including security over the assets of the borrower, shares in the borrower, real property, cross guarantees, limiting magnitude of downside loss, however not eliminating the risk, as in the event of a default, the value of the loan may exceed the security value (collateral risk).

Figure 10. Indicative Asset Diversification (% MV, Number of Assets)



Source: BondAdviser, Epsilon.
BondAdviser estimates based on fully ramped portfolio.

With the Fund aiming to build a portfolio of 15-20 loan investments in the range of $10-62.5m per investment (assuming a $500m Fund), diversification on an asset basis is similar to other bi-lateral lending fund alternatives. At the least diversified of the guided range, the Fund's largest single exposure would be 12.5%. Given our fundamental confidence in the Manager's investment process we believe it is an appropriate and manageable degree of concentration.

Liquidity Risk

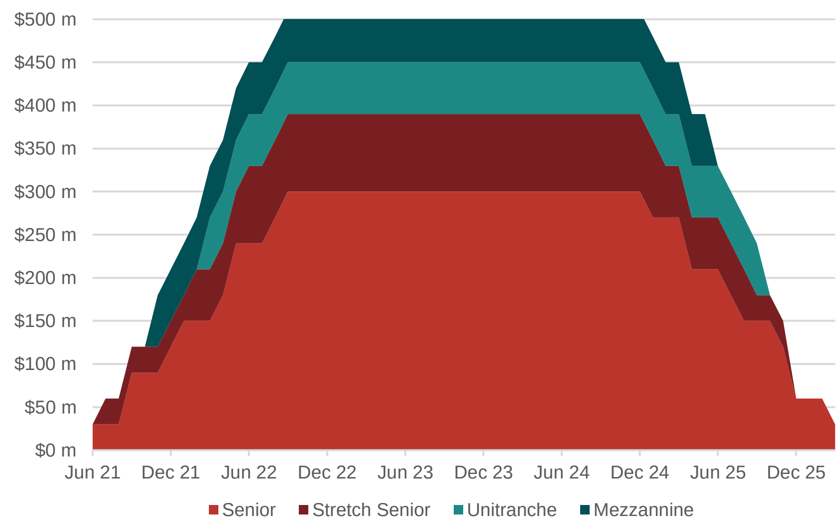
Liquidity risk for the Fund is comprised of two elements: (1) that it is able to provide liquidity to borrowers on request (in the lending strategies) within the loan commitment period; and (2) is able to meet investor redemptions.

Loan Liquidity

In order to maximise portfolio return, the Manager aims to have a minimal cash holding and operate close to 100% committed. However, given the Fund is newly launching, on receipt of cash from investors there should be no reason why the Fund should not be able to meet its facility requirement to borrowers. Epsilon will not enter contractual arrangements unless committed funds are available.

Currently, the Fund has not established a loan facility. Post ramp up, at the Manager's discretion, it may enter a facility. This is not uncommon of private credit funds, given a revolving facility can be utilised to facilitate any unexpected drawdowns without holding equity capital against these commitments.

Figure 11. Indicative Ramp Up and Subsequent Maturity of Loans



Source: BondAdviser, Epsilon.
BondAdviser estimates based on fully ramped portfolio.

Fund Liquidity

The Fund will be invested in an illiquid segment of the market – and investments are made with a buy and hold strategy. Given the relative illiquidity of the loans and their expected contractual terms, **the Fund is suitable for investors with an investment horizon of at least three to five years**. As such, the Fund has a three year lock up period (until the lock up date) during which time investors will not be able to redeem their units. This is designed to give Epsilon the certainty through the ramp up period required to execute its investment strategy.

After the lock up date, investors may issue a request for a redemption of their units by giving no less than 60 days written notice to the administrator. The trustee has the absolute discretion to accept or reject such a request in whole or in part.

