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Principal Alternative Credit

Principal Asset Management[SM]

Cutting through the noise:

Why lower and core middle market direct lending still delivers value in clients' portfolios.

A long-form perspective from Principal Alternative Credit on what investors should be watching—and what the headlines are missing—in today's private credit market.

A market under the microscope

Private credit has become one of the most discussed corners of institutional investing — and one of the most misunderstood. Daily headlines about troubled borrowers, struggling business development companies (BDCs), redemption pressure, and concentrated software exposure have created the impression of a market under stress. But beneath the noise, the lower and core middle market direct lending segment that has historically powered investor outcomes is performing well, behaving as designed, and, in our view, is about to deliver one of its most attractive vintages in years.

That was the central message from a recent Principal Asset Management webinar, *Cutting through the noise: Focusing on private credit investing beyond the headlines*, featuring Tim Warrick, Group Head of Principal Alternative Credit, and Matt Darrah, Head of Underwriting for Middle Market Direct Lending.

For institutional investors, such as pension plans, insurance companies, consultants, and wealth platforms, evaluating their private credit exposure today, the discussion offered a clear framework for separating the noise in the asset class from what is working exactly as intended.

What's really driving the headlines

The recent turbulence isn't one story; it's several converging at once.

Warrick pointed to a cluster of catalysts: the so-called "cockroach" credit episode (which, notably, was not a private credit transaction at all but became a proxy for fears about what might migrate into private credit); challenges among both listed and non-listed BDCs, including an attempted forced merger of a private BDC into a public vehicle trading at a steep discount to NAV; BDC managers struggling to defend distribution yields as base rates fall and spreads compress; the first meaningful wave of redemption requests: what Warrick called "the first real run on the BDCs"; rising non-accruals at select managers; and growing concern about software-as-a-service (SaaS) exposure underwritten on annual recurring revenue (ARR) rather than cash flow, now facing AI disruption risk.

Layered on top, investment banks that lost meaningful underwriting share to direct lenders over the past decade have a structural incentive to highlight cracks in the asset class. As Warrick put it, "Investment banks that underwrite to sell and earn fees are sensitive to losing market share." Headlines, in other words, should be read with their authorship in mind.

But Warrick's most important framing was this: **the demise of private credit is greatly exaggerated.** What's actually happening is a long-overdue reckoning between the broad label "private credit" and the very different sub-segments it now encompasses.

> *"The demise of private credit is greatly exaggerated."*
>
> **Tim Warrick,**
> Group Head of Principal Alternative Credit

Not all private credit is created equal

The single most important distinction for investors today is the difference between **lower and core middle market direct lending** — where Principal operates — and **upper middle market and large-cap private credit**, where most of the headline stress is concentrated.

Principal defines the segments precisely:

- **Lower middle market:** borrowers with $5–$15 million EBITDA and roughly up to $100 million in revenue.
- **Core middle market:** $15 to $50 million EBITDA, up to $250 million in revenue, with debt facilities typically up to $200–$250 million.
- **Overall middle market:** extending up to $100 million EBITDA and roughly $500 million in facility size.
- **Upper middle market and large-cap private credit:** multi-billion-dollar deals where terms increasingly resemble broadly syndicated loans (BSL).

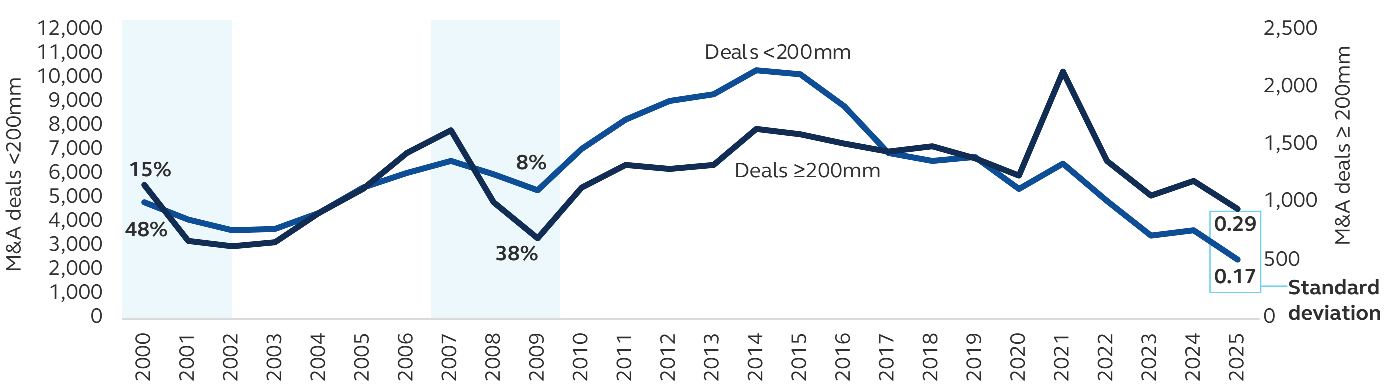
That last point matters. As deal sizes scaled, the *terms* moved up-market too. Cov-lite structures, payment-in-kind (PIK) toggles, ARR-based underwriting, and looser EBITDA add-backs migrated from the public markets into the larger end of private credit because, as Darrah explained, at that scale you are no longer competing with other direct lenders — you are competing with the BSL market and its CLO buyer base. “You have to offer cov-lite if you are competing against that broadly syndicated loan market. You might differentiate yourself by offering PIK, PIK toggle components to the structure. And so, all those factors impact credit quality and reduce your ability to effectuate better outcomes in a downside scenario.”

