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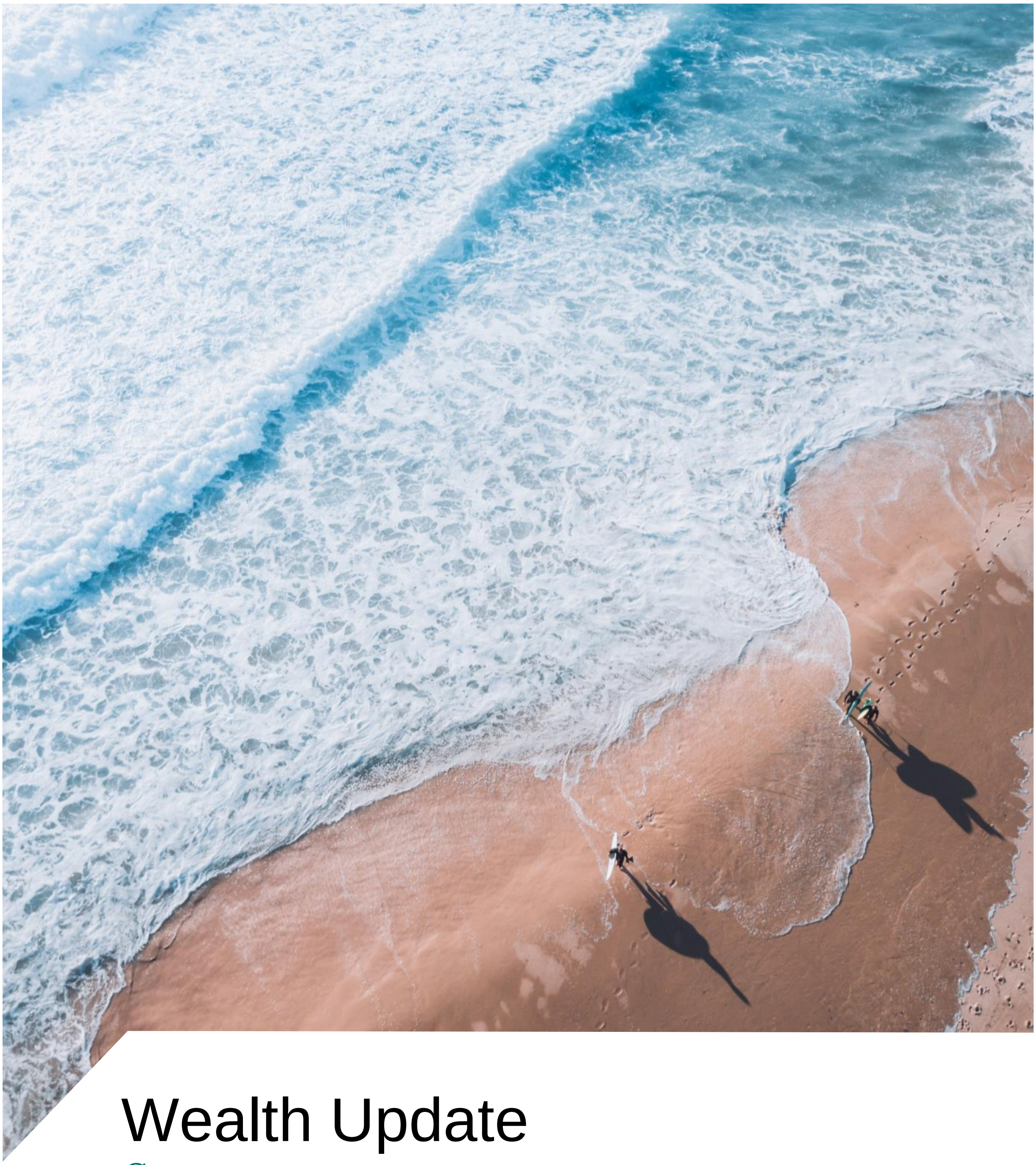