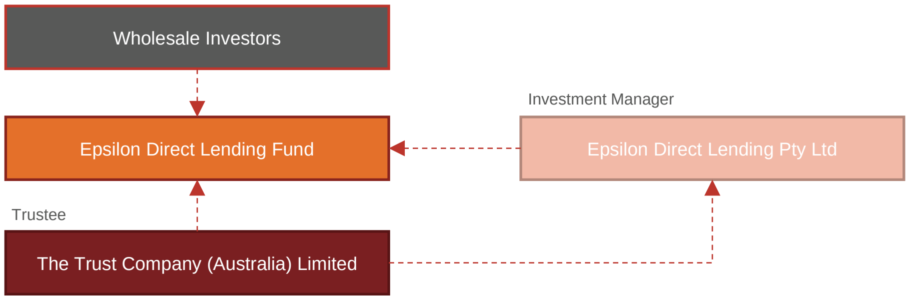
Alternatively, after the three year lock up period, investors may request the trustee to place their units into run-off, meaning that a proportion of the Fund's assets will be attributed to the relevant investor and liquidated proceeds in respect of those investments will be paid to investors when those assets are realised.

Fund Governance

The Epsilon Direct Lending Fund is an Australian-domiciled unlisted open-ended unit trust. It will be an unregistered managed investment scheme controlled by its governing documents, including the Information Memorandum, the Trust Deed and the Management Agreement. The Fund is accessible to wholesale investors only.

Perpetual Trustees (The Trust Company (Australia) Limited) is the trustee and custodian of the Fund. As trustee, Perpetual issues units in the Fund and is legally responsible to the unitholders for the Fund and its operation. In performance of its duties, The Trust Company has delegated the investment management of the Fund to Epsilon Direct Lending Pty Ltd under the Management Agreement, with EDL becoming the Investment Manager of the Fund. Perpetual Trustees provides the back office, administration and compliance support services to EDL. Perpetual have also engaged Alter Domus Australia to provide administration services to the Fund, IHS Markit as the loan administrator and KPMG has been appointed as auditor (noting the Fund is yet to be incorporated).

Figure 12. Simplified Legal Structure



Source: BondAdviser, Epsilon Direct Lending.

Determination of Net Trust Value is at the discretion of the Manager and there is no assurance that the calculations will reflect actual value nor that the accuracy of these calculations will be verifiable. However, the Manager intends to value in accordance with Australian Accounting Standards and it is likely for Epsilon that Level 3 methodology will be applicable to the majority of assets. Valuation of Level 3 assets, being the most illiquid and opaque, is based on inputs that are unobservable to third parties and requires judgment and estimation. To increase transparency, Epsilon will engage an independent expert to procure the valuation of assets in certain circumstances; these include any loan being downgraded to “B” or below, any loan breaching covenants or failing to pay interest or principal as it falls due.

The Fund has a three-year lock up period after which an investor can either request to redeem all or part of their stake, or alternatively, elect for a run-off. A run-off would involve realised investments being paid to the investor as they mature with a requirement for further contributions only for fees and expenses. Loans that are repaid may be reinvested prior to redemption requests being made and the Trustee has full discretion regarding redemption requests.

Quantitative Analysis

Limited publicly available data and the inherent opacity of direct and syndicated lending makes quantitative analysis of expected credit loss inherently more challenging than for other more transparent and developed asset classes. Whilst this is a positive in terms of a complexity premium, there is difficulty in applying traditional quantitative credit loss models, given the bespoke nature of investments. Though imperfect, the analysis presented in this section does provide an indication of the fundamentals underpinning the Fund in a variety of scenarios. **Our analysis is performed on the expected ramped portfolio (>$500m).** Accordingly, we highlight that the tail-risk outcomes of the Fund in infancy (or for a smaller, more concentrated portfolio) are more adverse than modelled in this analysis.

