

LSDI

**LINCOLN SENIOR
DEBT INDEX**

INTRODUCING: The Lincoln Senior Debt Index

Lincoln International is pleased to release the quarterly Lincoln Senior Debt Index (LSDI). The LSDI represents years of research and analysis of data and was developed by professionals from Lincoln's Valuations & Opinions Group in collaboration with Professor Pietro Veronesi of The University of Chicago Booth School of Business.

For the quarter ending March 31, 2023, it was good news and bad news for the direct lending market. The good news was that the LSDI yield reached its highest point in its history at 11.6% or a two basis point increase from December 31, 2022 and fair value was stable quarter over quarter at 96.3. However, defaults as of March 31, 2023 continued to increase rising by 30 basis points to 4.5% from 4.2% as of December 31, 2022. In other words, lenders benefited from high interest rates resulting in record yields and stable prices while the accompanying economic slowdown in revenue and earnings combined with high interest rates created additional credit stresses in portfolio companies.

Over the long-term the direct lending market and broadly syndicated loan (BSL) market are highly correlated. However, for the quarter and year ending March 31, 2023 the two markets performed quite differently. The most notable difference is the yield differential between the LSDI and BSL market. For the quarter ending March 31, 2023, the yield difference was only 2.3%; on average since 2016 the yield difference has been 3.9%. LSDI yields have risen from 8.7% to 11.6% (2.9%) from March 31, 2022 to March 31, 2023 whereas BSL yields have risen from 4.4% to 9.4% during this same period (5.0%).

The LSDI provides insight into the direct lending market as it is a fair value index consisting of four components:

1. Total return (income return plus capital gain return);
2. Price (i.e., fair value);
3. Spread; and,
4. Yield to maturity.

Each of the four components are then categorized into three types of senior loans:

1. All senior loans – consisting of first lien, Unitranche, and second lien loans;
2. Senior loans consisting of first lien and
3. Second lien loans.

In addition, we provide additional descriptive statistics including: (a) loan-to-value; (b) the impact of interest rate and credit changes on total return; (c) the results of stress testing spread changes in the current and subsequent quarters and, (d) default rates.

The U.S. non-investment grade corporate loan market has two segments: the BSL market, which attracts larger companies (i.e., as an approximation companies with EBITDA greater than \$150 million) and direct lending market (i.e., companies less than \$150 million of EBITDA). While correlated, there are subtle but significant differences between the two markets. Both markets primarily provide floating rate loans; however, divergences exist in terms of market liquidity, company size and credit facility size. Given the greater liquidity in the BSL market, pricing and terms are a function of technical market and competitive factors, whereas the more illiquid direct lending market has a stronger orientation to assessing company fundamentals.

In contrast to the Morningstar LSTA US Leveraged Loan 100 Index which is comprised of companies borrowing in the BSL market, the constituents in the LSDI are virtually all companies borrowing in the direct lending market.

KEY OBSERVATIONS: Lincoln Senior Debt Index

Q1

2023

How We Obtain the Information

On a quarterly basis, Lincoln values more than 4,500 private companies primarily owned by over 125 alternative investment funds and lenders to funds. Most of these companies are levered via borrowings from the direct lending market. A significant percentage of the LSDI constituents are based upon valuations of loans provided for non-public business development companies and other private investment vehicles and, therefore, not disclosed in public filings.

For many of the private companies valued quarterly, Lincoln advises on the fair value of at least one senior debt security in the capital structure. All valuations conform with GAAP

and fair value principles and have been reviewed by fund management, fund boards, limited partners and auditors.

Additional information can be found in our methodology discussion and on our website.

The direct lending market is a significant source of capital to private equity backed middle market companies. The LSDI benefits market participants by providing information to facilitate a greater understanding of the attributes of this important source of capital to the private sector.

96.3

Average Fair Value
of Loans in the Index
as of Q1 2023

LINCOLN SENIOR DEBT INDEX - KEY OBSERVATIONS - ALL LOANS - FIRST QUARTER 2023

- The LSDI returned 2.6% for the quarter ending March 31, 2023. This represented one of the highest quarterly returns since the inception of the LSDI which began in Q4 2014.
 - Returns consist of two components: (a) interest income; and, (b) capital gains or losses. Both income returns and returns from capital gains were positive due to increasing interest rates and yield and stable prices.
- Yields between the direct lending market and BSL market are compressing. Direct lending loans have yielded on average a 4.0% positive yield premium as compared to yields for loans within the Morningstar LSTA US Leveraged Loan 100 Index since 2016. However, this quarter the yield differential was only 2.3% as BSL yields are now the highest since the inception of the index in 2016.
- Prices in the BSL market increased \$1.00 to 93.9 as of March 31, 2023 while the LSDI was unchanged at 96.3.



