

PENGANA DIVERSIFIED PRIVATE CREDIT FUND

29 August 2024

Dear Investor,

We are pleased to provide you with our quarterly newsletter for the Pengana Diversified Private Credit Fund (the “Fund”).

This letter includes:

- An update on the Global Private Credit investment environment; and
- Portfolio performance to 30 June 2024.

GLOBAL PRIVATE CREDIT INVESTMENT ENVIRONMENT

Economic and market sentiment in the US and Europe continues to be cautious. Views remain divergent regarding (i) whether inflation has been tamed; (ii) the timing and pace of easing – is it too early or too late; and (iii) whether economies will encounter a soft, hard, or no landing. Uncertainty will continue to drive volatility in asset prices and liquidity.

So how does this impact Private Credit and the Fund’s Portfolio?

Given the Fund’s investments in direct lending and opportunistic credit strategies, and being almost exclusively private, we don’t see any immediate impact. However, we have contemplated two “bookend” scenarios:

1. From a rates perspective, a drop in rates would have a positive knock-on effect through relieving interest burdens on highly levered corporates, increasing asset values, and increasing M&A activity – all positive dynamics for direct lending; and;
2. On the downside, to the extent fears of a hard landing continue, market volatility could create a sustained widening of credit spreads which, in turn, would create significant liquidity issues for businesses. Additionally, a commensurate reduction in asset prices could remove the consumption driven by the wealth effects of rising asset prices, resulting in an economic slowdown.

The Fund's portfolio construction holds us in good stead in either scenario given:

1. Resilience: The core of the portfolio is focussed on senior secured bilateral lending to defensive companies with structural protections;
2. Geographic diversification: While the US market remains attractive, there is a growing bifurcation in the European market between the top-tier private credit managers and the rest. The top-tier managers have significant competitive advantages that are difficult to replicate: pan-European scale, long-tenured teams with proven track records, and significant capital. As a result, they face less competition, resulting in attractive spreads and transaction terms;
3. Strategy diversification: Opportunistic strategies around the core senior secured direct lending offering. Strategies such as subordinated debt, full capital stack solutions, and accretion in equity positions for the Fund's distressed managers will perform well in growth scenarios. Strategies such as distressed debt and capital solutions for companies facing liquidity issues will perform well in contraction scenarios;
4. Manager quality: Their scale, differentiation, proven track records and experience underpin their transaction origination advantages and their ability to manage through economic downturns and attract a disproportionate share of new capital to reinforce their competitive positions; and
5. Multi-manager portfolio: With the illiquidity of private credit, it is not possible to opportunistically trade in and out of market opportunities. The Fund's multi-manager portfolio allows us to benefit from dynamic market conditions, while also mitigating adverse impacts of changing competitive dynamics and structural changes in the markets.

So, while the economic environment remains uncertain, we feel optimistic about the resilience and flexibility of the Fund's portfolio of managers to deliver attractive risk-adjusted returns.

Private Credit Market Dynamics

Direct Lending

In the US, there are varying competitive dynamics emerging in different segments of the corporate mid-market. In the upper mid-market, conditions are very competitive with the return of liquid markets, significant capital raised by mega-funds and BDCs, and still anemic transaction activity. This competition has created an opportunity for large borrowers to attract cheaper capital at less restrictive credit terms. By contrast, the core (~\$100m EBITDA companies) and lower middle markets are experiencing strong transaction activity, attractive spreads, and returns.

In Europe, the top-tier managers dominate the market and are experiencing favourable spreads and returns across the board with no degradation across all segments. This reflects the much higher barriers to entry in the European market, where a proven pan-European presence and scale are critical to maintaining well-diversified portfolios.

Our selection of long-tenured and proven managers has been well-positioned in this context for three reasons:

1. Their large-scale and tenured origination capabilities allow them to participate across the full mid-market spectrum. For example, during the market dislocation in 2022, they were able to execute senior secured deals at 650-750 over base rate, as compared to the long-term average of 500-600, for a portion of their portfolios. With the leveraged loan market returning in early 2024 and many mega funds, listed BDCs and new funds having large pools of fresh capital to put to work, many large-cap deals are being refinanced at tighter spreads and on a covenant-light basis. Having wide coverage of the middle market provides the Fund's managers with the flexibility to dynamically refocus their origination to the more attractive market segments and targets;
2. Diversification. Scale underpins diversification and reduces concentration. Combining this with strong product structures (e.g., call protection and pre-payment penalties) and robust portfolio management allows managers to optimise their portfolios across the competing variables of diversification, concentration, liquidity, spread, and net returns; and
3. Proven risk management disciplines. High-quality, mid-market direct lenders have proven track records of better than peer net loss performance. This is a function of disciplined origination and underwriting at inception, rigorous portfolio monitoring and credit surveillance to allow for early intervention when issues arise, and depth and experience in workouts and restructuring.

We believe there will be increasing dispersion of returns across managers given the economic and market dynamics. Further, we believe the quality of our manager selection and diversification mitigates individual performance risk in this environment.

