The Lincoln Senior Debt Index (Second of Three Parts)

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Private debt, compared to private equity and real estate, is a relatively recent entrant to the alternative asset class. But that market has grown faster than others over the past decade. In 2007, just before the Great Recession, private debt AUM measured less than $200 billion. Today the universe of illiquid credit is $900 billion with growth estimates of 50% over the next 5 years.

As discussed last week the Lincoln Senior Debt Index provides lenders and investors a much-needed tool to assess portfolio performance and benchmark returns in an otherwise opaque market.

We continue our conversation with Lincoln's Larry Levine:

Larry, what is the average yield investors can expect to achieve in the direct lending market?

"The average yield of the Lincoln Senior Debt Index is 9.6%. The decomposition of yield changes over time with recent yields being a function of spread and Libor floors. That highlights the importance and stabilizing qualities of floors, particularly when Libor dropped below 1.0%.

"Loans in the direct lending market contain Libor floors more frequently than those in the BSL market. In low interest rate environments, the impact of those floors becomes a significant component of total returns. In effect, it's a fixed rate despite being a floating rate instrument."

And what has been your experience of price (i.e., fair value) for direct loans?

"Private debt investors understand returns are comprised mainly of interest income rather than capital gains. A portfolio of direct lending loans will always have a value at par, or below, since the fair value of private debt is generally capped at 100 cents on the dollar (or as relevant, the call premium). Hence capital appreciation is capped, but downside risk is uncapped.

"The combination of a ceiling on capital gains combined with the likelihood that at least one loan in a diverse portfolio will have a fair value less than 100 means that the fair value of a direct lending portfolio will likely be below par."

Larry, two key risks for private credit are changes in borrower performance and changes in interest rates. Which of these are more significant as measured by your Index?

"While certain fixed income asset classes are homogeneous (i.e., US Treasurys and pools of mortgage loans), loans in the direct lending market are heterogenous. Unlike other fixed income markets, total direct lending returns are dominated by changes in credit performance, rather than changes in Libor. Understanding the credit profile of each portfolio loan is more relevant to returns.

Finally, Larry, you've mentioned Lincoln had academic assistance in creating the Index.

"Yes, one of our Senior Advisers is Professor Pietro Veronesi. Professor Veronesi is the Chicago Board of Trade Professor of Finance at the University of Chicago, Booth School of Business. Among other accomplishments, he is the author of Fixed Income Securities: Valuation, Risk, and Risk Management and the Handbook of Fixed Income Securities. Professor Veronesi provided invaluable insights into the construction of the Senior Debt Index."

Next week: We conclude our special series comparing direct loans vs. BSLs.