Wealth Update

Summer 2025

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Contents

Demystifying private credit 3

What is private credit? 3

Types of private credit 4

Direct lending 4

Asset-backed lending 4

Securitised lending 5

Emerging categories 5

Returns 6

Risks 6

What are ideal investment characteristics? 7

Conclusion 7

Hybrids, where to from here? 8

Technical update: Super reform on the bench 10

Apprehension over taxing superannuation 10

Creating a principle of taxing unrealised gains 10

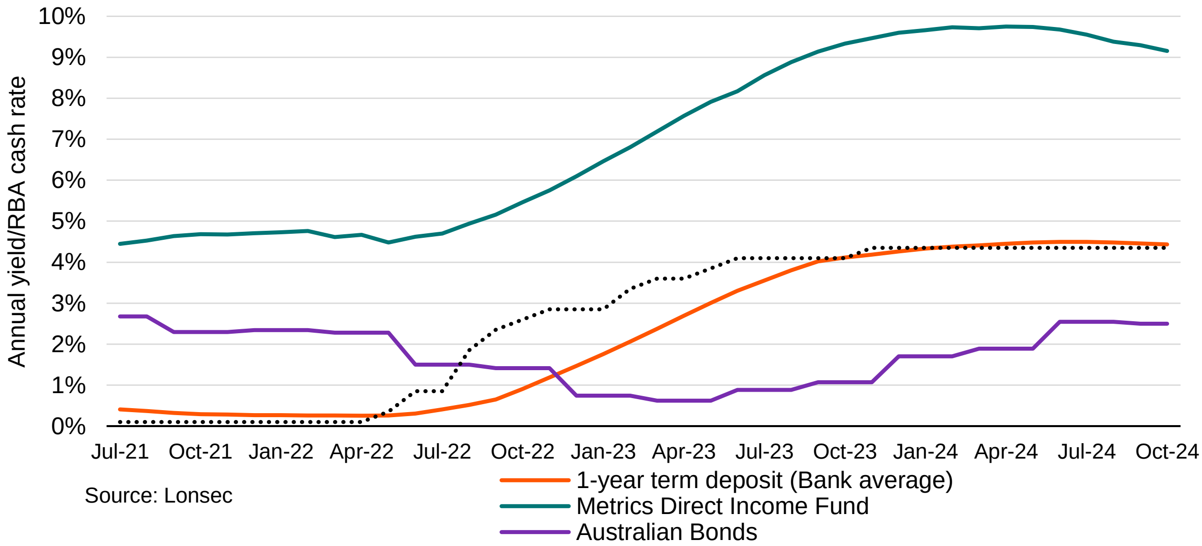
Demystifying private credit

What is private credit?

Private credit refers to a collection of investment strategies where a manager will take investor funds and using a fund lend this money to a range of borrowers in exchange for an agreed-upon rate of interest. The "private" part of the name refers to the fact that these loans are not traded publicly but instead held within the fund at valuations determined by the manager.

In addition these loans are typically structured as floating rate where a return above a benchmark rate (e.g. the RBA Cash Rate) is paid by the borrower. This offers greater leverage to boosting returns in a rising interest rate environment. By contrast traditional bonds or fixed income are priced with an initial rate that remains constant over the life of the bond. As we can see in the example below the Metrics floating rate strategy responds immediately to the tick up in the Cash Rate. By contrast Australian Bonds (proxied by the Vanguard Australian Fixed Interest Fund) sees a much slower response as the rise in the cash rate gets gradually reflected in new bond issuance.

Annual income return versus RBA Cash Rate (Jul-21 to Oct-24)



Source: Lonsec

Whilst private credit lending is growing rapidly it remains a small portion of the Australian lending market in aggregate. As noted by the RBA it accounts for less than 3% of total business borrowing as of August 2024[1]. Instead, the sector continues to be dominated by the major banks which collectively control the majority of borrowing in the market.

Private credit forms an important part of the financial system however. It can represent a stepping stone for borrowers who move from purely equity-financing (e.g. friends and family) to their first private credit facility as a way to grow their business. Eventually if growth has been material enough these borrowers "graduate" in quality (and size) to qualify for bank financing. This is typically at lower rates and a common feature of the lending landscape. In addition private credit can be a more flexible form of financing that borrowers prefer even if a bank lender is potentially available. For example a private credit manager may be able to offer finance more promptly than a bank which can be critical if time is of the essence. They may also be willing to offer more flexible terms such as receiving payment in equity rather than interest repayments which reduces the cashflow burden on the business. The key takeaway is that it is a feature of the credit landscape and one that appears set to stay.