RESULTS: Total Return

Q1

2023

Comparison of Total Return – Lincoln Senior Debt Index (All Loans) to Morningstar LSTA U.S. Leveraged Loan 100 Index



Observations:

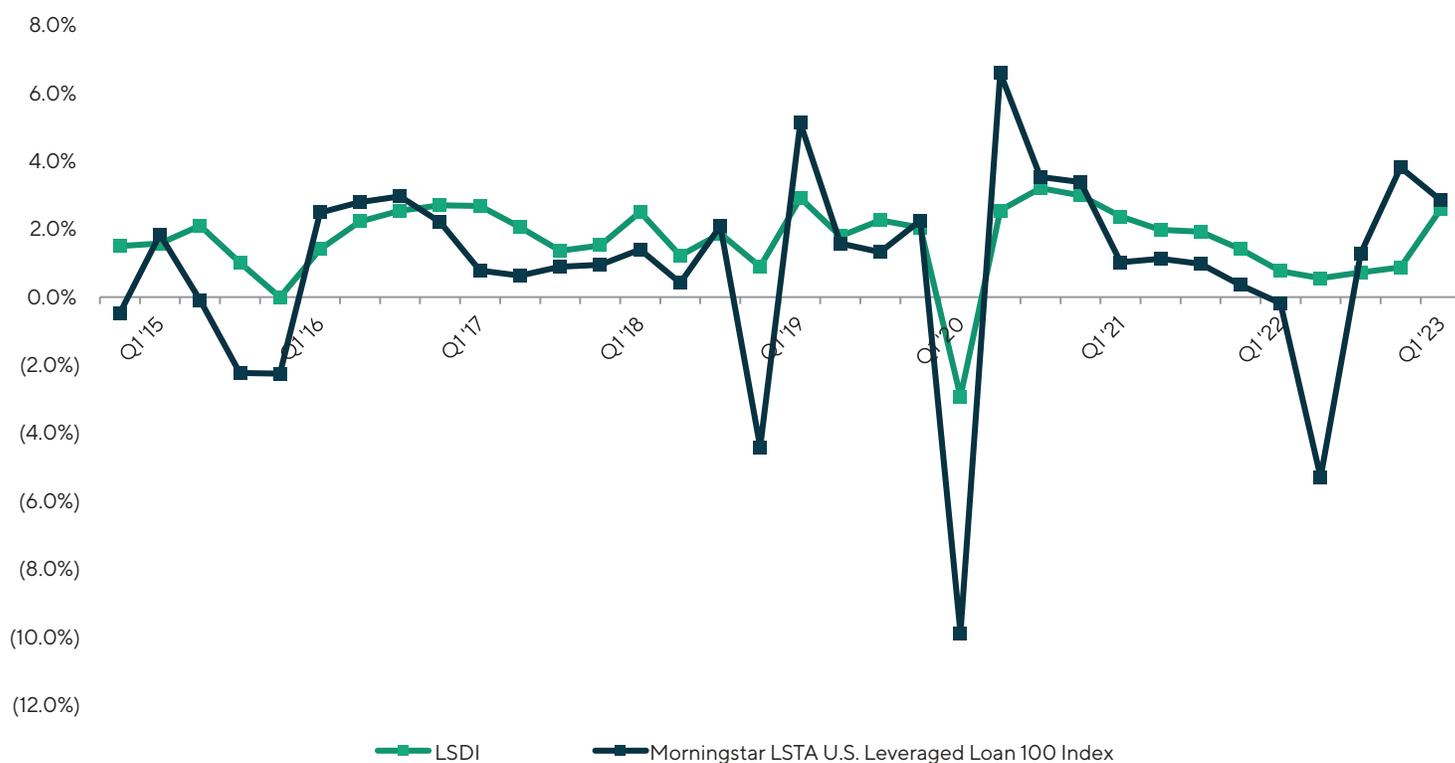
- Investment return is generated from two sources: (1) capital gains and losses; and, (2) income return. In the leverage lending asset class, income returns dominate capital gains or losses, resulting in a positive quarterly total return.
- Since the inception of the LSDI, both the Morningstar LSTA U.S. Leverage Loan 100 Index, which measures the performance of the BSL market, and the direct lending market have experienced an increase in total return. BSL returns for the quarter ending March 31, 2023 were 2.9% versus the LSDI of 2.6%.
- Given the relatively high level of interest rates we expect returns to remain high by historical standards.

RESULTS: Total Return (cont.)

Q1

2023

Correlation and Comparison of Quarterly Returns – Lincoln Senior Debt Index (All Loans) to Broadly Syndicated Loan Market



Observations:

- While the correlation between the LSDI and Morningstar LSTA 100 Investment is high at approximately 81%:
 - the LSDI is significantly less volatile; while,
 - generating higher returns.
- Investments in the direct lending market experience higher returns and lower volatility than the BSL market.
- The direct lending market experiences negative returns much less frequently than the BSL market, given its higher yields.
- Since the inception of the LSDI on September 30, 2014 through March 31, 2023, only the quarter ending March 31, 2023 reported a negative quarterly return whereas the BSL market has experienced eight quarters of negative returns.

RESULTS: Yields

Q1

2023

Comparison of Yields - Lincoln Senior Debt Index (All Loans) to Broadly Syndicated Loan Market



Observations:

- Due to rising interest rates, the yield of the LSDI was 11.6% for the quarter ending March 31, 2023 unchanged from the prior quarter.
- The LSDI yield of 11.6% was the highest yield since inception of the index. The yield for the BSL market was 9.4%.