We have adopted the CreditMetrics framework, which attempts to model credit migrations, including jump to defaults (JTD), that directly impact the valuation of the Fund. Based on historical and estimated fair value yield curves, we can revalue each individual holding for each derived credit rating, which is intended to simulate the likelihood and severity of deterioration in security values, as would be expected as part of the valuations process. The core of the analysis, however, is determined by the probabilities of a JTD and the ultimate recovery given default (loss given default, LGD). Our analysis places no limit on adverse credit migration to model a possible worse-case scenario for investors. We note this approach makes no implicit assumptions on Epsilon's proven capability to avoid capital losses.

We model the probability of JTD and mark-to-market losses from historical data, known as transition rates (Table 1). This data reflects long-term statistics (1970-2019) regarding the probability of an issuer moving from its current credit rating over a one-year period, and, in the event of default, the average ultimate recovery is based on priority of repayment (seniority). Although the investment horizon is beyond one year, we apply a one-year credit migration outlook for the quantitative framework to limit the uncertainty of variables.

Table 1. Adjusted* Avg. Migration Rates (1970-2019)

FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	**99.3%**	0.0%	0.0%	0.0%	0.0%	0.0%	0.7%	0.0%
AA	0.0%	**96.2%**	0.0%	0.0%	0.0%	0.0%	3.2%	0.5%
A	0.0%	0.0%	**97.1%**	0.0%	0.0%	0.0%	2.4%	0.5%
BBB	0.0%	0.0%	0.0%	**97.0%**	0.0%	0.0%	2.2%	0.8%
BB	0.0%	0.0%	0.0%	0.0%	**93.5%**	0.0%	3.2%	3.4%
B	0.0%	0.0%	0.0%	0.0%	0.0%	**83.6%**	9.9%	6.5%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**87.1%**	12.9%

Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation. Further adjusted such that revaluation only possible for migration to CCC or default.*

For each rating rank and for most of the portfolio, an instrument's credit rating is likely to remain static over the modelled timeframe, with some probability of an adverse movement. This highlights that credit ratings are negatively skewed, which is amplified for loans in our analysis, by explicitly eliminating any probability of a ratings increase, given for the infrequency that loans are revalued upwards of par. Our analysis builds on the principles behind Merton's structural credit model to randomly generate a series of credit ratings in one year's time. The core assumption is that asset returns are normally distributed and that the value of an asset in one year is determined by the credit rating or default, of the issuer at that time.

For some of the portfolio, external public credit ratings may be available. For otherwise unrated assets, for the purpose of our analysis, we assign a proxy rating of BB. For the purpose of our modelling, in Scenario 4 we selectively notch down provided ratings by a full band (i.e. all assets rated B), to examine the impact on the portfolio of a considerably weaker credit profile.

We simulate 10,000 scenarios for each set of assumptions, where each portfolio asset has an end credit rating defined by transition probabilities. Mapping valuation changes, or loss given default, to these hypothetical states, allows us to derive a probability distribution of portfolio valuation. The revaluation overlay allows us to estimate (unrealised) mark-to-market losses over a one-year horizon. The primary driver of our scenarios is contingent on JTD and LGD rates.

Additionally, in selected figures (curves labelled: w/income) we have included the estimated impact of coupon carry and origination fees for the year (noting we do not subtract management fees – this can be thought of as the gross return for Class A units). These curves illustrate the offsetting impact interest payments have against credit migration losses. When an individual asset adversely jumps to default (JTD) in any single scenario, we assume no interest payments are made. In evaluating a recovery value in a JTD event, we simulate a random variable utilising a beta-distribution. Distributions vary by seniority and are constructed using largely historical data (Table 2).

Table 2. Recovery Rate Inputs (Bonds and Loans)*

	1970 - 2019 Average	GFC Scenario	Benign Scenario
First Lien Loans	77%	70%	84%
Senior Secured^	59%	43%	60%
Senior Unsecured^	43%	27%	44%
Subordinated^^	32%	22%	33%
Equity**	10%	5%	15%

Source: BondAdviser, Moody's, S&P
** Individual recovery rates will vary, based on a simulated random variable utilising a beta-distribution, using mean and variance parameterisation.*
*** Not empirically based, standardised across all BondAdviser QA testing as a punitive input.*
Constant standard deviation of 10% used for equity.
^ Based on bond recoveries only. ***Epsilon do not lend in a bond format.***
^^ Based on bond and loan recoveries.