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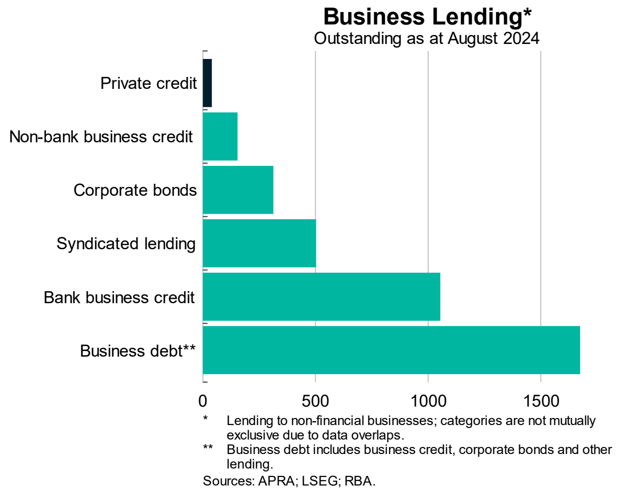
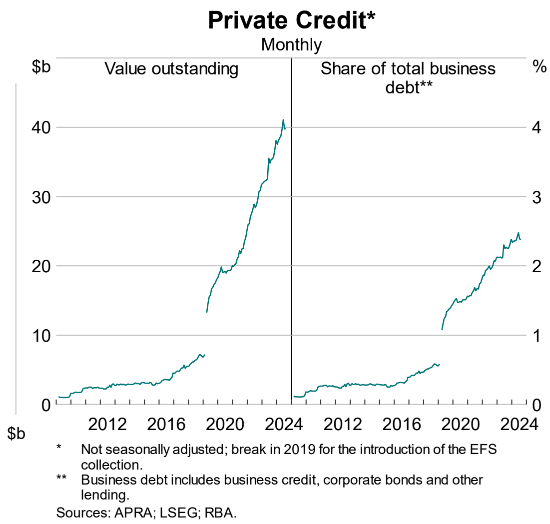
[1] A. Chinnery, W. Maher, D. May and J. Spille, 'Bulletin – October 2024, Growth in Global Private Credit', *Reserve Bank of Australia* (17 October 2024), https://www.rba.gov.au/publications/bulletin/2024/oct/growth-in-global-private-credit.html#:~:text=The%20Australian%20private%20credit%20market&text=RBA%20(A%2440%20billion)%20(,part%20of%20a%20syndicated%20loan (accessed 17 October 2024).





Source: RBA

Types of private credit

Broadly speaking, we see private credit come in three main forms here in Australia:

Direct lending

This category refers to loans targeting corporate borrowers. So for example a company may wish to borrow $10m to help fund a $20m acquisition. In this case a fund manager may fully fund the debt component themselves and provide the $10m. Alternatively, the debt may be syndicated which would see several investors provide a portion of the total amount and receive their equivalent share of the loan interest income.

One example of the type of loans underwritten can be seen below. Here the fund manager, Metrics, underwrote a floating rate debt facility to a private equity firm's portfolio company which will be used for funding ongoing spending needs e.g. operating costs and potentially capital spending. This is for a five-year period paying a floating rate.

Case study | LBO debt

The sponsor is one of Australia's leading mid-market private equity firms. Leading Australian manufacturer and supplier of condiments and sauces, primarily selling into the B2B channel with small but growing exposure in the retail grocery channels.

Metrics participated in a senior secured loan package.

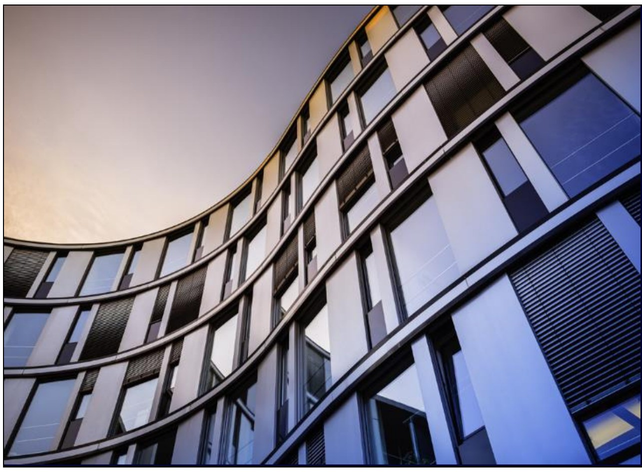
Credit rating	bb-
Sector	Consumer products
Limit	$40m
Loan term	5 years

