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The Yield Illusion: Navigating Fair Value in Structured Investments

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Structured investments provide companies with flexible financing solutions that minimize equity dilution and have become increasingly prevalent in venture lending, growth-stage financings, and special situations.

These financings are often a debt instrument paired with an equity-linked component, such as common stock warrants, which increase the debt's original issue discount (OID; i.e., the total implied discount to par, inclusive of both the stated debt discount and the fair value of the associated equity-linked instruments) at inception. While the resulting yield may appear compelling on a risk-adjusted basis, it can distort the fair value of the debt instrument at subsequent measurement dates, particularly when non-credit-related components, such as warrants, drive part of the return expectations at inception.

This paper explores how fair value measurements for structured investments can incorporate dynamic yield reassessment while adhering to ASC 820's principles of unit of account, market participant assumptions, and exit price. We examine calibration techniques and data-driven valuation practices that can help to avoid distorted fair values and arrive at more accurate pricing over time.

The Yield Problem in Structured Investments

At inception, the all-in implied OID for a debt security reflects the bundled economics of the structured investment, including both the debt and equity-linked components. However, at subsequent measurement dates, particularly when the debt and equity instruments are treated as separate units of account, the implied yield on the debt may no longer reflect its stand-alone credit risk. Even in the absence of improving company performance, tightening market spreads, or declining credit risk, the original implied yield may still warrant reassessment if it was structurally inflated due to non-credit elements.

While the implied yield at the debt's inception date may appear structurally elevated, it can nonetheless represent fair value at day one depending on the deal's context. For example, a company seeking flexible growth capital or pursuing a strategic opportunity may negotiate a structured investment tailored to investor return targets. In such cases, lenders may require warrants or deeper OID to align with their desired IRR, especially when the structure defers participation in equity upside or includes return-enhancing features in lieu of current cash yield. These features reflect market participant expectations under prevailing terms. However, as the accounting treatment shifts and the instruments are evaluated separately, the originally implied yield may no longer accurately reflect the stand-alone credit risk of the debt. At that point, reassessing the appropriate yield becomes essential to maintaining alignment with ASC 820 fair value principles and market participant assumptions.

Why Is the All-In Yield So High and Why Start at Cost?

Structured debt transactions often carry elevated all-in yields because they combine a credit instrument with equity-linked features such as warrants, an OID, or payment-in-kind (PIK) interest. These components enhance the investor's return without increasing the cash coupon. From the borrower's perspective, these structures may be preferable to priced equity due to factors such as reduced dilution, board dynamics, tailored investor alignment, or clearer economics around capital structure and future liquidity.

Despite the enhanced economics, most funds calibrate to cost on day one, treating the total consideration paid as fair value. This avoids recognizing a day one gain, which could prompt questions from auditors or limited partners (LPs) and is often at odds with prevailing practice to initially mark structured investments at cost. However, once the transaction closes and the debt and equity components are treated as separate units of account, valuation professionals must reassess whether the implied yield reflects the debt's stand-alone credit risk at subsequent measurement dates. This often necessitates recalibrating the yield at these dates, especially when the original return was influenced by non-credit-related terms.

> A misstated day one valuation can distort the implied yield, misrepresent the debt's stand-alone credit risk, and skew the valuation path.

Day One Valuation of Equity-Linked Components

Structured debt transactions often include an equity-linked instrument, such as common stock warrants. While the investment may be negotiated as a package, ASC 820 determines the unit of account based on market participant assumptions, meaning the debt and equity-linked components may be valued separately or as a combined unit, depending on how market participants would transact in their economic best interest.

When valued separately, the initial allocation of value directly impacts the implied debt OID and sets the trajectory for yield-based pricing going forward. A misstated day one valuation can distort the implied yield, misrepresent the debt's stand-alone credit risk, and skew the valuation path.

If the equity feature is initially overvalued, the resulting implied OID may be artificially deep, leading to an overstated implied yield. Conversely, if the equity feature is initially undervalued, the implied OID may be too shallow. In both cases, initial pricing must be calibrated to market participant assumptions to ensure fair value reflects economic reality and ASC 820 principles.

Determining the Appropriate Yield at Subsequent Measurement Dates

At subsequent measurement dates, the required yield should not automatically anchor to the inception yield or be derived through a purely mechanical trajectory. While a time-based pull-to-par may appear reasonable in the absence of major changes in market or credit conditions, it often fails to reflect the debt's stand-alone credit risk, especially when the original yield was influenced by non-credit-related components.

Key Considerations

01

Credit Fundamentals

The issuer's credit profile, such as leverage, cash flow coverage, liquidity, and operating performance, should inform the estimated required yield at subsequent measurement dates. Even if these fundamentals remain stable since inception, the yield may warrant adjustment if the original deal structure included significant non-credit features like warrants. Recalibrating yield to reflect the debt's stand-alone credit profile may provide a more accurate fair value.