Credit Opportunities

The Fund's portfolio takes advantage of market dislocation, volatility and distressed situations through its investments in credit opportunities and structured finance managers. These investments play a very important diversification role in the portfolio by providing flexibility to take advantage of relative value opportunities through credit cycles.

In the current elevated interest rate environment, the managers are cautious and focused on limiting credit risk by prioritising senior positions in the capital structure of high-quality companies, and downside protection through strong security and asset selection, lending to businesses that can survive through significant stress. However, they have also indicated they are seeing a large and growing transaction pipeline of the best quality deals they have seen in decades. We have included two examples below.

1. Tighter bank regulation implemented in 2022 is creating a structural funding gap in asset pools of banks, e.g. residential mortgages, SME loans, asset-backed finance. In response to regulatory changes, banks need to do three things: (i) shore up their provisions to deal with credit issues relating to commercial real estate; (ii) maintain client relationships where they will no longer be able to lend due to increased regulatory capital requirements; and (iii) improve their ROEs to enable access to equity capital by transitioning to more fee driven, capital light business models.

The Fund's structured finance strategies are in place to capitalise on this opportunity through their ability to underwrite investment grade and near investment grade bank originated and managed pools of assets that pay attractive interest yields and have amortising loan structures. This is a highly technical space that requires managers with strong credit, operational, and transaction structuring skills. A recent example of this type of transaction in the portfolio is as follows:

A second tier US regional bank came under liquidity and capital pressure. To shore up its capital base, it commenced a process to sell certain high FICO consumer and SME loans. One of the Fund's structured credit managers set up a special purpose structured finance vehicle to acquire the loans at a discount to par and with significant over-collateralisation. The deal was underwritten at a net IRR of 14% over an expected life of just under two years. The transaction is 3x ahead of schedule with regard to the cash flow payback profile, with more than half of the loans paid back in 6 months, and is on track to significantly beat the 14% IRR target as a result.

2. Persistent high interest rates have led to distressed situations where, for example, companies that levered up when base rates were at zero and need to refinance in the current environment are unable to do so given their over leveraged balance sheets. A recent example is as follows:

One of the Fund's distressed debt managers invested in a segment leading food business that has top three brand positions in its categories across international markets, with multiple times the market share of its nearest competitor in each market in an industry with high barriers to entry. The business became stressed due to significant margin compression as a result of higher inflation and increased raw materials costs. The distressed manager, over a period, purchased the company's senior secured debt that was to mature within 18 months, at 70 to 80 cents on the dollar. From this position, it negotiated a refinancing with the company that resulted in an extension of the company's debt maturity profile over five years, following which the manager was able to realise its investment. Over a 1.5-year transaction timeframe, they realised an IRR of 41%.

PORTFOLIO UPDATE

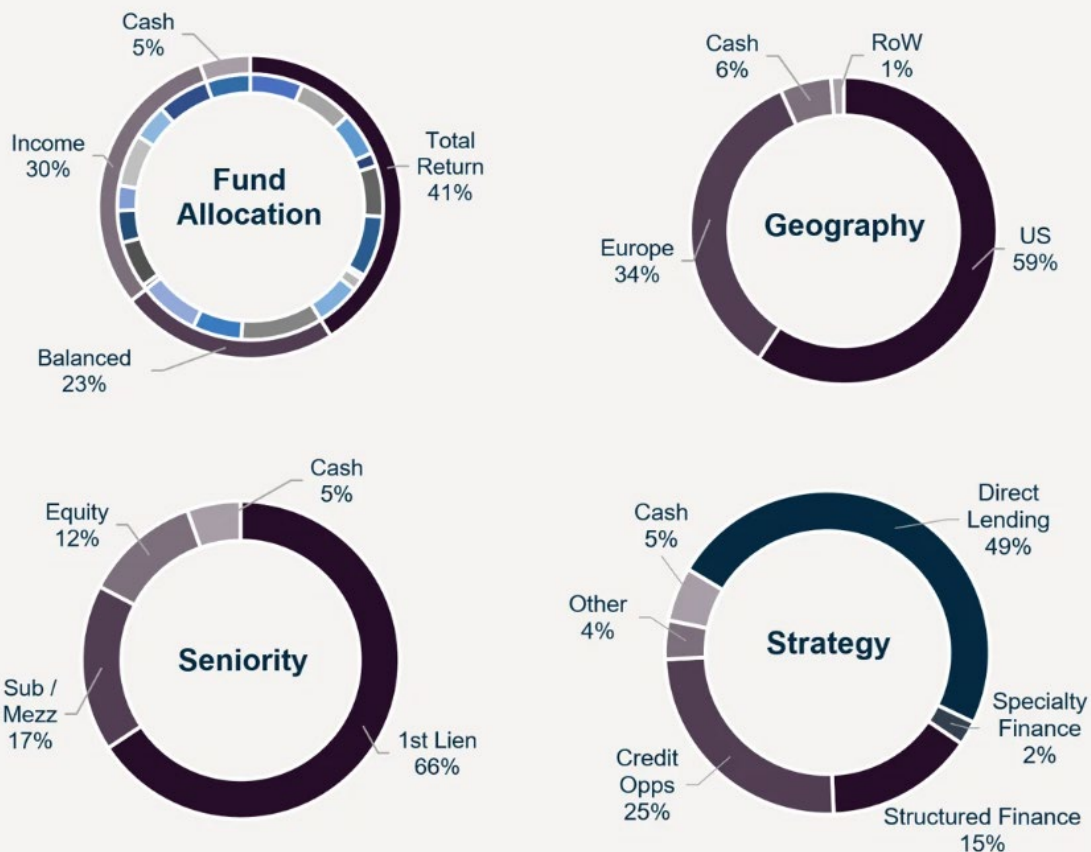
Within the current environment, mid-market companies in the Fund’s senior secured manager portfolios have proven to be resilient, experiencing revenue and EBITDA growth in the mid to high single digits with no deterioration in credit metrics. Cash yields at the manager level remain attractive, averaging 9.7% in the June quarter. At the same time, the credit opportunities-oriented strategies are performing strongly given the market volatility and favourable deal dynamics.