Source: Metrics Credit Partners Presentation November 2024

Asset-backed lending

This type of lending refers to loans secured by so-called "hard" assets, typically real estate. The use of an asset security as collateral gives the lender a fallback option in the case of default by the borrower. As the majority of lenders write loans for a value below this security's value e.g. a loan-to-value ratio of 65% or below, there has tended to be few cases of capital loss even if a borrower defaults. This is because it would take the security declining over 35% in value before its value is less than that of the loan.

Other examples of assets promised as collateral include equipment financing. In most Australian cases, given the relative immaturity of our market, the security tends to be real estate however. One example of the type of loan that might be offered can be seen below.



Case study | CRE debt

The project comprises the construction of mixed-use development including 214 apartments, ground floor retail and commercial suites.

In April 2024, Metrics provided a land and construction facility to assist with the delivery of the project.

Location	Rhodes, NSW
Sector	Residential / Commercial
Limit	$242m
Loan term	2 years, completing Nov 2026

Source: Metrics Credit Partners Presentation November 2024

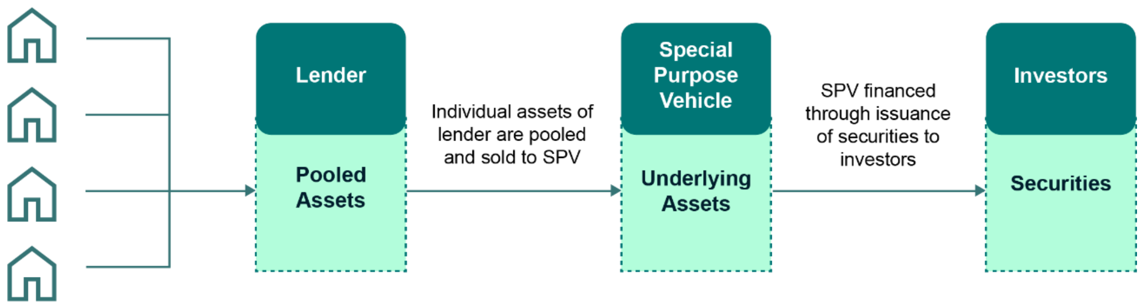
Here the lender is underwriting a mix of both retail and residential construction over a two-year period. This would be secured against a mix of both the land value as well as the assessed-value on completion of the site. In addition these facilities are typically segmented to protect the lender. This means that only a portion of the loan is released as the builder progresses towards completion. In taking this approach the lender reduces the downside in the event of a borrower default or other difficulties as they have not extended the full loan amount.

Securitised lending

This refers to pools of loans usually backed by physical assets such as property, cars or equipment. Investors purchase units which give differing units of seniority to this pool of loans. For example an A tranche will be paid out ahead of a D tranche. In addition if a series of loan defaults occur, the D tranche will weather more of these losses. The A tranche by contrast will not until the lower tranches are exhausted. It will, however, typically earn a lower interest rate in recognition of the higher degree of security it enjoys.

Typically the lender will source a range of loans and place these into a new entity known as a Special Purpose Vehicle (SPV) which is then on sold to investors in a unitised form split by multiple tranches. Tranches with lower ranking to the overall pool (meaning they are earlier in line to incur losses) will typically earn higher intertest to compensate for their greater level of risk.

Figure 2: The Securitisation Process



Source: Aquasia, *An Introduction to Securitisation* https://www.aquasia.com.au/an-introduction-to-securitisation/

