PENGANA DIVERSIFIED PRIVATE CREDIT FUND

14 February 2025

Dear Investor,

Since our last update, two key themes have dominated news flow and investor queries regarding private credit: (i) how the actions taken by Donald Trump since being inaugurated as the 47th President of the United States will impact on performance drivers, particularly inflation and the absolute level of interest rates and economic conditions; and (ii) the continuing growth in the flow of funds to private credit and how this will impact on the sustainability of returns. In this update, we seek to provide some perspective regarding these concerns and how they may impact on fund performance.

The Trump Effect?

Trump has hit the ground running from inauguration day with a series of executive orders that have created significant uncertainty and increased volatility in global markets. Questions regarding the impact of tariffs, tax cuts and increasing budget deficits on inflation, rates and economic growth have created a wide range of prognostications about the implications for financial markets – both good and bad.

While we cannot predict the future, we feel confident that our core tenets of manager selection, diversification, and flexible portfolio construction will serve to mitigate the downside implications of any adverse outcomes and help to provide stability within increasing uncertainty given the following:

1. **Manager selection:** Our focus on selecting managers with proven track records of performance through economic cycles and market turbulence. Uncertainty and volatility have been the norm since the GFC. Managers with proven credit origination, deal construction, portfolio management and workout skills, and the ability to adjust to dynamic circumstances are the first line of defence. In particular, the focus on senior secured lending with significant equity cushions; resilient, non-cyclical industries; selective origination with lots of top of funnel opportunities and low conversion rates; selecting strong companies with significant market share and high free cash flows; and resilient deal structures and tight documentation;
2. **Portfolio diversification:** With over 2,000 loans across the US and Europe; 19 managers across 20 funds; different risk/return drivers from different strategies; the majority of borrowers in asset light, services oriented, non-cyclical businesses; and a focus on minimising concentration and correlations across the portfolio; we are well placed to mitigate these risks and create a very sound foundation of resilience; and
3. **Flexible portfolio construction:** Our all-weather portfolio is anchored with our Direct Lending managers but provides us with the flexibility to take advantage of dislocation, volatility and distress through our credit opportunities and multi-strategy managers, as well as to gain footholds in new and emerging strategies which attract enhanced economics through high illiquidity and complexity premia.

So, while uncertainty may reign, we believe we are well positioned to deliver attractive risk adjusted returns through our manager quality, diversification and portfolio flexibility.

Implications of Explosive Growth in Private Credit

Private credit has experienced significant growth since the GFC with over 15% compound annual growth to approximately $3 trillion of assets under management based on recent analysis published by Oliver Wyman[1]. This growth has raised many questions regarding the sustainability of returns and illiquidity premia, particularly around spreads and asset quality. While various segments of the market are experiencing heightened competition and less favourable terms, the structural dynamics remain positive. Key observations are as follows:

1. There is a growing bifurcation in the market between the mega funds in Direct Lending and smaller funds that have raised large amounts of capital but do not have large, existing portfolios. With the M&A market still subdued, these funds are having to compete directly with the leveraged loan market for new deals, which is driving significant spread contraction, up to 300 bps from 2022 levels, and poor deal structures and protections. While the mega funds can withstand this competition given their scale and significant, diversified portfolios of loans, smaller managers can only take pieces of these deals with no ability to manage or control outcomes. We expect there will be significant performance dispersion that arises as a result. This is already evident when looking at performance dispersion across the BDC market. Manager selection and portfolio diversification are key.
2. Where competition between public and private credit is most aggressive is in the large corporate and upper mid-market segments where private credit competes directly with the high yield and leveraged loan markets. While these markets are large, over $2.6 trillion of outstandings, they are subject to very large swings in capital supply, which reduce their reliability as a funding source for issuers. While the current trend is to refinance private credit transactions originated at very wide spreads when markets were shut in 2022, borrowers continue to recognise the value of flexible private credit solutions and the scale of managers who are able to deliver them, particularly when public markets are not available;
3. There are still very significant and growing structural opportunities for private credit strategies. For example,
    a. the top US banks have assets of more than $20 trillion with private credit being approximately 10% of that total. With banks continuing to focus on improving their capital efficiency and balance sheet optimisation as a result of increasing regulatory and market demands, private credit is expected to continue to absorb bank capacity;
    b. private equity dry power remains at all-time highs at US$2.6 trillion. Private credit's value proposition of certainty, speed, efficiency and discretion will continue to attract PE firms and their companies; and
    c. there is a fast-growing demand for private credit's value proposition in asset-backed markets across many different types of asset classes and strategies, many of which are the domain of banks or securitised credit markets. It is estimated that private credit accounts for less than 5% of a current addressable market of US$5.5 trillion, with expectations this will continue to grow as banks and non-banks seek bespoke, structured solutions. Specialist managers in these segments achieve very attractive illiquidity and complexity premia given the favourable supply/demand dynamics.

So, while the market continues to grow, we believe the structural opportunity will remain very attractive for many years to come.

Our master portfolio is very well positioned to continue to reap the benefits of these dynamics for our investors given:

- our clear line of sight to the industry dynamics and trends, existing and emerging managers, and our ability to assess and select managers through our partnership with Mercer;
- our Direct Lending portfolio is focused on the core middle-market, where there is no alternative to high yield or leveraged loan markets, and so credit spreads, deal structures and protections remain attractive for scaled, long tenured managers; and
- our ability to flexibly allocate across managers, geographies and strategies as market conditions evolve.

