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With Private Credit Funds it's protection not a recession that matters

For the investor, private credit funds can provide a steady income stream and a simple way to diversify your portfolio. Brett Craig is Portfolio Manager for both the Aura High Yield SME Fund and the Aura Core Income Fund and identified a market gap left by the banks, in the provision of funding to small and medium-sized enterprises (SMEs). With SMEs searching for alternative sources of credit beyond the major Australian banks, investors are afforded an opportunity to provide funding with a professional manager filtering the opportunities and assessing the risks.

By Roger Montgomery
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We've recently been speaking around the country with investors and their advisers to explain the features and benefits of private credit funds, specifically the Aura High Yield SME Fund and the Aura Core Income Fund. Both funds invest in pools of Australian small to medium corporate loans, originated by non-bank lenders.

The Aura High Yield SME Fund has a near six-year track record generating monthly cash income with no negative months, even during the pandemic, yet some advisers point out that private credit funds haven't been tested through an economic cycle.

In response, they think about investing in the funds 'tactically', waiting for a recession or some sort of economic setback before proceeding. Some advisers believe there will be an economic slowdown and conclude credit margins aren't high enough to compensate for that risk.

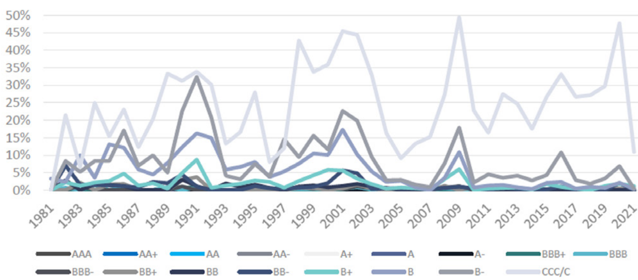
> Timing investments to side-step, what might arguably be the most predicted recession in history, has some obvious and detrimental second-order consequences that don't require repeating here.

Putting those aside and assuming the predictions are correct we are fortunate to have ample data concerning the performance of asset-backed, interest-bearing securities during previous market cycles.

When these are combined with an understanding of the structure of the Aura High Yield SME Fund and the Aura Core Income Fund, and in particular, the unique character of the relationship between the Aura funds and the underlying lenders, we are afforded some comfort.

Figure 1. Default experience through history

(click to enlarge)



Source: S&P Global 2021 Annual Global Corporate Default and Rating Transition Study: One Year Global Corporate Default Rates By Rating Modifier (1981 2021)

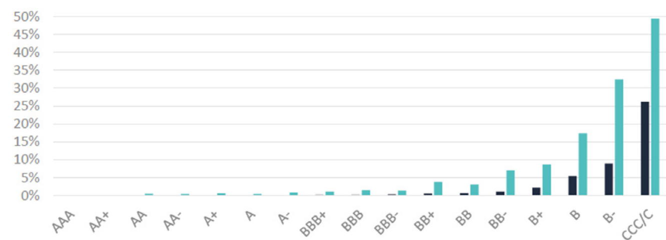
Figure 1. reveals the varying default experiences of corporate loans sorted by rating from AAA to CCC/C over the last four decades. Clearly, lower-grade securities receive their ratings for a reason. More of them defaulted during tough economic times, such as during the recession of the early 1990s ("The recession we had to have"), the aftershocks of the tech wreck in 2000, the global financial crisis of 2008/09, and most recently, the devastation wrought by the COVID-19 pandemic.

Figure 1., reveals that defaults are positively correlated to economic conditions. When the performance of the economy worsens, so does the frequency of defaults. In other words, defaults are procyclical.

Figure 2., displays the data as an average experience over all the cycles in the last four decades, revealing there is merit in S&P Global's credit classification system, with average and maximum default experiences aligning with the ratings of the underlying securities.