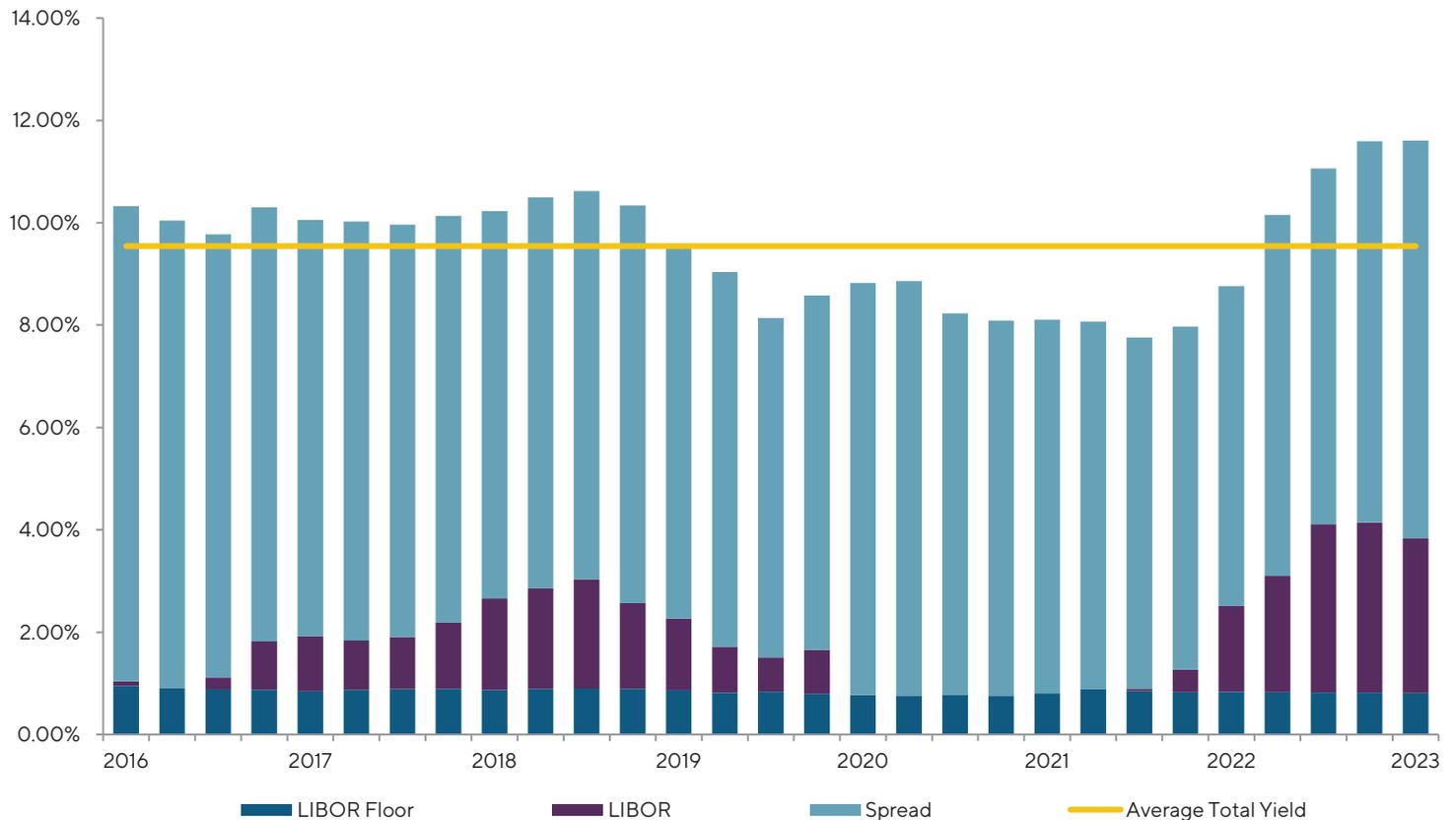
RESULTS:

Decomposing Yields in the Direct Lending Market – LIBOR Floors and Spreads

Q1

2023

Decomposing Yield – LIBOR, LIBOR Floors and Spreads – All Loans



Note: LIBOR Floor reflects fair value weighted average for each period while LIBOR above reflects the extent to which LIBOR is above the floor

Observations:

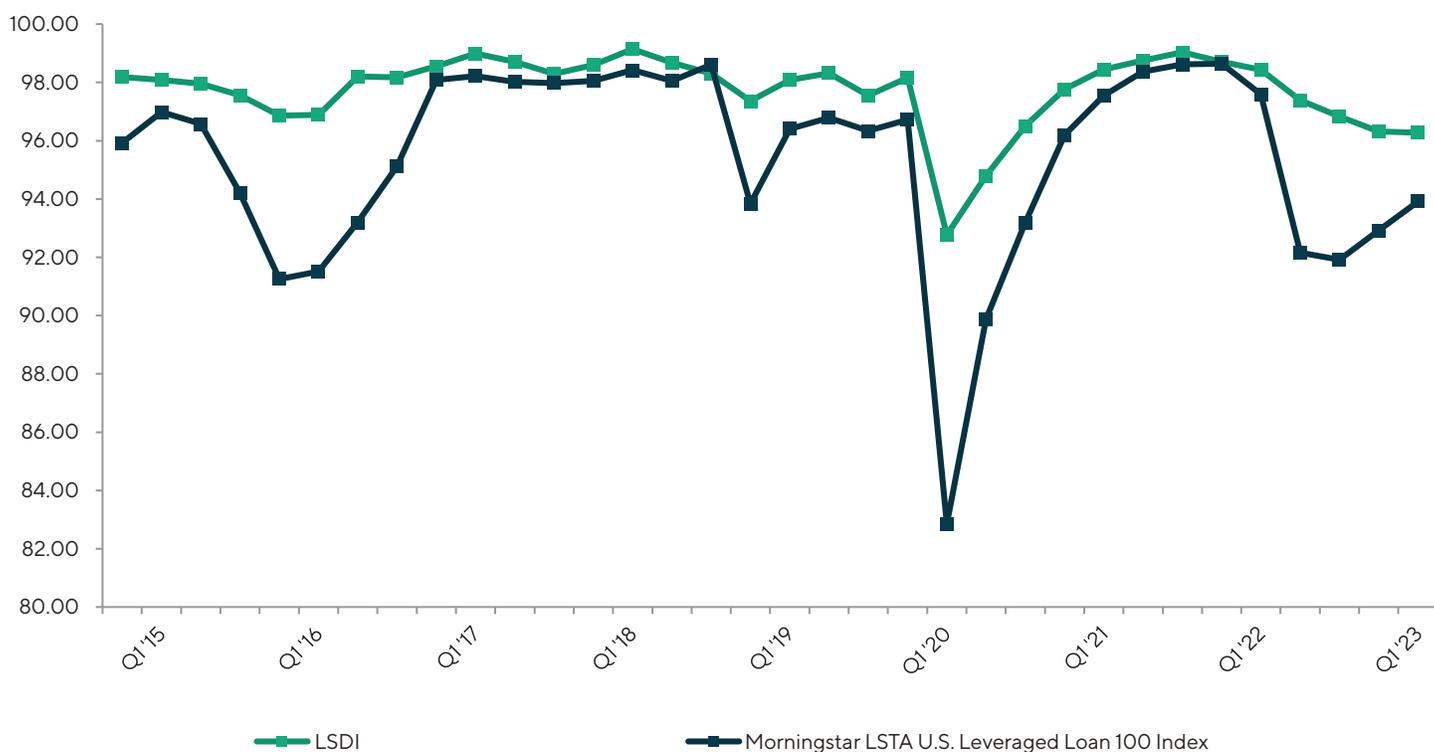
- The average yield of the LSDI since inception has been approximately 9.5%.
- From 2016 until the quarter ending June 30, 2022, yields in the direct lending market had remained in a band between 8.0% and 10.0%. However, given the significant increases in LIBOR / SOFR the LSDI yield was 11.6% for the quarter ending March 31, 2023, the highest since inception.
- In the direct lending market, the change in spreads has a greater impact on the fair value of a loan versus changes in LIBOR / SOFR. As direct lending loans are based on a floating rate, LIBOR or SOFR, from a valuation point of view, the loan's discounted cash flow model contains LIBOR or SOFR in the numerator and denominator, thus canceling each other out. However, the numerator is LIBOR or SOFR plus the contractual spread, whereas the denominator is LIBOR or SOFR plus the market required spread – the fair value spread. Therefore, it is the change in the denominator or credit spread that positively or negatively impacts fair value.

RESULTS: Fair Value – Price – Trends

Q1

2023

Fair Value – Lincoln Senior Debt Index (All Loans) Compared to the S&P / LSTA U.S. Leveraged Loan Index



Note: Price based on fair value of the Lincoln Senior Debt Index and average bid of the Morningstar LSTA U.S. Leveraged Loan Index

Observations:

- The LSDI was 96.3 as of March 31, 2023 unchanged from the prior quarter.
- A fair value of 96.3 is the lowest since the peak COVID-19 impacted quarters of 2020. Over time, prices, on a fair value basis, have generally ranged between 97.5 to 99.0.
- There are several reasons for this phenomenon whereby loans in the direct lending market do not experience the same price volatility as observed in the BSL market:
 - Loans in the direct lending market trade much less frequently than loans in the BSL market.
 - Investors in the BSL market have a greater ability to liquidate their investment should they decide to exit, as trading is a viable option. In contrast, investments in direct lending funds are structured whereby investor redemptions are limited. Therefore, capital flows are not as volatile as the BSL market.