In summary, we remain very positive about the outlook for global private credit. While market conditions will continue to change with political, economic and competitive dynamics, our core focus and capabilities around manager selection, diversification and flexible portfolio construction provides investors with unparalleled access and the ability to realise attractive risk adjusted returns despite an uncertain macro environment.

PORTFOLIO UPDATE

Portfolio Returns

The September quarter valuations for our underlying funds were very strong overall, which is reflected in recent above target Fund returns.

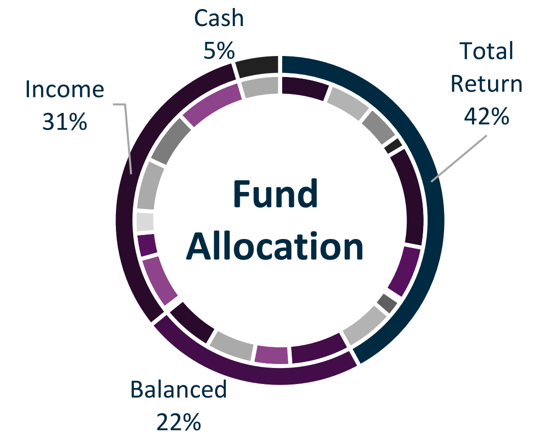
- ***Income class*** funds reported weighted average returns of 3.1% for the quarter, which is above target returns.
- ***Balanced class*** funds reported weighted average returns of 2.4% for the quarter. This is towards the lower end of the target returns due to continued ramp-up of investments within these funds. As at the end of 2024, these funds are more than 90% deployed, so we expect future returns to trend upwards.
- ***Total Return class*** funds reported weighted average returns of 5.3% for the quarter, which is above target returns. Of note, several of the funds that focus on credit opportunities performed extremely well on the back of global market volatility. Other funds are still in their ramp up phase and should start to contribute meaningfully to returns over the coming months.

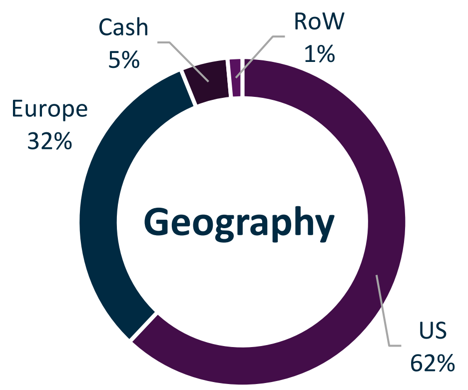
Over the December 2024 quarter, the Fund returned 3.56%. Based on discussions with the fund managers, and as more funds achieve scale, we expect returns to remain positive going forward.

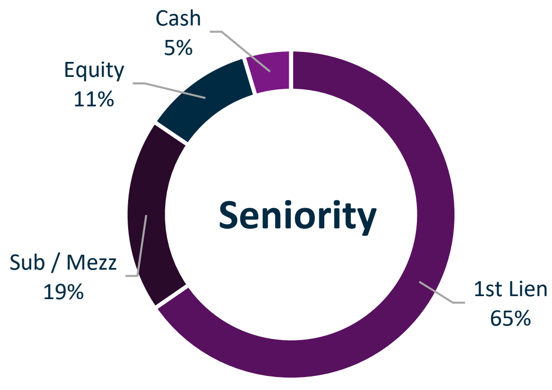
Net Returns After Fees (%)[2]

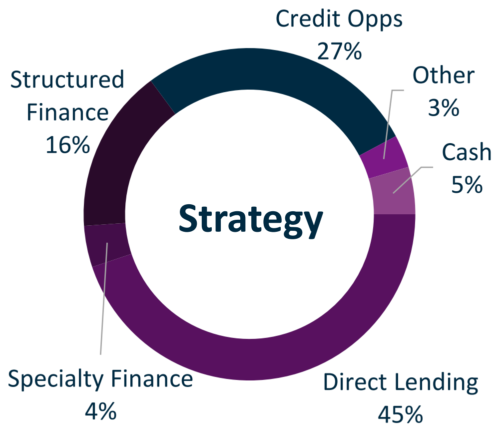
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD[2]
FY25	0.37	0.55	1.09	0.59	1.98	0.95	1.00						6.71
FY24				0.32	0.86	1.11	0.83	0.82	0.94	0.38	1.56	0.11	7.14

Portfolio Composition









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

New Investments

The Fund is invested in 20 underlying funds. We have identified several new funds which will provide additional diversification benefits and should enhance portfolio returns. We expect to make commitments to these funds progressively during 2025. Commitments to new funds will also ensure the Fund remains fully invested as existing closed-end funds move into their harvest periods. Being able to achieve this capital efficiency on a diversified basis in closed-end funds is a key differentiator of the Fund.

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

Yours sincerely,

Nehemiah Richardson
CEO Pengana Credit

Russel Pillemer
CEO Pengana Capital Group

Adam Rapeport
Portfolio Manager

Nick Griffiths
CIO Pengana Capital Group

[1] Oliver Wyman. *Private Credit's Next Act,* 2024.
[2] 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.

PENGANA CAPITAL LIMITED
ABN 30 103 800 568
AFSL 226566

PENGANA.COM

FOLLOW US

CLIENT SERVICE

T: +61 2 8524 9900

E: clientservice@pengana.com