Figure 2. Average and maximum default experiences over 40 years

(click to enlarge)



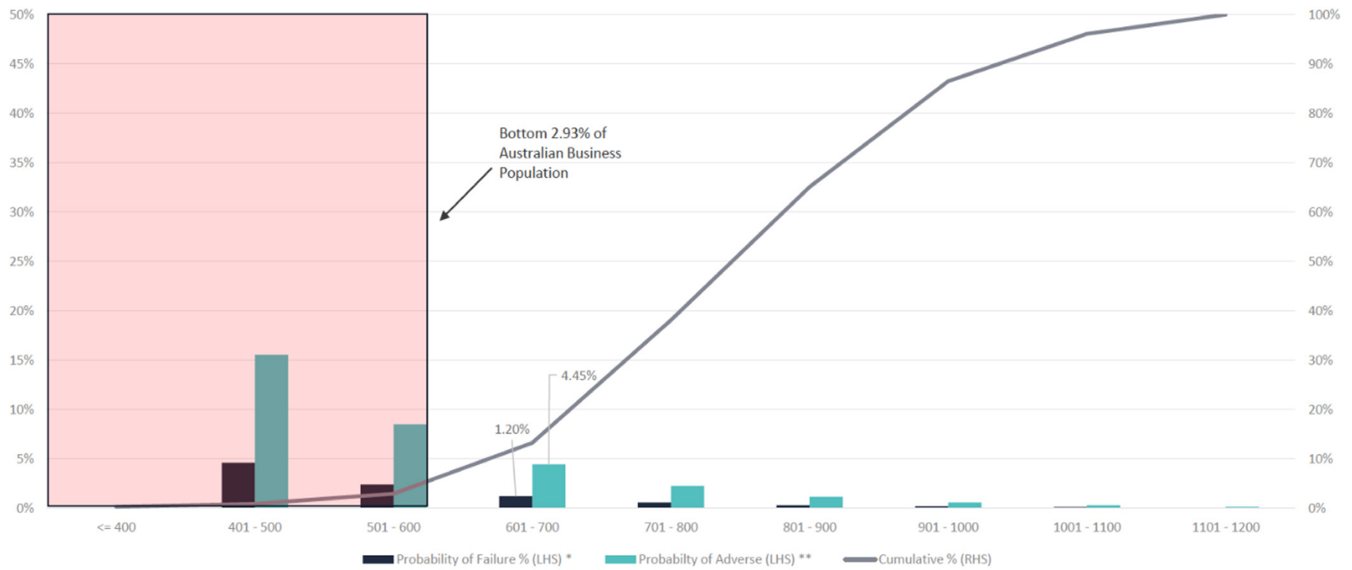
Source: S&P Global 2021 Annual Global Corporate Default and Rating Transition Study: One Year Global Corporate Default Rates By Rating Modifier (1981 2021)

The global historical experience suggests 'you get what you pay for'. Those looking for the lowest price receive the highest (junk) yield, and that yield must compensate for the higher risk of default. The risk/reward theory is supported empirically.

Credit scores for Australian business borrowers

Atlanta-based Equifax, alongside Experian and Illion, provides scores for Australian business borrowers, making it easier for lenders to extend credit responsibly by assessing the risk of default for each customer.

Figure 3. Probability of failure and adverse events for Australian companies in next 12 months sorted by the Equifax credit score



Source: Equifax Australia

The Australian construction industry – Equifax credit scoring in action

An example of the scoring system in action can be seen in Equifax's warning about the state of the construction industry back in May 2022. Equifax Australia then warned the domestic construction industry would experience rising insolvencies while revealing small construction business operators were dipping into their personal finances to keep their operations afloat. Many entities in this sector rank in the Highly Speculative 'B' range and were already vulnerable to adverse business, financial and economic conditions.

A year later, and a third of the businesses Equifax assessed saw their credit ratings downgraded to 'CCC' / High-Risk Credit Watch category. And most recently, Equifax insolvency data for the financial year to April revealed construction insolvencies jumped 89 per cent. Construction insolvencies increased by 50 per cent in the second half of 2022 compared to the first half.

The construction industry now ranks in the top five of 'late-payers', and a higher proportion of construction businesses are experiencing eroding margins and reduced cash balances, with many reporting net cash outflows.

Probability of Australian businesses experiencing failure and adverse events

Figure 3., reveals the probability of failure and the probability of a business experiencing an adverse event. Adverse events, which are considered a leading indicator, can include default, court judgement, external administration or even missing an energy bill. The Equifax Credit Score is aligned to the prediction of such adverse events occurring, and being recorded on a credit report, in the next 12 months.

As Figure 3., shows, businesses with an Equifax score of 601 to 700 have a 1.2 per cent probability of failure in the next twelve months assigned to them and a 4.45 per cent probability of an adverse event.