In the lower and core middle market, those compromises don’t apply. Every Principal deal carries true, meaningful financial covenants: Debt-to-EBITDA tests, fixed charge coverage tests, and tighter EBITDA add-back discipline. Leverage runs one to one-and-a-half turns lighter than the upper middle market. These loans are typically held by only one to three lenders, dramatically reducing the risk of liability management transactions that have made headlines and correlation risk during periods of stress.

The distinction also shows up in deal flow. When the second-term Trump administration introduced tariff shifts on so-called “Liberation Day,” large transaction activity slowed considerably. But sponsored and non-sponsored lower and core middle market deal flow stayed steady, a reflection of the more durable nature of that market with more idiosyncratic drivers of transactions.

According to Capital IQ, U.S. M&A deals valued at less than $200 million have exhibited much more stability than the rest of the M&A market. The standard deviation for the change in number of deals completed year-over-year is 17% for deals sub $200 million and 29% for deals above $200 million since 2000. You can also see in Exhibit 1 that the lower middle market remains relatively stable in times of distress, such as in 2001, where large deal volumes were down 42% but smaller deal volumes were only down 15%. Even in the Great Recession, large deal volumes declined 38% in 2008 and 32% in 2009, versus 8% and 11% respectively for smaller deals.

Exhibit 1: U.S. M&A deals over time



Source: S&P Capital IQ, 30 September 2025

These smaller deals are typically owner operators selling to private equity for the first time. Owner operators have idiosyncratic drivers to sell that are more immune to macro-economic forces. The business owners of the baby boomer generation often face the challenge of their children not wanting to take over the family business, and thus need to find new ownership for their business. Often, these owners sell to private equity, while rolling a significant portion of their equity into the new deal. The initial transaction serves to diversify their wealth and provides the ability to share the risk of growth with a private equity firm who brings additional resources and experience to the process.

In addition, we believe non-sponsored deals when underwritten well can offer a strong source of alpha for client portfolios and provide a stabilizing force on origination volume. Non-sponsored deal flow is often not reliant on large-scale M&A, but instead on changes in ownership (e.g. management teams buying out minority shareholders), refinancing pieced together capital structures to simplify them (often they feature a mix of equipment lines, bank loans, etc.), and smaller, tuck-in M&A activity.

Structural vs. macro: Where the real risk lives

When asked how much of today's private credit concern reflects macro conditions versus structural decisions, Darrah was direct: most of it is structural — and it's bifurcated.

Product structure is one driver. Many BDCs operate at high leverage with no public-market sleeve to provide liquidity, which works beautifully in a bull market and badly when investors want their money back. "Managers that have operations both in public and private credit can be quite valuable to their clients in times like these," Darrah noted. Some return drag from public assets is the *price* of being able to meet redemptions when the tide goes out.

Investment strategy is the other driver. Many of the troubled credits being cited, such as First Brands and Tricolor, were not direct lending at all; they were broadly syndicated loans that ended up in BDC portfolios because those vehicles scaled so rapidly that they had to deploy capital wherever it was available. That same dynamic pushed BDCs heavily into ARR-based software deals, where 20–30% concentrations are now common and where AI presents real existential questions.

Said another way: the cracks are real, but they are concentrated in specific structures (highly levered BDCs without liquidity ballast) and specific strategies (large-cap BSL-style and ARR-heavy exposures). They are not features of the broader private credit asset class.