Downwards revaluations of a loan asset will directly impact the Fund, this decision can be subjective and binary which makes it difficult to model with respect to credit risk. Given the bilateral, private credit nature of the loans, we only impair assets upon migration to CCC status. This better reflects respective valuation policies of the underlying Fund. Furthermore, we assume for loans that there is no migration upwards and that unmarked assets are priced at par unless impaired or in default.

Table 3. Adjusted* GFC Migration Rates (2009)

FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	**100.0%**	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	**95.4%**	0.0%	0.0%	0.0%	0.0%	4.1%	0.5%
A	0.0%	0.0%	**96.0%**	0.0%	0.0%	0.0%	3.3%	0.8%
BBB	0.0%	0.0%	0.0%	**95.6%**	0.0%	0.0%	2.8%	1.6%
BB	0.0%	0.0%	0.0%	0.0%	**91.8%**	0.0%	3.1%	5.1%
B	0.0%	0.0%	0.0%	0.0%	0.0%	**74.5%**	15.9%	9.7%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**64.2%**	35.8%

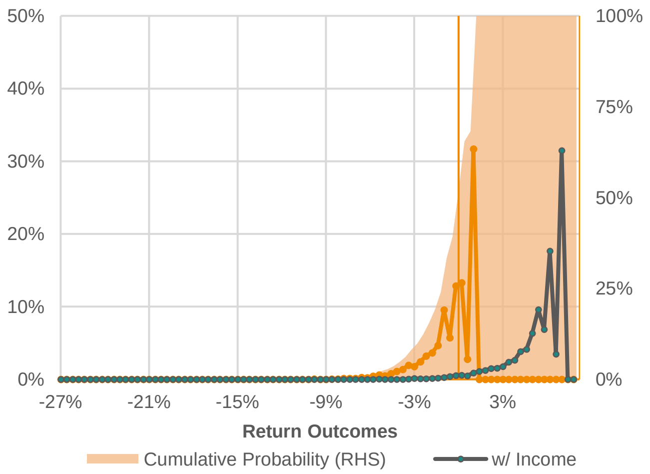
Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation. Further adjusted such that revaluation only possible for migration to CCC or default.*

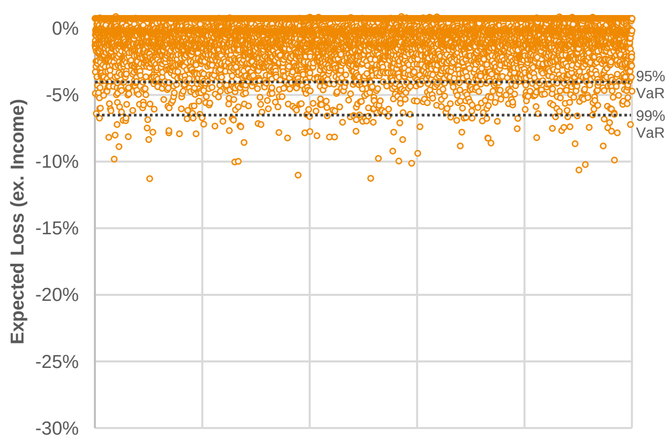
For Scenario 1, **the Fund demonstrates excellent** resilience to adverse credit migrations. This resilience is tested in later scenarios, for which two key attributes remain true. The first is the seniority of the loans; senior secured loans have significantly better LGD outcomes than bonds, this relies on the assumption that previous default outcomes will not materially alter from historical recoveries. The second is the diversity of the portfolio, on a look through basis, our modelled portfolio for EDL contains ~17 unique assets, which is relatively concentrated – amplifying the impact of any single adverse valuation.

We note that the relatively small number of underlying assets results in a smaller number of possible modelled outcomes. This creates a more bi-modal distribution (less smooth) in our simulations.