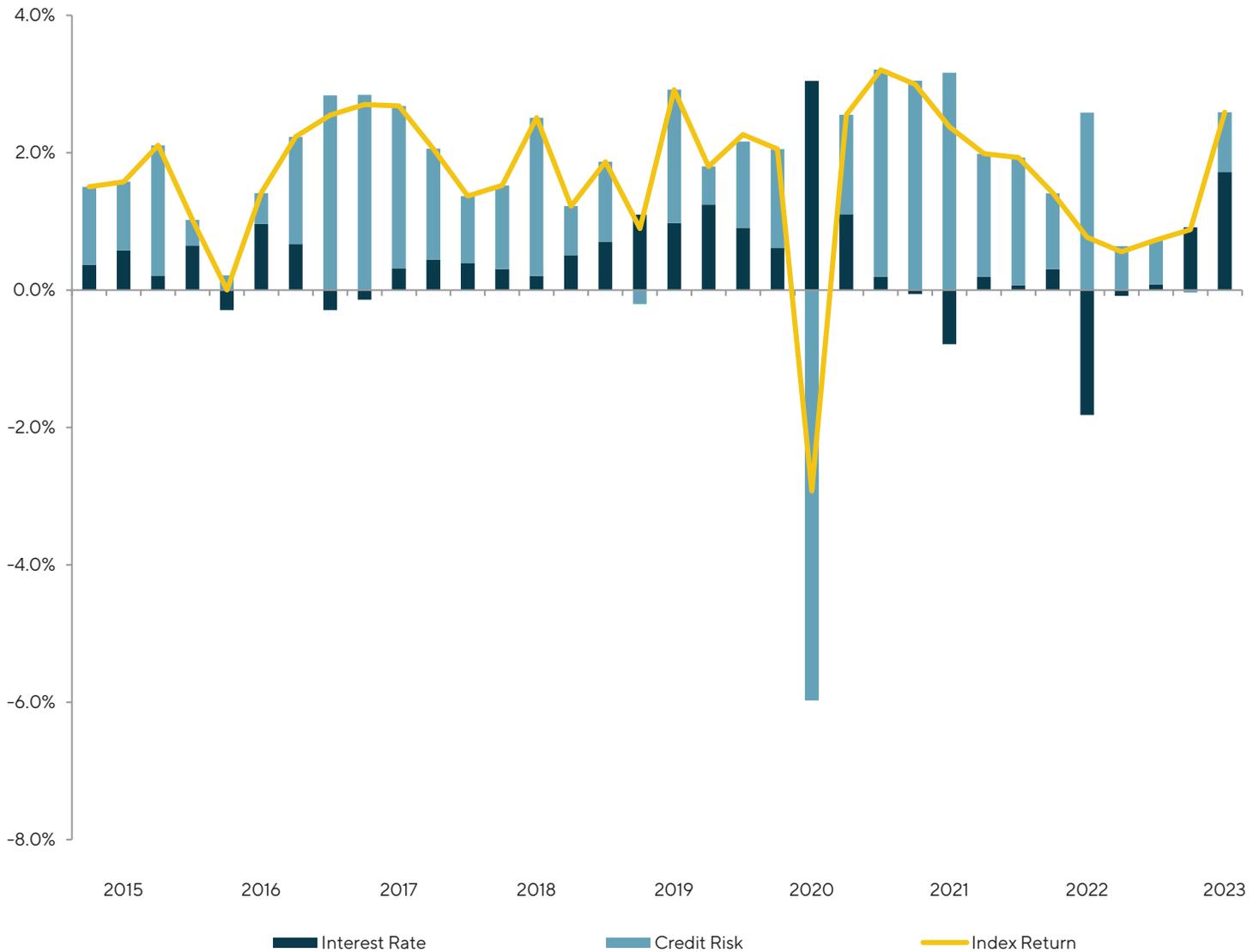
RESULTS:

Bifurcation of the Impact on Total Return Due to Credit Risk and Interest Rate Risk

Q1

2023

Decomposition of Index Returns: Interest Rate versus Credit Risk



Observations:

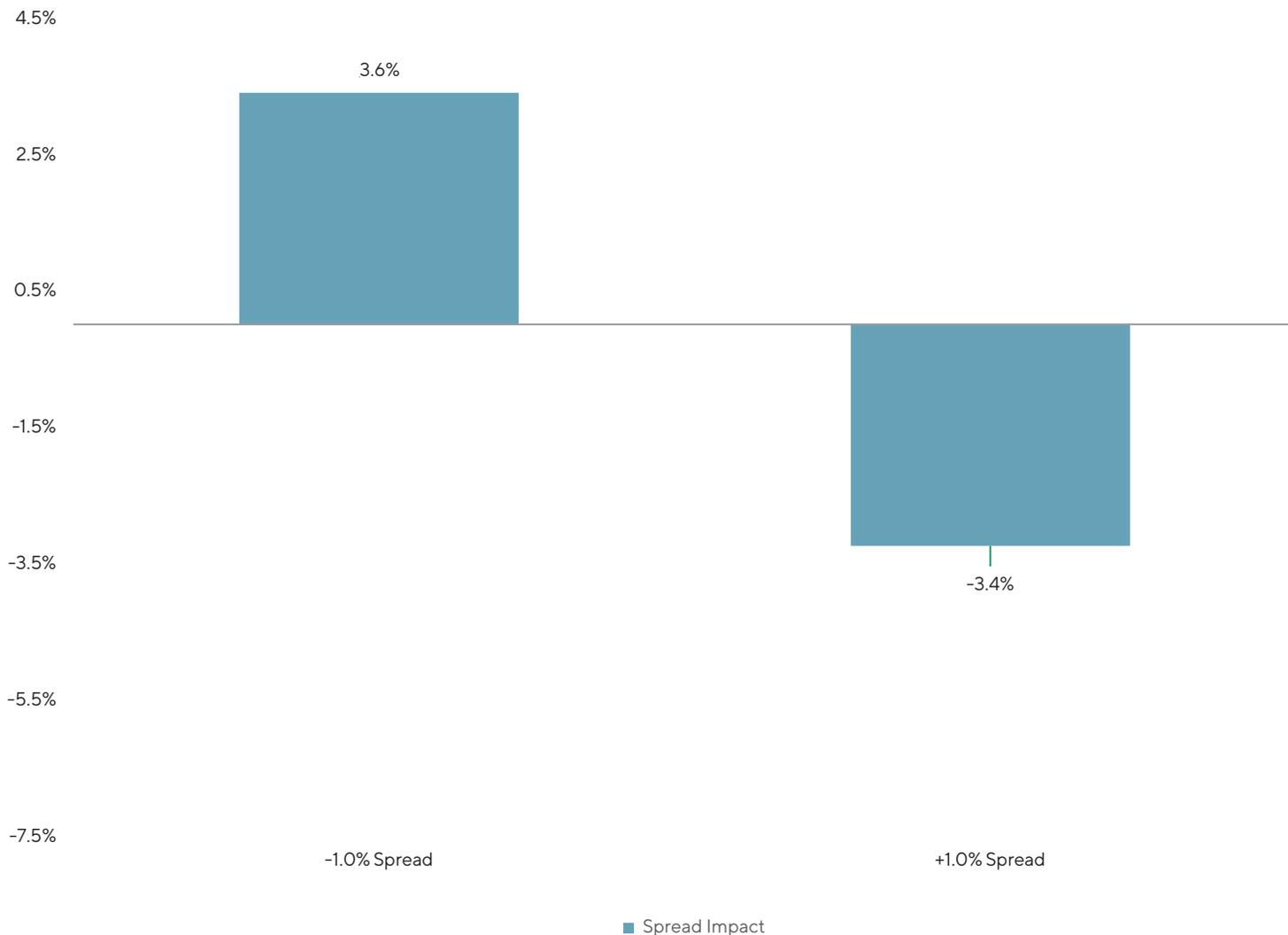
- The LSDI returned 2.6% for the first quarter of 2023 versus 0.9% for the fourth quarter of 2022.
- Decomposing the quarterly return of 2.6%, the majority of the return is due to higher interest rates, at 1.7%, while the impact from changes in credit risk was 0.9%.

RESULTS: Spread Sensitivity

Q1

2023

Q1 2023 Lincoln Senior Debt Index Spread Sensitivity



Observations:

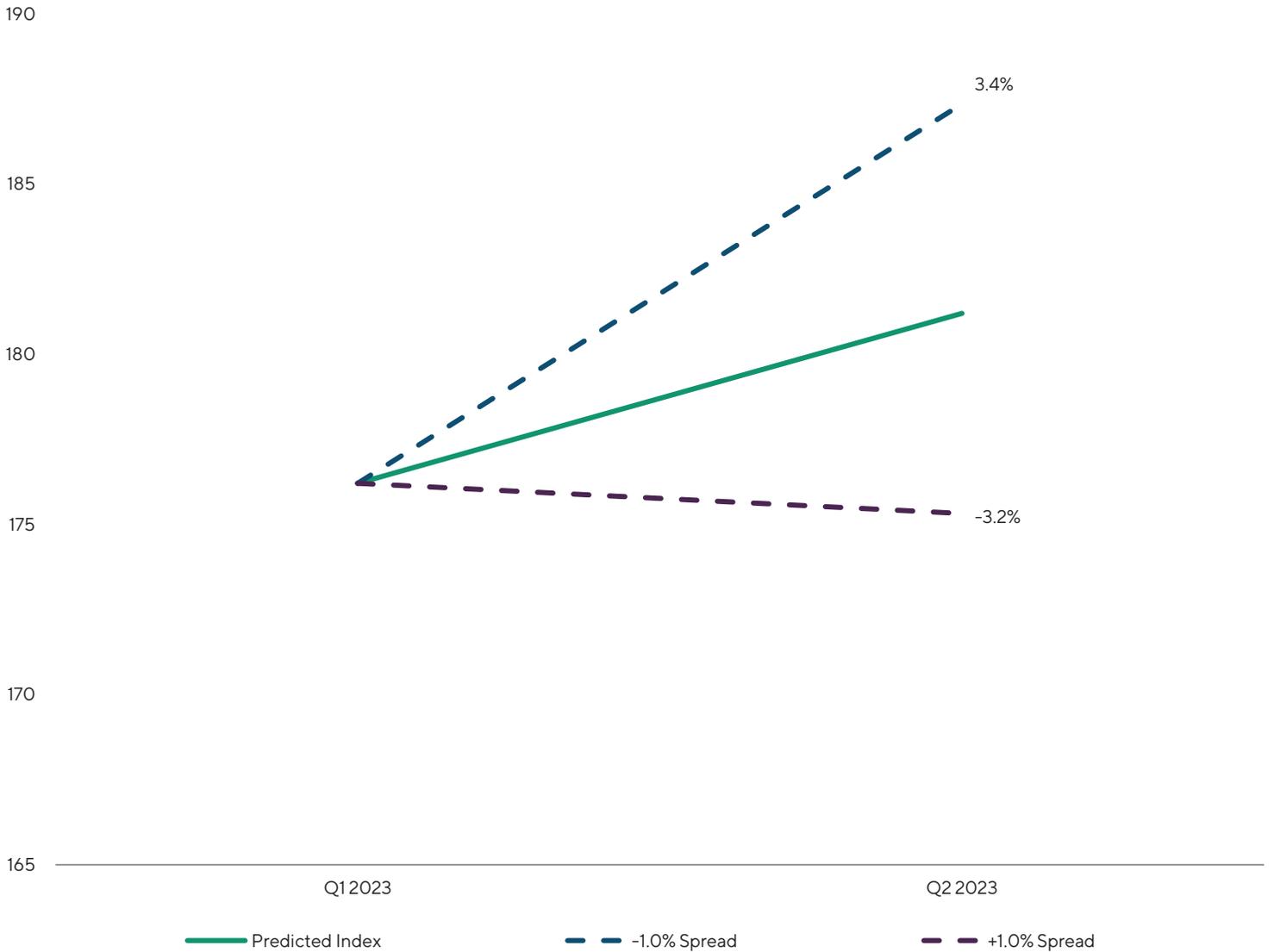
Measuring the immediate impact on total returns, as of March 31, 2023, a 1.0% increase in spreads would decrease the value of the LSDI by 3.4%. Conversely, the impact from a 1.0% decline in spreads would have increased the LSDI by 3.6%.