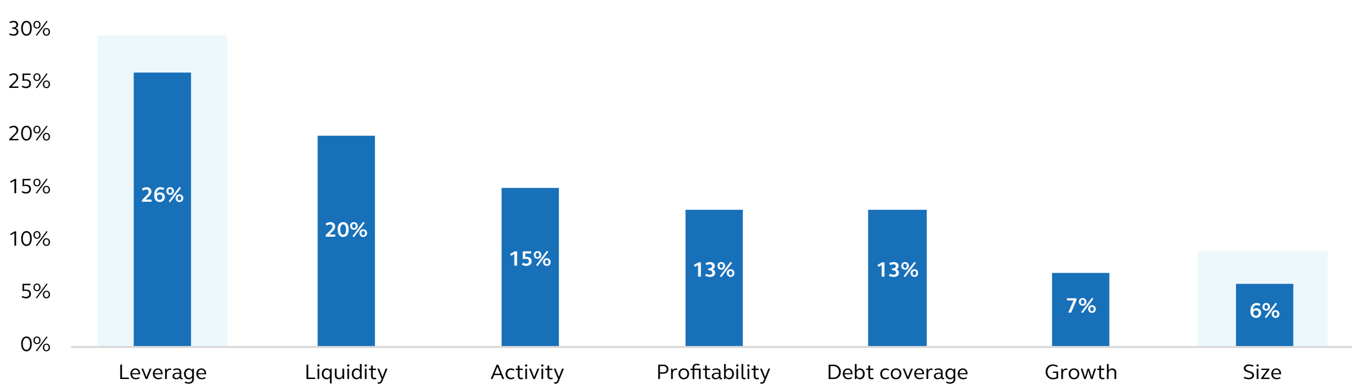
The risk lens: Leverage, sectors, liquidity, and covenants

For investors evaluating their managers today, four risk vectors deserve focused attention.

1. Leverage

Leverage is the single biggest predictor of default in corporate credit, by a wide margin. A Moody's study cited by Darrah found that size ranked only seventh among predictive factors, while leverage was first. Investors should know exactly what their managers' average and median leverage levels are, and how they have trended.

Exhibit 2: Default probability predictor in the private debt market



Source: Moody's Analytics RiskCalc, 28 February 2019. Most recent available data used. Not to be construed as investment advice.

A particular flag: ARR-based software loans never used traditional cash-flow leverage at all. They were levered against revenue, with the thesis that growth would eventually produce cash flow. That works until growth slows. As Darrah explained, a creditor lending to a slow-growing business that generates meaningful cash flow may not care if growth drops from 6% to 3%. But for an ARR lender, growth dropping from 16% to 8% can be catastrophic because valuation is highly sensitive to the rate of change.

2. Sector concentration

Concentration risk has shown up most visibly in software, where capital had to be deployed quickly and large deals dominated. Many BDCs ended up with 20–30% software exposure, much of it in ARR transactions with PIK toggles: exposure that has now become uncomfortably correlated to a single, generationally disruptive technology.

Warrick stressed that intentional portfolio construction matters far more than the industry generally acknowledges. "You need to essentially position the portfolio before you ever originate a loan," he said — choosing industries and sub-industries known for durable cash flow, durable margins, and steady (not equity-like) growth. The lower and core middle market naturally enables this discipline: thousands of potential transactions, minimal portfolio overlap across managers, and steady access to service-oriented businesses driving the U.S. economy.

3. Liquidity reality

"The reality is private credit is not meant to be liquid," Warrick said plainly. Sponsors and borrowers chose private credit precisely because banks became less flexible after the global financial crisis and public markets are subject to episodic shutdowns. They pay a couple hundred basis points more for certainty of execution — and lenders capture the corresponding illiquidity premium.

But the wrapper matters. Warrick contrasted three structures:

- **Non-listed BDCs:** Redemptions depend on the manager's willingness and capacity, not regulatory requirement. In bull markets, new inflows funded outflows. When inflows slow, the strain becomes visible — sometimes triggering increased leverage or capital distributions disguised as income.
- **Listed BDCs:** Tradable but have shown meaningful discounts to NAV when credit concerns rise, introducing the very public-market volatility investors entered private credit to avoid.
- **Interval funds:** Fully registered '40 Act vehicles, audited, with leverage limits (no more than 33%), required liquidity demonstration, and quarterly redemptions of 5% of NAV. Yield is comparable but alignment and durability are materially higher.

4. Covenants

Cov-lite structures are functionally an agreement to wait for a payment default before having a seat at the table. Worse, borrowers often draw on the lender's own revolver before defaulting, meaning by the time the lender has a seat, much of the cushion is gone.

Real financial covenants: Debt-to-EBITDA and fixed charge coverage tests, let lenders intervene early: repricing for risk, demanding new equity, and partnering with sponsors to stabilize businesses through temporary challenges. Darrah noted that this is precisely why private credit has been so resilient through prior downturns. When covenants exist, lenders can drive better recoveries; when they don't, the asset class begins to behave like the BSL market it sought to differentiate from.

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>
> **Tim Warrick,**
> Group Head of Principal Alternative Credit

Where Principal sees opportunity: Local services and AI-resilient cash flow

If software concentration is the cautionary tale, **local service businesses** are the opportunity Darrah is most enthusiastic about: daycares, automotive collision repair shops, plumbing, electrical, and various residential or consumer services. These are the AI-proof, recurring-demand businesses that power everyday American life.