Additionally, Scenario 1 benefits from two other attributes, which are altered in subsequent scenarios to isolate the impact on the portfolio. The first is the low probabilities of adverse credit migrations, relative to distressed market conditions, by use of a long-term average. The second is from credit quality, this is altered in Scenario 4, to isolate the considerable benefit afforded to investment grade assets in our modelling. Scenario 1 has a mean capital loss (excludes coupon carry and management fees) of -0.7% and total capital value-at-risk of -6.6% (again excluding coupon carry and fees, 1% VaR probability).

Scenario 1. Baseline Asset Assessment (Long Term Average Data)



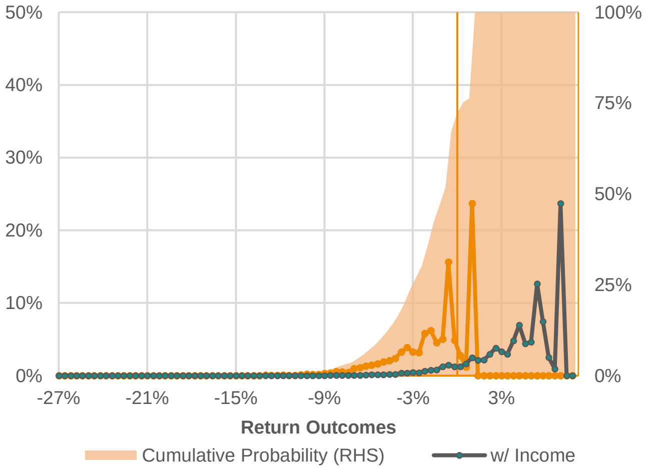


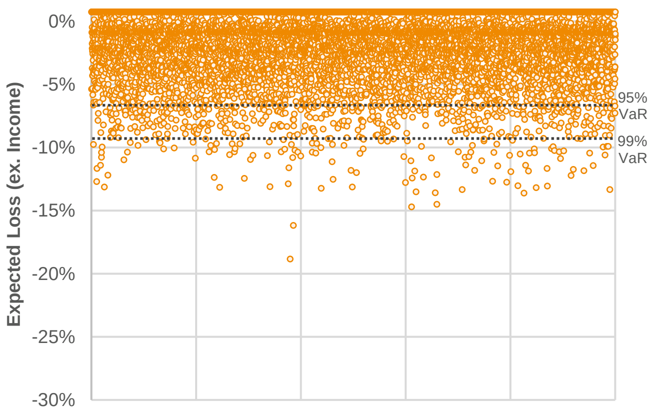
Source: BondAdviser Estimates. Excludes impact of management fees.

To test the portfolio under distressed conditions we use migration rates from 2009, the worst year for corporate defaults globally during the GFC. Scenario 2 models against assumptions that are identical to Scenario 1 except for migration probabilities and historical corporate yield curves. As illustrated in Table 3, JTD probabilities increase ~1.5x for BB rated bond and loan assets, however the probability is still relatively small (5.1%). The table highlights a material increase in the migration to CCC or JTD probability across all ratings, the impact of which is further amplified by materially lower recovery rates during this time.

The portfolio's results deteriorate in the stressed assessment, having a mean capital loss of -1.9% and total capital value-at-risk of -9.8% (1% VaR probability). This demonstrates that even with markedly higher chances of default, the Fund continues to perform well through its seniority.

Scenario 2. Stressed Asset Assessment (2009 Data)





Source: BondAdviser Estimates. Excludes impact of management fees.