How Aura Group limits exposure to default risk to less than 1.2 per cent

In addition to its own due diligence and analysis process, Aura prioritises the probability of failure and refrains from allowing its lenders to extend credit to corporates with scores below 600. By removing from consideration, the three per cent (2.93 per cent to be precise) of businesses with Equifax Credit Scores below 600, Aura further reduces the already extremely low risk of exposure to failed businesses by more than half.

What remains are businesses with scores between 601 and 1200 with a probability of default of no more than 1.20 per cent.

It is worth keeping in mind, in Australia, credit scores are updated every time there is a negative report. Curiously whenever a corporate applies for credit, it is considered a negative event. For example, if a courier, over the course of a year, applies multiple times to lease additional vans, it receives a negative adjustment to its score for each application. Clearly, this might not be an accurate reflection of any change to the business's ability to meet its obligations as and when they fall due. Still, it generally produces a conservative outcome with respect to the score.

And it is these scores, formed over a very large sample size and significant empirical experience, credit providers rely on.

Incorporating this information with the historical experience of, say, BBB-rated securities during previous recessions and financial crises (maximum default rates of less than two per cent), we can conclude that a conservative approach to extending credit offers investors a source of comfort.

Aura's selected lenders provides an additional level of protection

Finally, investors and their advisers should also consider another level of protection offered through the relationship structure between Aura and its selected lenders (also called originators). These are the financial services businesses that process the loan applications and select the business borrowers they will lend money to.

For investors in the Aura High Yield SME Fund, and the Aura Core Income Fund, this relationship requires the originator to add their own equity capital to the loan.

By way of example, take a book of loans with an initial value of $100 million. As part of that amount, the originator has extended $10 million of their own equity. And that $10 million is the first loss piece.

If any of the business borrowers do fail (in aggregate, there's less than 1.2 per cent chance of that occurring according to Equifax), and the security provided against those loans are unrecoverable, the first losses are experienced by the originator, not the investors in the funds.

First, the originator would lose some of the net interest they would have earned from the pool of loans. If the losses were broader among this pool of higher-scoring borrowers, such that all of the originator's net interest was eroded, the originator would then lose some, or all, of their principal.

For investors in an Aura fund to realise any diminution in interest earned or capital however, the defaults, and unrecoverable subsequent losses, need to exceed the credit scoring benchmarks established through history and the experience of Equifax, Illion and Experion. The defaults and subsequent losses must also then exceed the accrued interest earnings and capital of the originators who commit and expose those amounts to any losses first, and which further helps align the originator with the intention of the funds to lend only to higher-quality borrowers.

Excluding the COVID-19 inspired economic crisis, it is true that Australia has not experienced a recession for a very long time. It is therefore also true that few credit or debt funds have ridden a complete economic cycle. It would nevertheless be a mistake to assume that such a recession, should it occur will automatically produce outcomes beyond that which history has demonstrated, the same history that has informed the constantly-updated credit scores used in Australia to provide insights into the probability of such failures.

Conclusion

In assessing the suitability of the Aura High Yield SME Fund and the Aura Core Income Fund for a portion of a portfolio, investors and their advisers should consider the protections available at both the deal (loan) level and through the relationship structure between Aura and the lenders employed to originate, assess and fund loan applicants. And even if the world's most-predicted recession were to eventuate, it's not certain it would be a detriment to fund investors. For example, businesses with Equifax credit scores below 600 are removed from consideration. Thinking about Private Credit strategically rather than tactically may ultimately produce a more desirable long-term outcome for investors and their advisers.

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Learn more about the Aura High Yield SME Fund and the Aura Core Income Fund

If you would like to learn more about the Aura High Yield SME Fund (wholesale clients only), please visit the fund's web page to learn more: Aura High Yield SME Fund

For retail investors, if you would like to learn more about the Aura Core Income Fund, please visit the fund's web page to learn more: Aura Core Income Fund

Do you want to get in contact with the team at Montgomery?

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You should read the relevant Product Disclosure Statement (PDS) or Information Memorandum (IM) before deciding to acquire any investment products.

Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.

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You should obtain and carefully consider the Product Disclosure Statement (PDS) and Target Market Determination (TMD) for the Aura Core Income Fund before making any decision about whether to acquire or continue to hold an interest in the Fund. Applications for units in the Fund can only be made through a valid paper or online application form accompanying the PDS. The PDS, TMD, continuous disclosure notices and relevant application form may be obtained from www.oneinvestment.com.au/auracoreincomefund or from Montgomery.

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