RESULTS: Spread Sensitivity (cont.)

Q1

2023

Lincoln Senior Debt Index Forecasted Spread Sensitivity



Observations:

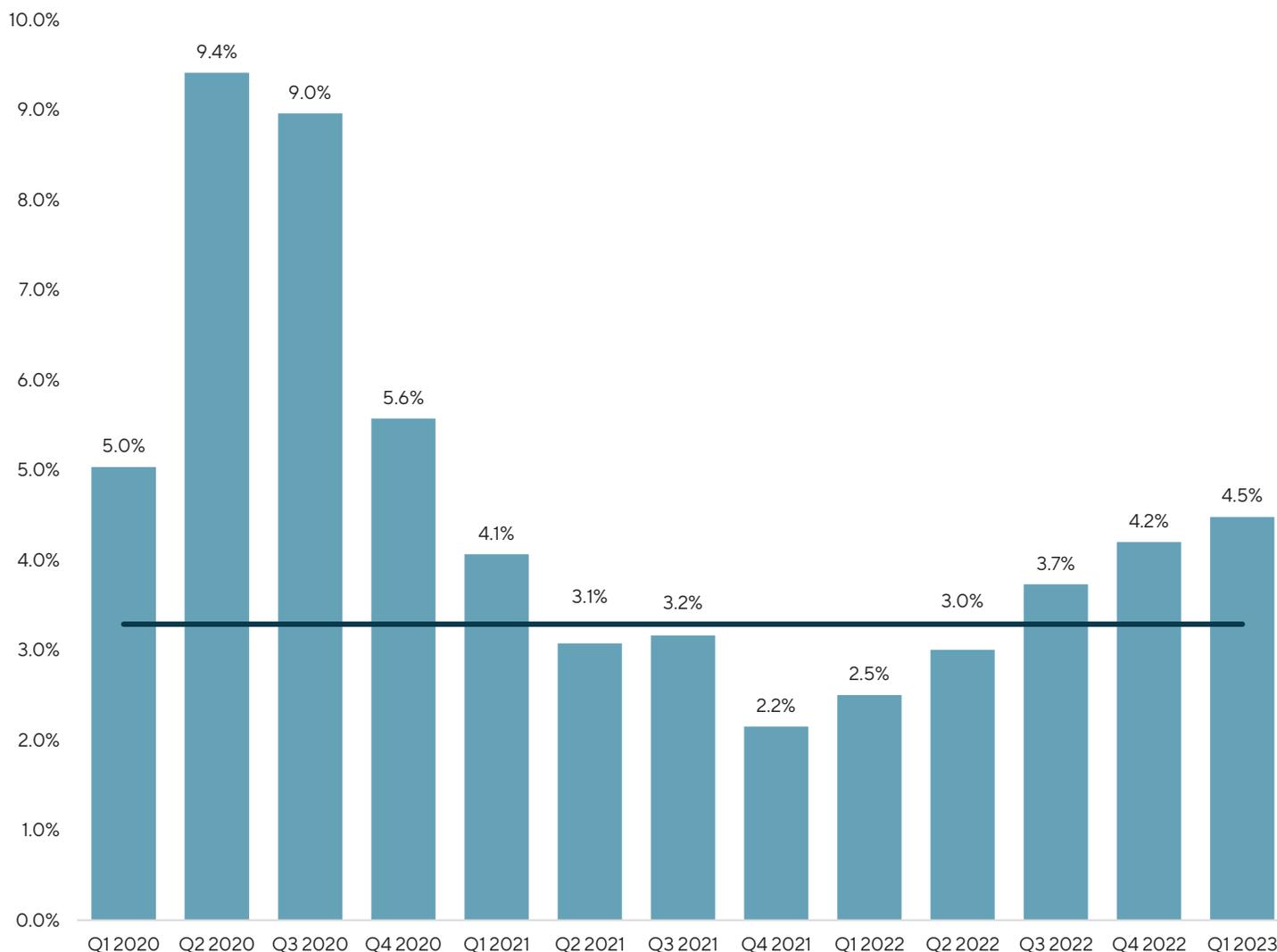
Measuring the impact on predicted total returns as of the next quarter, from March 31, 2023 to June 30, 2023, a 1.0% increase in spreads would decrease the predicted value of the LSDI by 3.2%. Conversely, the predicted impact from a 1.0% decrease in spreads would be an increase of 3.4%.