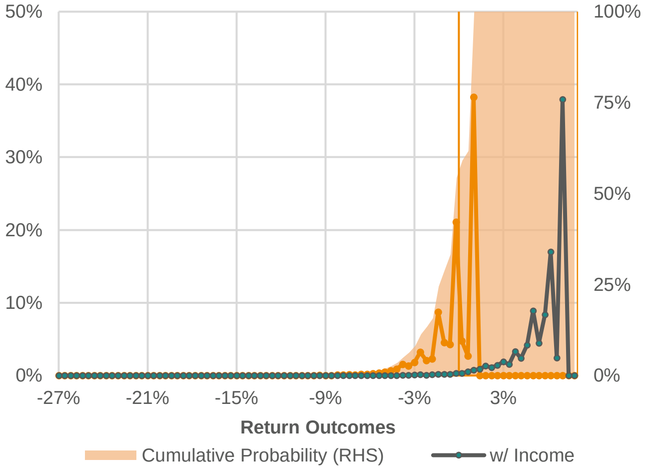
To further separate the impact of migration rates and to examine the simulated impact of benign economic conditions, Scenario 3 utilises the credit migration probabilities in Table 4. Scenario 3, the most positive, has a mean capital loss of -0.5% and total capital value-at-risk of -5.8% (1% VaR probability).

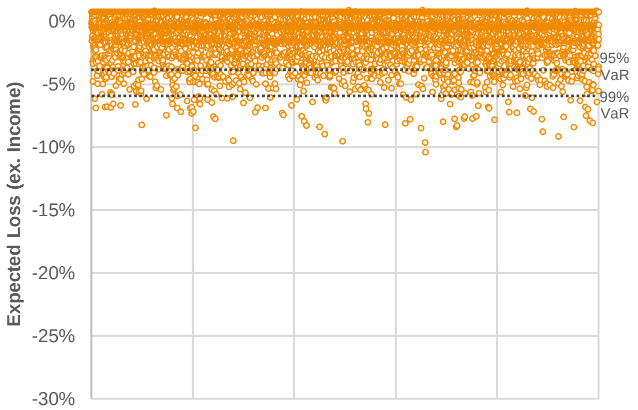
Table 4. Adjusted* Benign Migration Rates (2018)

FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	**100.0%**	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	**98.2%**	0.0%	0.0%	0.0%	0.0%	1.5%	0.3%
A	0.0%	0.0%	**98.2%**	0.0%	0.0%	0.0%	1.4%	0.4%
BBB	0.0%	0.0%	0.0%	**98.2%**	0.0%	0.0%	1.3%	0.5%
BB	0.0%	0.0%	0.0%	0.0%	**94.4%**	0.0%	3.0%	2.6%
B	0.0%	0.0%	0.0%	0.0%	0.0%	**87.9%**	7.9%	4.2%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**91.3%**	8.7%

Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation. Further adjusted such that revaluation only possible for migration to CCC or default.*

Scenario 3. Benign Asset Assessment (2018 Data)

