How Perpetual manages private credit risk by knowing what not to own

By Perpetual Asset Management

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Private credit can offer attractive income, but recent headlines have reminded investors that the risks inside the asset class are not all the same, argues Perpetual's MICHAEL MURPHY.

- Focused lending to quality corporates
- Avoiding concentrated property development risk
- Find out about Perpetual's credit and fixed income capabilities

WHEN it comes to income investing, risk management starts well before a loan enters a portfolio.

"It begins with evaluating which borrowers, sectors and structures meet our quality threshold — and which don't," says Michael Murphy, a portfolio manager with Perpetual's Credit and Fixed Income team.

"We're really focused on quality and capital preservation," says Murphy. "We favour large Australian corporates that have sustainable competitive advantages and in markets that are resilient to economic downturns."

That discipline is particularly important in Australia, where property developer lending represents a significant share of the private credit market.

Perpetual's unconstrained and private credit funds do not engage in direct property or development lending, says Murphy.

Why property risk is treated differently

Many Australian investors already have meaningful exposure to property, either directly through residential or commercial assets, or indirectly through Australian banks.

Adding private credit exposure that is also concentrated in property development can therefore compound an existing risk, rather than diversify it.

"We're very mindful that investors typically have significant exposure to Australian property already, either through direct investment or exposure to Australian banks," Murphy says.

"So we really see value in providing diversification to large corporates rather than to property developer lending, which we don't do."

Instead, Perpetual typically invests in senior secured debt issued by high-quality, large Australian corporates.

"In the broad spectrum of private credit, it covers everything from a loan to a large corporate, say a Qantas or a Woolworths, all the way through to a loan to your local coffee shop," explains Murphy.

Perpetual typically only lends to large corporate and avoids small to medium enterprises (SMEs). These large corporate borrowers are generally established businesses with earnings history, scale and the ability to service debt from operating cash flows.

Murphy says that focus helps support the role credit is meant to play in a portfolio: providing income while prioritising capital preservation.

Quality is the filter

Perpetual's credit process is designed to identify issuers and assets of sufficient quality.

The team looks for companies with good balance sheets, predictable cash flows, competitive market positions and capable management teams with strong governance.

It also considers whether a business is exposed to regulatory change, political risk, litigation or other event risks that could undermine credit quality.

On sector selection, Murphy says the team looks for "strong economic moats" such as "scale, network effects and barriers to entry".

In software and AI-related lending, the question is whether the software "is able to be easily replicated by AI" — and, ideally, whether "AI can actually enhance the offering and add more value to customers."

This bottom-up assessment is paired with portfolio diversification.

Murphy says the team seeks to avoid concentration in any single sector or risk factor, aiming instead to build exposure across a range of industries where risk is being adequately rewarded.

"We want to be really diversified across a number of sectors and not have a real concentration to anyone sector or risk factor," says Murphy.

Hear more from Perpetual's Credit and Fixed Income team

About Michael Murphy and Perpetual's Credit and Fixed Income team

Michael is a portfolio manager and senior high-yield analyst with Perpetual's credit and fixed income team.

Michael manages Perpetual Diversified Private Debt Fund.

Perpetual offers a range of cash, credit and fixed-income solutions.

Our credit and fixed income team are specialists in investing in quality debt.

They take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Learn more about Perpetual's Credit and Fixed Income capabilities

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