Emerging categories

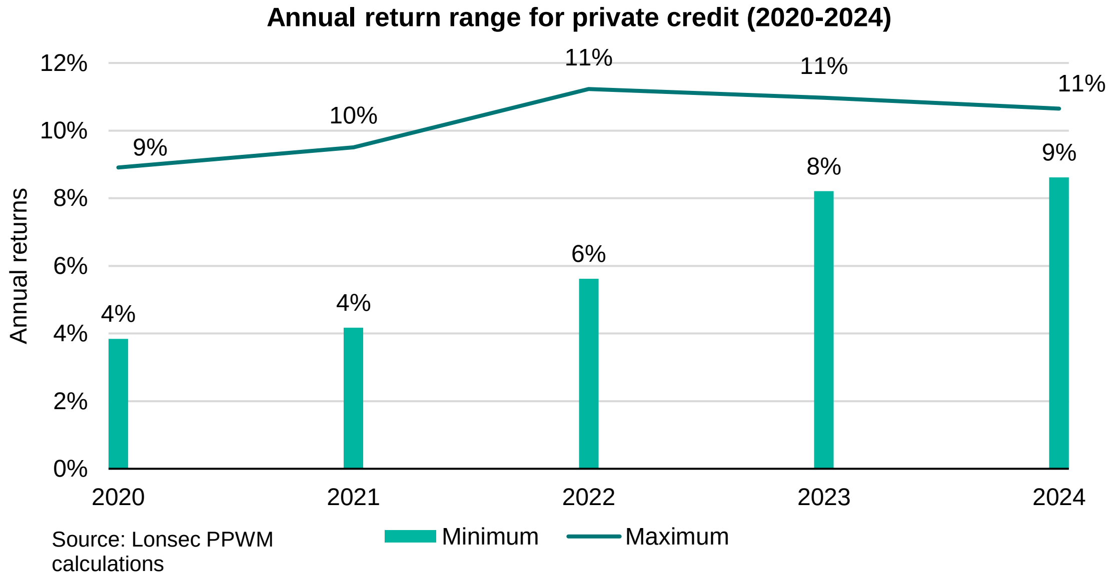
There are other emerging categories of private debt which are smaller in scope but more prominent in offshore markets. These include:

- Extending asset-backed lending from “hard” assets to intangibles such as contingent legal fee receivables or other receivables due from customers as well as other “hard-to-price” items such as intellectual property.
- Special situations opportunities can refer to companies in some form of distress or in need of a more specialised, often structured type of financing solution to finance a growth opportunity for example.

Returns

As mentioned above, the sector returns typically anchor around short-term interest rates. In the Australian case we typically see funds target an overall return of RBA Cash rate plus a margin. The below chart depicts a range of returns achieved by a subset of private credit funds. It is a reminder that there is significant dispersion in returns so investors need to aware of the nuances in this space. Funds can vary their return outcomes significantly by:

- Flexing the degree of leverage they’re willing to offer the borrower e.g. a loan-to-value ratio (LVR) of 60% would need the borrower to contribute 40% in their own equity versus an LVR of 80% contributing only 20%.
- Changing asset allocation to prioritise higher yielding sectors e.g. construction over syndicated corporate lending. In the former, you are taking on the risk that the construction is not successfully completed and demand a higher return as a result whereas the latter is targeting higher quality corporate businesses with diverse operations and pays a lower yield due to its lower risk nature.



Source: Lonsec PPWM calculations

Risks

Investors in this sector must face a range of risks that need to be factored in as part of the investment selection process. Some notable examples include:

- **Underwriting risk**: The investment manager cannot typically rely on external credit ratings given the borrower size and must vet the investment quality through their own processes and analysis. Mistakes or oversight at this juncture could result in extending credit to a poor-quality borrower and lead to capital losses as a result.
- **Default risk**: As with any lending investment there is a risk of a borrower defaulting on the loan and causing capital loss. This can be partially or completely mitigated by the quality of any security offered against their debt. It can also be countered by emphasising borrower quality as part of the underwriting process, reducing the likelihood of default occurring.
- **Valuation risk**: Investors face the risk of stale or misleading valuations for their investment. Manager disclosure rules vary and may understate the risk of an investment by failing to capture underperforming borrowers. For example, a Fund valuation may not recognise adverse investment performance until the borrower defaults, making the representations in the lead up to this event inaccurate and potentially causing investors to overpay as a result. This is an issue for the broader

superannuation sector including examples such as private equity and unlisted property as noted by APRA[2].

- **Liquidity risk**: These funds can struggle to meet investor redemptions in extreme cases. For example during the global financial crisis many strategies were forced to freeze redemptions due to a slew of investors seeking to redeem simultaneously[3]. This is somewhat reduced in private credit due to the typically shorter duration nature of the loans being offered compared to say unlisted property which can take far longer to transact. It is a factor that investors should be aware of and prioritise taking only as much liquidity risk as their circumstances can allow.
- **Concentration risk**; Lastly managers can, depending on their target niche, engage in high concentration amongst borrowers. This can leave the strategy exposed to poor performance due to over-exposure in a borrower that falls into arrears or even defaults.