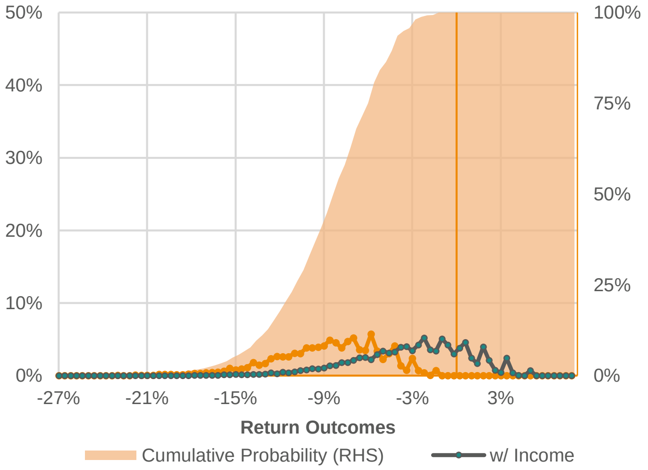


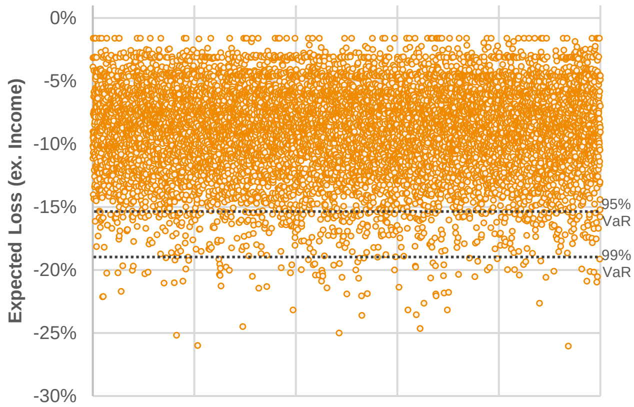


Source: BondAdviser Estimates. Excludes impact of management fees.

Our final and most punitive model, Scenario 4, utilises the same assumptions as Scenario 2, except for credit quality. To illustrate the impact of credit quality in our modelling, we have subjectively downgraded the portfolio by a full rating band for each underlying asset. The difference between Scenario 2 and 4 is significant and highlights the importance of credit quality during distressed economic conditions. The portfolio here exhibits some stress, having a mean capital loss of -8.9% and total capital value-at-risk of -19% (1% VaR probability). This simulation is particularly punitive - at every junction the assets are subject to materially higher chances of impairment, default and weaker recoveries post a default. We note it is not our base case.

Scenario 4. Distressed Asset Assessment (2009 Data – Portfolio Notched Down)





Source: BondAdviser Estimates. Excludes impact of management fees.

When comparing the four scenarios, it is clear that JTD and LGD significantly drive ultimate outcomes of the modelling onto the portfolio. Generally, the portfolio performs well across all scenarios but this is significantly influenced by the **seniority of the assets** (driving stronger LGD outcomes) - however, given the concentration, adverse credit migrations are particularly impactful to the overall portfolio.

We are aware and highlight the many deficiencies of our approach, not least that:

- Private lending is not identical and has different default paths and outcomes to rated corporates.
- It does not consider the additional protections implemented by Epsilon to mitigate credit migration or default risks, nor account for the restructuring capabilities of Epsilon in the event of distress or default.
- Our modelling contains assumptions, several of which are subjective and have material output impacts.

The quantitative framework defines the forward-looking risk score for our overall product assessment of the Fund. This is consistent with the BondAdviser Fund Research Methodology and overlays an objective evaluation to our recommendation. On the basis of our analysis, **we assign the Fund a risk score of 'BB'** or 'High'.

This risk assessment does not account for the previously mentioned expertise of Epsilon in avoiding defaults and instead assumes that assets would be held to default, without stipulating any restructuring activities. In reality, borrowers are actively researched, followed and subjected to many levels of scrutiny and oversight. We expect that, in-line with demonstrated history, assets would be managed prior to such an event occurring. Considering all the above, we are comfortable with Epsilon's ability to avoid significant credit losses whilst delivering consistent income.

Research Methodology

Overview

At BondAdviser, our focus is on delivering the highest quality data, research and insights so that investors can make intelligent decisions about the fixed income market. At the centre of our approach is a proprietary 5-pillar process for analysing fixed income funds in a rigorous and disciplined manner. Our approach results in a recommendation scale that investors can readily use to identify the most attractive investment opportunities.

Our ability to provide a clear and concise investment recommendation from the very diverse and unique fixed income portfolios and funds within our coverage universe is a key benefit of our research process. We simplify an otherwise complex procedure for investors into a simple, recognisable and consistent recommendation scale.

We use a bespoke combination of qualitative assessments and forward-looking quantitative analysis. In our experience, most other research is backwards looking, which naturally limits its usefulness. By combining our deep understanding of fixed income markets and their emergent trends with our extensive modelling and forecasting capabilities, we aim to solve this limitation and output meaningful, risk-adjusted prospective recommendations for investors.

