THE LEAD
https://theleadpc.com/the-lincoln-senior-debt-index-last-of-three-parts/

The Lincoln Senior Debt Index (Last of Three Parts)

THE LEAD | May 13, 2021

"Thank you for this series. I'm curious how the benchmark accounts for where the loan is in the cap structure? For example, recovery rates for unitranche, 1st lien and second lien are different. Any portfolio would have to match the composition to effectively compare against the benchmark. Otherwise, you would need different benchmarks for each." – A Lead Left reader

Lincoln's Larry Levine answered (see our first *Chart of the Week*):

"We prepare various analyses of the Index. For example, looking at only first lien / unitranche, and separately, second lien. From a yield perspective, as one would expect, returns for second lien loans are higher but more volatile than first lien and unitranche. The latter shows average yields in our Index of 9.2%, while the former was 11.1%.

From a default viewpoint, Lincoln's default rates and fair values of loans experiencing covenant defaults have been constructed two ways: equally weighted and size weighted. In certain periods, when there are meaningful differences between the two portfolios, we prefer size weighted data. There, also as expected, the fair value of loans that experienced a covenant default for second lien loans is lower than that of first lien and unitranche loans. It should be noted the Index contains only performing loans. We tested the Index including impaired loans and the conclusions were not meaningfully different."

Turning to our final topic, let's compare the total return of the Lincoln Senior Debt Index relative to the S&P/LSTA U.S. Leveraged Loan 100 Index, a commonly accepted benchmark for broadly syndicated loans. As our second *Chart of the Week* highlights, assuming both Indexes start at 100, the Lincoln Senior Debt Index was 154.27 at year-end 2020 vs. the S&P/LSTA Index at 125.38.

Once again, Mr. Levine: "Virtually all the difference is attributed to income returns. Since 2016 the Lincoln Index return was 9.6%, while large caps were 5.5%. Compounding this 4% yield difference over time is meaningful."

How does the price or fair value of a portfolio of direct lending loans compare to the BSL market? "While the correlation between the Lincoln Senior Debt Index and S&P/LSTA Index is high (about 86%), prices (as measured by fair value) of the Lincoln Index exhibit much lower volatility than BSLs.

"In part this is due to the impact of LIBOR floors, particularly in low interest rate environments. As we discussed last week, floors in direct lending are more common than in the BSL market. In effect, whenever LIBOR is below 1.0% (the typical direct lending floor) the loan becomes a fixed rate investment. Today three-month Libor stands at 18 basis points.

"Then there's the issue of illiquidity. Direct lending loans trade infrequently, if at all, compared to BSLs. Finally, capital flows. BSL investors have a greater ability to monetize their investment (though in times of market volatility, at significant discounts) should they wish to exit the market. This illiquidity premium for direct lending loans is reflected via a higher interest rate.

“In other words, investments in direct lending funds are generally structured with limited investor redemptions. On the other hand, by their liquid nature, BSL investors have more opportunities to exit. But that can come at a cost: the significant capital outflows from retail loan funds in the first half of 2020 was a good example, resulting dramatic price declines.

“Middle market loan values held their own during that same period, demonstrating much less correlation to broader market moves – a virtue our valuation data clearly depicts.”