02

Market-Based Comparables

Observable pricing data from recent issuances, realizations, or comparable instruments helps assess whether the required return remains appropriate. If instruments with similar credit risk and duration are trading at tighter spreads or closer to par, this may indicate that the current yield overstates risk. These external signals help keep valuation grounded in market realities.

03

Independent Risk Assessment

While insights from deal teams provide valuable context, valuation professionals must independently and dynamically assess credit risk at each measurement date. Yield assumptions should reflect a market participant's perspective and remain consistent with ASC 820's fair value framework.

Even without observable changes in market conditions or company fundamentals, valuation professionals must determine whether the inception yield still reflects a market-based required return. If it does not, a reassessment is necessary to ensure fair value remains aligned with the debt's stand-alone risk profile.

Structured Artifact vs. Reflection of Credit Risk

A central challenge is distinguishing whether, at subsequent measurement dates, the required yield should remain anchored to the original deal economics or if it should be dynamically reassessed to reflect changes in credit fundamentals, market liquidity, and pricing of comparable instruments. This is especially relevant if the inception yield was structurally elevated due to non-credit elements. Valuation professionals must determine a yield trajectory that reflects the debt's stand-alone credit risk and aligns with ASC 820's fair value framework, including unit of account considerations, market participant assumptions, and exit price principles.

ASC 820 requires valuation professionals to estimate fair value based on observable inputs and market participant assumptions. These considerations help determine when recalibration of the original implied yield is necessary, particularly when the inception yield was shaped by non-credit-related structural elements. Unless market participants price the structured investment as a whole, the debt component should be valued independently, based on its own risk and return profile.

To guide that analysis, valuation professionals can consider the following questions:

01 **How would market participants price this debt if sold as a stand-alone instrument today?**

02 **Are comparable instruments priced at tighter spreads, suggesting the current yield may overstate required return?**

03 **Does the required yield still reflect the issuer's stand-alone credit profile?**

04 **Is the debt being valued independently, consistent with unit of account?**

By grounding yield assumptions in market inputs and ASC 820 exit price principles, professionals can ensure valuations reflect actual credit risk, thereby avoiding distortions driven by structural artifacts.

Case Study Recalibrating Yield for Stand-Alone Credit Risk(1)

Hypothetical Illustrative Case: Ayumi Capital's Valuation Process

Ayumi Capital, a technology-focused lender, recently provided $100 million in structured financing to Yukari Software, a late-stage enterprise SaaS company preparing for an IPO. Yukari Software, which had achieved positive EBITDA and demonstrated strong recurring revenue, sought this financing to expand its market presence while limiting equity dilution. Furthermore, Yukari Software valued flexibility and alignment with long-term strategic goals, making a structured deal with warrants more attractive than a traditional equity raise or straight debt. The transaction included a senior secured loan paired with common stock warrants, structured to deliver both downside protection and equity upside to the investor.

At inception, the debt was issued at 97.5% of par, reflecting an implied all-in straight debt yield (inclusive of the warrants) of approximately 14.5%. However, this yield was not purely a function of the loan's credit risk, as it also reflected the embedded value of the equity-linked warrants. While the total package economics justified the entry price, the implied yield overstated the required return for the debt on a stand-alone basis.

(1) Ayumi Capital and Yukari Software are fictional names used solely for illustrative purposes. Although the fact pattern draws from real-world dynamics, all details have been created for this example and do not reflect any actual client or transaction.