These businesses share several attractive features:

- High free cash flow, supporting debt paydown.
- AI-agnostic: limited risk of technological obsolescence.
- Geopolitically insulated — they don't import or export.
- *Strengthening* moats over time. As Darrah observed, a collision repair shop with 1,000 five-star Google reviews is exceptionally difficult to dislodge.

This is the kind of "boring is beautiful" exposure that performs through cycles — and is generally accessible only at the lower and core middle market scale Principal operates in.

Narrative vs. reality: Defaults, valuations, and what is happening

One of the more striking observations from the discussion: "The narrative on private credit has gotten worse as the portfolio stats have gotten better."

> *"The narrative on private credit has gotten worse as the portfolio stats have gotten better."*
>
> **Matt Darrah,**
> Head of Underwriting, Middle Market Direct Lending

The data supports this. Middle market direct lending default rates currently sit at 1.27% as of 12/31/2025, well below the long-term average of about 2.05% and meaningfully below public high-yield and broadly syndicated loan default rates, which today are in the 4 to 5% range. PIK usage across the market is generally trending down. Non-accruals are below historical averages. Underlying borrowers in Principal managed portfolios are growing EBITDA and revenue at over 14% year-over-year on average.

Yes, defaults will happen, with roughly 2,500 middle market direct lending loans outstanding and another 1,000 large-cap private credit transactions; even a 2% default rate produces 50–70 defaults annually. That is plenty of fodder for headlines. But the headline names being cited—First Brands, Tricolor—were broadly syndicated loans, not lower and core middle market direct lending.

On **valuations**, the criticism around opaqueness deserves a fair hearing and a fair response. Reputable managers, Principal included, employ third-party valuation firms, audits, and continuous direct engagement with sponsors and borrowers. The Principal Interval Fund is marked daily by a third-party valuation provider. Historically, BDC valuations have proven conservative relative to ultimate realizations. Middle market direct lending has consistently outperformed high-yield and BSL with higher income, lower drawdowns, lower volatility, and lower credit losses over multi-decade windows.

The argument that quarterly marks "flatter" risk-adjusted returns versus daily public pricing has surface appeal — but as Darrah noted, twenty-plus years of realized outcomes show that the valuations played out. Even meaningful adjustments to today's ending marks would not materially alter the long-term return profile of the asset class.

What investors should be watching

For investors looking for forward indicators of stress, Darrah offered a clear framework, working backward from outcomes:

1. **Non-accruals and defaults:** the lagging result.
2. **Loan grade distributions:** managers typically grade on a 1–5 scale; benchmark your manager's mix against peers.
3. **PIK interest levels:** and critically, the source of PIK (ARR-driven vs. covenant-default negotiation).
4. **Fixed charge coverage ratios:** Darrah's preferred leading indicator because, unlike interest coverage, it accounts for CapEx and taxes, capturing the real burdens on the business.

The 2026 vintage looks compelling

Despite the headline volatility, perhaps because of it, Principal sees the next six to twelve months as a constructive setup for lenders. EBITDA growth across its portfolio companies is averaging nearly 15%. Equity contributions per deal are robust, with many transactions over-equitized. Leverage levels are coming *down*. Fixed charge coverage is improving. Spreads have widened modestly.

Behind it sits more than **$400 billion of private credit dry powder and $2 trillion of private equity dry powder**—long-horizon capital that stabilizes pricing, supports refinancing, and grounds valuations in fundamental credit risk rather than technical flows.

For LPs, the takeaways are clear:

- **Know what segment you are actually in.** Lower and core middle market direct lending behaves fundamentally differently than upper middle market or large-cap private credit.
- **Demand transparency.** Direct lenders have far more information on borrowers than any 10-K provides. Make your managers share it.
- **Interrogate the structure.** Leverage, covenants, sector concentration, liquidity mechanics, and PIK composition all matter; and they vary enormously across managers.
- **Align with managers who have skin in the game.** Principal invests alongside every loan in its direct lending platform, backing the program with significant balance sheet capital and managing more than $2 billion in assets across both sponsored and non-sponsored transactions, supported by relationships with more than 400 private equity sponsors. Typically, the Principal balance sheet has 3x – 4x the exposure to an underlying loan relative to our third-party clients' exposure.

The current headline cycle is uncomfortable. It is also clarifying. As Warrick framed it, the scrutiny is producing exactly the discipline a maturing asset class needs: tighter docs, lighter leverage, better pricing, and a re-emphasis on the segments that built private credit's track record in the first place.

For investors who want the diversification, income, and downside mitigation private credit was originally designed to deliver, the lower and core middle market—patient, disciplined, covenant-protected, and aligned—remains where the persistent value lives.

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