What are ideal investment characteristics?

It is important to understand that it can be straightforward to find investments offering a wide range of returns in this space. This must, however, be balanced in our view against taking reasonable risk for the return outcome being sought.

For our purposes we like to emphasise several features we see as critical to the manager selection process. These include, but are not limited to:

1. **Diversification**: We need strategies that are well-diversified internally and do not over index on a particular sector or borrower. Importantly, we also should have a level of diversification between strategies e.g. real estate lending versus corporate borrowing to further reduce investor risk.
2. **Transparency**: it is important that managers are forthright on portfolio performance including flagging problematic investments and remain transparent to investors. This includes undertaking best practice in valuing investments and prompt communication if or when an adverse development returns.
3. **Fair returns**: We want to earn reasonable returns for clients without taking excessive risks. This requires understanding manager portfolios in detail and ensuring the return profile is commensurate with the different kinds of risks being undertaken.
4. **Experience**: Private credit is an emerging space where many strategies have not yet been tested over the course of different economic environments. We look to focus on teams and individuals that possess this experience including, but not limited to, track records that highlight their resilience under testing market conditions.

Conclusion

In summary we have introduced the concept of private credit investments and their varying iterations. This piece also highlights both the return and risk profile these strategies offer to investors and closes with a focus on what to look for in one's portfolio from our perspective.

We encourage you to engage with your adviser if you have found this piece of interest and would like to learn more.

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[2] H. Wootton, 'Super funds fall short on unlisted asset valuations: APRA', *Australian Financial Review*, (19 June 2024), https://www.afr.com/policy/tax-and-super/super-funds-fall-short-on-unlisted-asset-valuations-apra-20240619-p5jn4m (accessed 17 November 2024).

[3] D. McCormick, 'It's time for investors to face the truth about frozen funds', *Money Management*, (15 March 2010), https://www.moneymanagement.com.au/features/editorial/its-time-investors-face-truth-about-frozen-funds (accessed 20 October 2024).

Hybrids, where to from here?

The investor's guide to the phase-out of hybrid securities in Australia

The proposed phase-out of bank-issued hybrid securities should be an invitation for investors to reassess their portfolios and their risk appetite as they chase yield in the future.

Bank hybrids have long been part of investment portfolios, with their unique blend of debt and equity characteristics that appeal to both institutional and retail investors.

But their days appear to be numbered – and new issuances could cease by 2027.

In September, the Australian Prudential Regulation Authority (APRA) announced plans to phase out bank hybrid securities, a move largely seen as a response to the sudden collapse of global bank Credit Suisse in 2023.

APRA states the proposed changes “seek to support financial system stability at times of crisis … and banks would remain ‘unquestionably strong’.”

This was supported by the Australian Securities and Investments Commission, who considered bank hybrids too risky for retail investors, as many do not grasp their risk level.

The proposed framework would commence from January 1, 2027, with all current bank hybrids expected to disappear by 2032. This approach offers a gradual exit strategy for the hybrid market, enabling a smooth transition as existing hybrids reach their first call dates.

Many investors see bank-issued hybrids as a safe bet, and they are popular amongst retirees. Hybrids pay a set margin above the bank bill swap rate and, if purchased at issue, they are purely a yield investment, with the investors anticipating their capital will be returned at the first call date.

Hybrids are traded on the ASX where investors can purchase at the prevailing market price, with a return comprising both income and capital. The capital return can be positive or negative as it is a product of the difference between the purchase price and the face value of $100. An investor buying on-market today can expect a total return around 6%-7% inclusive of franking, depending on the issuer and time remaining to the first call date.

With numbers like that, it is among the higher yield investments when compared with government bonds, investment grade corporate bonds or even dividends from direct shares.

So, if retirees were to lose a good income source, how do they replace that in the portfolio?

There isn’t a genuine "like-for-like" replacement for bank hybrids, which creates a void and a temptation for investors seeking similar yield to turn to higher-risk alternatives.

Investors could look to high-yield bonds or private credit but need to be aware of the different risks – these offer a very different risk profile to a hybrid issued by a Big 4 bank.