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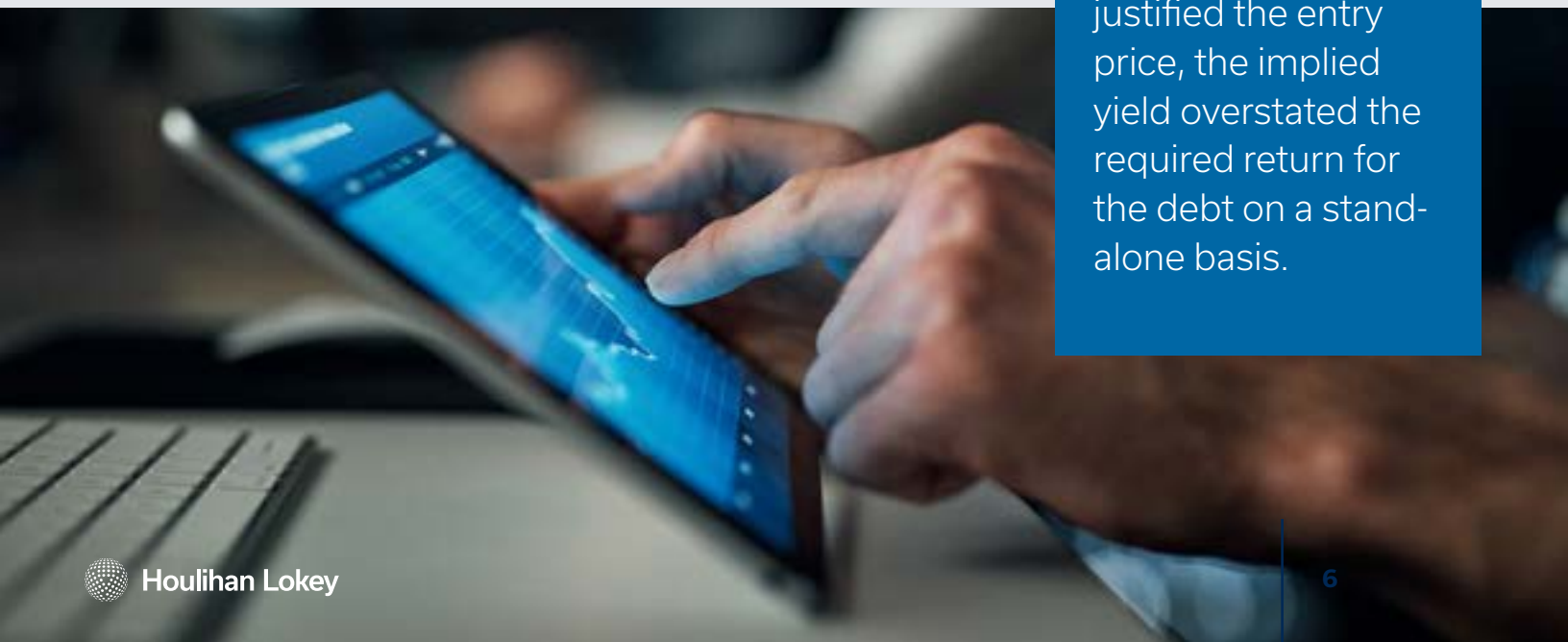

Case Study Recalibrating Yield for Stand-Alone Credit Risk(1)

Recalibrating Yield at the Six-Month Measurement Date

Six months later, Ayumi Capital's valuation team was tasked with reassessing the fair value of the debt. Yukari Software's performance had remained stable: revenue growth, EBITDA margins, and cash flow were all in line with expectations. Leverage remained low, and no adverse developments had occurred. In the broader market, spreads for comparable late-stage SaaS credits had tightened modestly, and similar senior secured loans were trading between 99% and 100% of par.

While these external observations were helpful, Ayumi Capital's valuation team recognized that the need to reassess yield did not hinge solely on market movements or performance improvements since inception. Rather, another key consideration was whether or not the original all-in yield may have been structurally inflated, influenced by the bundled nature of the deal, including the warrant value.

Ayumi Capital approached the subsequent measurement date by independently evaluating the debt and warrant components in accordance with ASC 820's unit of account and fair value principles. It conducted a comprehensive review incorporating:

Market-Based Comparisons

Recent trades of similar loans continued to price close to par, suggesting that the required return for this level of credit risk was likely lower than the original yield implied.

Internal Portfolio Benchmarks

Other senior secured positions in Ayumi Capital's portfolio with comparable credit profiles and durations were marked with required yields in the range of 10.5% to 11.5%, reinforcing that the 14.5% inception yield overstated the true credit risk.

Independent Credit Risk Assessment

The credit team confirmed that Yukari Software's fundamentals were unchanged or marginally improved. There was no justification for maintaining a structurally elevated yield, especially now that the equity component had been unbundled.

Yield Calibration Analysis

The valuation team revisited the day one discount rate and recalibrated it using updated market data. The warrant was valued independently, and the debt valuation was reassessed based solely on its expected cash flows and credit risk.

Following this analysis, Ayumi Capital determined that the original yield was no longer representative of a market participant's required return for the debt alone. Based on updated inputs, it concluded that a more appropriate stand-alone yield was approximately 11.0%, resulting in a revised fair value of 99.25%. This adjustment deviated from the mechanical trajectory and better aligned with stand-alone market pricing.

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Case Study Recalibrating Yield for Stand-Alone Credit Risk(1)

Case Summary Ayumi Capital

INITIAL YIELD
14.5% all-in yield based on package economics

DAY ONE VALUATION
Anchored to total cost, no gain recognized

VALUATION CHALLENGE
Yield did not reflect stand-alone credit risk of the debt at subsequent measurement date

REASSESSMENT
Yield recalibrated to 11.0% at subsequent measurement date

OUTCOME
Fair value marked closer to par, reflecting credit fundamentals and market participant assumptions

Comparing Yield Reassessment vs. Inception Anchoring

Had Ayumi Capital continued using the original 14.5% yield, the resulting fair value of the debt would have remained artificially suppressed. This approach would have ignored both the structural separation of units of account and the fact that the original yield reflected non-credit-related economics. By reassessing the required yield using current inputs and market participant assumptions, Ayumi Capital arrived at a fair value that more accurately reflected the price a hypothetical market participant would pay for the debt in an orderly transaction as of the measurement date.