The benefits of these dynamics will emerge in the Fund’s NAV over the remainder of the year as we start to receive the underlying portfolio distributions and valuations, which are lagged by 3-4 months in some strategies. (Please refer to the ‘Portfolio Returns’ section below for a more detailed explanation)

We are in active dialogue with the Fund’s managers as Q2 reporting becomes available, with key topics being economic conditions and outlook, interest rate expectations, and changes in the lending environment. More recently, increasing concerns regarding the fragility of the US economy has increased market volatility and raised concerns about credit quality. For the Fund’s managers, watchlists and default rates have been stable, indicative of portfolio resilience and diversity.

The dynamic economic, market, and competitive environments will continue to evolve. With the quality of the managers and their differentiation, multiple strategies with different risk/return drivers, and the Fund’s geographic diversification, we believe we have constructed a portfolio that will prove resilient in any likely market environment.

Portfolio Composition



The portfolio is well diversified across geography, seniority and asset class and sits within target allocations.

New Investments

The Fund is invested in 19 underlying funds, with plans to onboard one additional fund in September. This will complete the onboarding of all funds in the initial target pipeline. Going forward, we continue to evaluate new funds to determine whether their inclusion in the portfolio will provide additional diversification benefits and enhance portfolio returns. Commitments to new funds will also ensure the Fund remains fully invested as existing closed-end funds move into their harvest periods.

Portfolio Returns

March quarter returns continued the recent trend of predominantly meeting or exceeding target returns.

- **Income class** funds reported weighted average returns of 3.0% for the quarter, which is at or above target returns.
- **Balanced class** funds reported weighted average returns of 2.6% for the quarter. This is towards the lower end of the target returns due to continued ramp-up of investments within these funds.
- **Total Return class** funds experienced a wider range of quarterly returns due to the differing stages of investment and realisation. On a weighted average basis, returns from these managers were approximately 4.5% for the quarter, which is above target returns.

The Underlying Funds continue to show strong results, which are not currently fully reflected in the Fund's performance. We index returns from the Underlying Funds at the RBA Cash Rate + 6% until the actual returns are reported by the managers, which can take 3 to 4 months. This means that during the lagged period until the actual returns are reported, the Fund's returns may be under or overstated depending on whether the actual returns are above or below the index rate. When the index rate is below the actual returns being achieved by the Underlying Funds, which we believe (based on manager conversations) is currently the case, the Fund's returns will be understated. While the most recent few months will always be impacted by indexing, the indexed proportion of the track record will diminish as the Fund's track record grows, and indexing will therefore have less of an impact on long term performance. There is also an additional dilutive impact while the Fund is growing quickly due to a short-term lag in the income received from new investments in Underlying Funds, however this will also diminish over time as the Fund reaches scale and inflows form a lower % of the NAV.

Net Returns After Fees (%)¹

	Q1	Q2	Q3	Q4	YTD ²
2024	2.62	2.06			4.73
2023				2.30 ³	2.30

Thank you again for providing us with the opportunity to be a custodian of your capital.

Yours sincerely,



Nehemiah Richardson
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Russel Pillemer
CEO Pengana Capital Group



Adam Rapeport
Portfolio Manager



Nick Griffiths
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1. Due to the lag in underlying fund valuation reporting, and in order to more closely reflect the current NAV for new investors, the Trustee adjusts the NAV by the RBA Overnight Cash Rate + 6% p.a. since the date of the last valuation provided by underlying managers.
2. Fund return reflects compounded movements in the NAV.
3. The returns for the first quarter were earned over 81 days rather than a full 3 months.

Pengana Capital Limited (ABN 30 103 800 568, AFSL 226566) ("Pengana") is the issuer of units in the Pengana Diversified Private Credit Fund (the "Fund"). An information memorandum for the Fund is available and can be obtained from our distribution team. A person should consider the information memorandum carefully and consult with their financial adviser before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This information has been prepared for Wholesale Clients only. This information does not contain any investment recommendation or investment advice and has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on this information a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Past performance is not a reliable indicator of future performance and may not be repeated.

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