RESULTS: Default Rates

Q1

2023

Direct Lending Default Experience



Note: Defaults defined as loan covenant defaults (not monetary defaults)

Observations:

Default rates increased as of March 31, 2023 to 4.5% and have been increasing since Q4 2021.

Source of Data and Sample Size

On a quarterly basis, Lincoln determines the enterprise fair value of over 4,500 portfolio companies for approximately 125 private equity sponsors and lenders. These portfolio companies report quarterly financial results to the sponsor (i.e., private equity group) or lender. Lincoln obtains company and loan level information to create the LSDI.

All information is prepared in accordance with the fair value measurement principles of generally accepted accounting principles. Finally, each valuation is then vetted by auditors, company management, boards of directors and regulators.

Additional information about the methodology of the LSDI can be found at: www.lincolnternational.com/perspectives/an-overview-of-the-lincoln-senior-debt-index.

Academic Advisor

Professor Pietro Veronesi is the Chicago Board of Trade Professor of Finance at the University of Chicago, Booth School of Business. He is also a research associate of the National Bureau of Economic Research and a research fellow of the Center for Economic and Policy Research.

Professor Veronesi's research has appeared in numerous publications, including the *Journal of Political Economy*, *American Economic Review*, *Quarterly Journal of Economics*, *Journal of Finance*, *Journal of Financial Economics* and *Review of Financial Studies*. He is the recipient of several awards, including the 2015 AQR Insight award, the 2012 and 2003 Smith Breeden prizes from the *Journal of Finance*, the 2008 WFA award, the 2006 Barclays Global Investors Prize from the EFA, the 2006 Fama / DFA prizes from the *Journal of Financial Economics* and the 1999 Barclays Global Investors / Michael Brennan First Prize from the *Review of Financial Studies*. Professor Veronesi teaches both masters- and Ph.D.-level courses. He is the recipient of the 2009 McKinsey Award for Excellence in Teaching.

His undergraduate work was in economics at Bocconi University where he received a laurea magna cum laude with honor in 1992. He earned a master's degree with distinction in 1993 from the London School of Economics. He joined the Chicago Booth faculty upon obtaining his Ph.D. in Economics from Harvard University in 1997.

SUMMARY:

Q1 2023 Lincoln Senior Debt Index

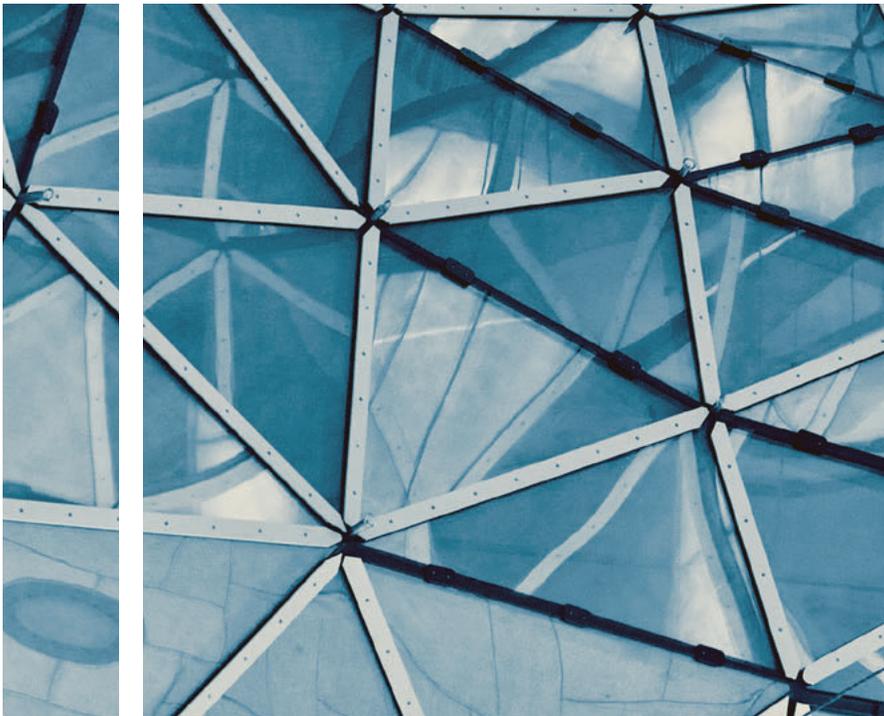
- From 2014 through March 31, 2023, a portfolio of direct lending loans has yielded higher returns and lower volatility relative to BSLs.
- The LSDI provides market participants many unique valuation insights into the fair value of direct lending loans and represents a significant enhancement to the information available within an opaque market.

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