Why This Mark Was Justified

ASC 820 requires that structured debt valuations reflect the exit price a market participant would pay in an orderly transaction at the measurement date. Maintaining the original yield would have overstated the risk premium and understated the fair value of the loan.

However, rather than immediately marking the position at 100% of par, Ayumi Capital's valuation team exercised judgment, recognizing that while a full "pull-to-par" was supported by external pricing, liquidity remained a consideration.

This case illustrates how a market-driven, judgment-informed valuation approach, one that is grounded in proper unit of account treatment and ASC 820 principles, can yield fair values that are both defensible and aligned with investor expectations. Recalibrating yield to reflect stand-alone credit risk, rather than anchoring to structurally influenced starting points, is essential for accurate and transparent valuation of structured investments.

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Conclusion

Structured debt with equity-linked features presents complex valuation challenges, particularly around determining the appropriate yield over time. While simple, a static or mechanically derived yield may fail to capture evolving market dynamics or reflect the debt's stand-alone credit risk.

A market-driven approach, grounded in observable inputs, issuer-specific fundamentals, and liquidity considerations, ensures that fair value reflects how a market participant would assess required return at each measurement date, rather than relying on historical deal economics.

Accurate valuation of structured debt is not just a regulatory or financial reporting exercise but also a critical factor in capital raising, fund performance reporting, and investor relations. Funds looking to attract institutional investors must ensure their valuations accurately reflect market conditions. Overly conservative marks may understate portfolio value, while aggressive valuations risk scrutiny from auditors, regulators, and potential investors. Striking the right balance requires a disciplined, market-driven approach to valuation.

At Houlihan Lokey, we specialize in navigating these complexities, providing funds, institutional investors, and private credit managers with robust, defensible valuation solutions.

Conclusion

Our team combines deep industry expertise, access to real-time market data, and extensive experience in fair value measurement to help investment firms confidently mark their structured debt holdings. Whether for financial reporting, capital raising, portfolio management, or risk assessment, our approach ensures transparency, credibility, and investor confidence.

The Ayumi Capital case study illustrates how structured credit investors must balance quantitative analysis with qualitative judgment, leveraging multiple data points to arrive at a defensible, market-aligned valuation. Funds that implement transparent, well-documented valuation processes will be better positioned to navigate regulatory scrutiny, auditor reviews, and evolving market conditions. More importantly, they will build trust and confidence with their investors and LPs, ensuring that their valuation marks reflect both fair value principles and the true economic positioning of their portfolios.

In today's evolving credit landscape, partnering with an experienced, independent valuation provider like Houlihan Lokey empowers funds to navigate complexity with confidence. By adopting a disciplined, yield-informed valuation approach, investors can make more informed decisions, strengthen investor confidence, and enhance capital deployment strategies.

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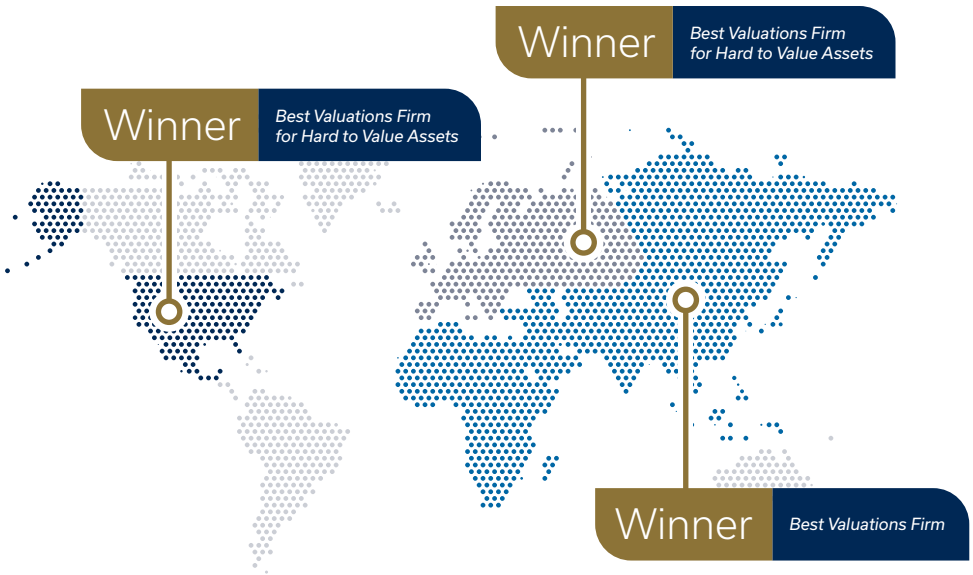

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