Hybrid securities are listed on the ASX and offer flexibility and liquidity that alternative investments may lack.

Although private credit funds may offer liquidity windows, these are often capped at 5% of the value of the fund. Investors should also consider where the capital ultimately ends up. For example, funds lent for property development are tied up until project completion, meaning liquidity is contingent on asset sales, creating problems for investors seeking an earlier exit.

Pitcher Partners’ clients were among those to have hybrids in portfolios in the past, but we've been letting them run off for some time.

That money has been reallocated between defensive investments that provide yield, such as government bonds and investment grade bonds, while also allocating to higher growth alternatives including unlisted infrastructure, which has a yield component.

Another option has been to deploy capital into a very select group of private debt funds that are not lending to developers but to high quality corporates. There is limited liquidity in these funds but in our opinion, sufficient return premium to justify giving up immediate access to capital.

So, there are options for investment, but investors should first reflect on the objectives of their portfolio before deciding the best course of action. Start with fundamental questions, such as what role did hybrids play in my portfolio? Do I need similar liquidity, risk exposure, or yield?

The proposed phase-out of bank hybrid securities marks a notable shift in the Australian investment landscape, but investors can adopt a proactive approach to restructuring their portfolio, by:

- Evaluating options not only for yield but for liquidity, risk, and alignment with their broader financial goals.
- Conducting thorough assessments of alternative instruments, focusing on factors like their overall asset allocation, market conditions, and risk tolerance; and
- Recognising that the absence of hybrids may shift demand across other sectors.

Take a fresh look at risk appetite, liquidity needs, and long-term goals of your portfolio to create tailored strategies that can be put into action as hybrids mature.

A focus on strategic decision-making will help investors navigate the changing landscape and preserve yield potential.

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Technical update: Super reform on the bench

The Federal government's proposal to raise taxes on superannuation accounts over $3 million by revising Division 296 has faltered at the last hurdle. The government failed to secure adequate support for the measure from opposition parties and has now postponed the measure[4].

This tax proposal faced substantial community opposition along two dimensions:

Apprehension over taxing superannuation

An additional tax increase of superannuation was seen as detrimental to retirement goals particularly with the lack of indexation to inflation. This would mean proportionately more Australians fall into this category over time and will be set to face higher taxes as a result reducing the overall pool of savings available to offset demand for the Age Pension.

Creating a principle of taxing unrealised gains

The targeting of unrealised gains was the bigger issue however. This is largely unprecedented in how our system operates with respect to wealth taxes where taxes are typically levied as a result of a realisation e.g. selling the shares to another buyer. To instead charge on realised gains forces an individual to either sell an investment (potentially incurring capital gains tax as well) to fund the tax payment or be forced to find the funds from elsewhere.

We had already observed some clients and members of the industry contemplating strategy changes to counteract the tax's implementation. In some cases people already looked to move assets or unwind trust structures such as self-managed superannuation funds.

Conclusion

The reform appears to have been postponed permanently given it was not included in the blitz of legislation that successfully passed in the last sitting of Parliament in November[5]. This saga serves as a reminder of the temptation to intervene in superannuation as the overall pool of savings continues to expand. During the pandemic we saw one such example through the Early Access scheme[6] and more may be forthcoming over the medium term. For now however, absent any commitments in next year's Federal Election, this reform proposal is off the table.

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This view is general advice only and does not take into account your personal circumstances or finances. If you have further questions, we encourage you to consult with your adviser.

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[4] '$3m super tax official abandoned for this year', *SMSFAdviser* (28 November 2024), https://www.smsfadviser.com/news/24022-3m-super-tax-officially-abandoned-for-this-year, (accessed 30 November 2024).

[5] P. Coorey, 'PM's legislation blitz clears decks for election', *Australian Financial Review*, (28 November 2024), https://www.afr.com/politics/federal/prime-minister-clears-the-decks-for-an-early-election-20241127-p5ktt4, (accessed 30 November 2024).

[6] H. Wootton, 'Coalition's early super access scheme largely used to get cold hard cash', *Australian Financial Review*, (16 March 2023), https://www.afr.com/policy/tax-and-super/coalition-s-early-super-access-scheme-largely-used-to-get-cold-hard-cash-20230316-p5cspg, (accessed 30 November 2024).

Making business *personal*

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