Research Approach

BondAdviser has adopted a multi-pillar, risk-based approach to the assessment of funds. In our opinion, an investor's exposure to credit risk is not uniform and can be well mitigated by manager skill, experience and supporting governance structures. We identify 5 key pillars of credit risk mitigation and these then form sections of analysis in our reports:

- Investment Objectives, Strategy and Performance
- Portfolio Construction and Investment Process
- Liquidity, Operating & Financial Risk Management
- Governance, Asset Stewardship and Compliance
- Quantitative Analysis

Research Process

The initial screening of funds and assets is based on a globally recognised best practices approach to alternative assets as defined by the Alternative Investment Managers Association (AIMA) and risk management as identified by the International Organisation of Securities Commissions (IOSCO).

All assets and managers must meet minimum requirements as outlined in our initial due diligence questionnaires. Detailed interviews, operational checks, process documentation and data collection then follow. Each of these steps helps to ensure that our recommendations are consistent and are based on a comprehensive understanding of the key drivers of the underlying market segment and asset class(es), the investment manager and broader portfolio.

Classification

We broadly adhere with international and Australian accounting standards and global best practice in designating assets according to their place in the fair value hierarchy defined in International Financial Reporting Standard 13 (IFRS13) - Fair Value Measurement (Australian version – AASB 13). All assets designated as "Credit" fall under three categories based on market observability as outlined below:

- **Level 1 (Active Markets)** - assets that have quoted prices in active markets, providing the most reliable evidence of fair value. As a result, transactions for these assets can generally occur at this price as at the measurement date. Domestically, typical examples of Level 1 assets include Australian Government Commonwealth bonds, listed debt and hybrid instruments and RBA repo-eligible financial instruments.

• **Level 2 (Non-Active Markets)** - assets that have observable prices (directly or indirectly), not included within the Level 1 category (i.e. not quoted on an exchange). Assets referencing credit spreads and interest rates would qualify if the input is observable for the full tenor. This category generally encompasses credit markets which have limited secondary market activity such as corporate bonds, subordinated debt and syndicated loans.

• **Level 3 (Illiquid and Alternative Credit)** – assets that have mostly unobservable inputs and hence valuation models are used, driven in part by assumptions and expectations. There may be an independent overlay and a model risk adjustment to derive an exit (market) price. A limited secondary market is typical and these assets are often referred to as alternative credit. Examples of this segment include "structured" credits such as RMBS, CMBS, ABS and private debt investing.

Product Assessment

The BondAdviser Product Assessment is the culmination of our research process applied to our pillar-based research approach. We conclude whether a fund is screened-out, approved, recommended or highly recommended as broadly defined below:

• **Screened Out** – The fund does not (or no longer) satisfies our minimum criteria for research inclusion.

• **Approved** – Our research allows us to conclude that the fund manager, governance structure, policies and procedures appear to be sound and capable of managing the fund adequately to target its benchmark.

• **Recommended** – We have a reasonable expectation that the fund will achieve its target benchmark.

• **Highly Recommended** – We believe that superior skills, systems and processes mean that the fund has a high likelihood of meeting and probably exceeding its benchmark target. Note that we only Highly Recommended assessments after issuing multiple reports over an extended period of time

Risk Score

Our Risk Score is aligned to the same methodology that is utilised in BondAdviser's single-instrument reports. It is not a credit rating and should not be used as such.

• AAA – Very Low

• AA – Low

• A – Lower Medium

• BBB – Upper Medium

• BB – High

• B – Very High

• CCC – Extreme

• D – Default (Fund Closed)

Our overall Risk Score is driven by the underlying credits of a fund coupled with our quantitative analysis. It is mutually exclusive to the Product Assessment. For example, it is possible for a fund to be Highly Recommended and have a risk score of CCC. This could occur where the fund invests in riskier credit assets but we are very confident of its capability to meet or exceed its benchmark target. Conversely, a fund comprising mostly of government bonds may hold a Risk Score of AAA but its governance processes, history and controls are not as strong as peers and warrant only an Approved assessment.

Important Information

BondAdviser has acted on information provided to it and our research is subject to change based on legal offering documents. This research is for informational purposes only. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

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Report created on 27 January 2021.