Principal Asset Management℠

Investment education

Why smaller does not always mean riskier: The case for lower and core middle market direct lending

HIGHLIGHTS

- **Lower and core middle market direct lending provides privately negotiated senior-secured loans to companies with $5 – 50 million in EBITDA, offering enhanced yield potential and structural protections.**
- **While direct lending is sometimes viewed as a single asset class, returns increasingly depend on where capital is deployed, particularly across lower, core, and upper middle market segments.**
- **Middle market direct lending has historically exhibited lower default rates and higher recovery rates than broadly syndicated loans, supported by low leverage, robust covenants, and active lender monitoring.**

The global financial crisis transformed the way middle market companies access debt capital. As traditional bank lenders retreated due to tighter regulations, non-bank lenders emerged to fill the gap, creating a substantial private credit market.

For wealth advisors and their clients, middle market direct lending offers access to privately negotiated loans with enhanced yield potential, structural protections, and diversification benefits. This primer explains what direct lending is, the different characteristics across market segments, and key implementation considerations.

As private credit continues to scale and capital concentrates in larger transactions, understanding these distinctions has become central to accessing the expected risk-return characteristics of the asset class.

What is middle market direct lending?

Middle market direct lending involves providing debt financing to companies, typically in partnership with private equity sponsors or directly with business owners. Unlike broadly syndicated loans that are marketed to institutional investors, direct loans are privately negotiated with one or a small group of lenders.

The middle market encompasses companies with annual EBITDA (earnings before interest, taxes, depreciation, and amortization) between $5 million and $100 million. Within this universe, distinct sub-segments offer different risk-return profiles:

UPPER MIDDLE MARKET

- Companies with $50 – 100 million EBITDA
- More competitive, with pricing and terms more comparable to the broadly syndicated loan market

CORE MIDDLE MARKET

- Companies with $15 – 50 million EBITDA
- Balanced competition, solid covenant packages, historically attractive risk-adjusted returns

LOWER MIDDLE MARKET

- Companies with $5 – 15 million EBITDA
- Less competition, stronger structural protections (including covenants), typically lower leverage, and higher yields

WHILE COMPARABLE TO OTHER PRIVATE CREDIT STRATEGIES, LOWER AND CORE MIDDLE MARKET DIRECT LENDING HAS IMPORTANT DISTINCTIONS:

Relationship-driven

Direct lenders maintain ongoing relationships with borrowers and private equity sponsors throughout the investment lifecycle. This enables customized structures and proactive engagement when challenges arise.

Negotiated documentation

Unlike broadly syndicated loans with standardized terms, direct lenders can influence covenant packages, security arrangements, and structural protections to match specific credit profiles and risk tolerances of investors.

Market inefficiency

Lower and core middle market segments experience less competition than larger markets. Fewer institutional participants, limited secondary market liquidity, and higher barriers to entry create favorable structural and pricing opportunities for specialized lenders.

Active monitoring

Smaller loan sizes and direct borrower relationships allow for detailed oversight, including monthly financial reporting, regular management calls and engagement, site visits, and covenant compliance monitoring throughout the investment period.

Together, these features allow lenders in the lower and core middle market to exert a level of control and influence that is increasingly difficult to achieve in larger, more competitive segments.

Size matters: The lower and core middle market advantage

Direct lending activity in the U.S. is robust, with over 2,500 transactions completed in the first nine months of 2025 (up 7% year-on-year), totaling $231 billion across leveraged buyouts, refinancings, and growth capital.[*1]

However, the recent influx of capital into direct lending has not affected all parts of the middle market equally. The upper middle market segment, for example, increasingly resembles public broadly syndicated loan markets. Competition with the broadly syndicated loan market is also evident in direct lending to large cap borrowers. Large transactions in both the upper middle market and large cap private credit market attract numerous institutional lenders competing for placement, driving yield compression, and covenant erosion.

By contrast, the lower and core middle market segments remain underserved. This allows lenders to negotiate favorable terms without being bid down to the lowest price or weakest structure.

Overall, two characteristics support lower and core middle market segments' advantage:

1 Diversification through granularity

The abundance of smaller transactions can contribute to enhanced portfolio diversification. A strategy focused on lower and core middle market companies might hold more than 100 individual positions, with no single investment exceeding 1-2% of total assets.

Lower and core middle market lenders benefit from accessing thousands of distinct companies across diverse industries, geographies, and business models. This genuine diversification—both within middle market direct lending portfolios and relative to other asset classes—has historically contributed to stable returns across cycles. Achieving comparable diversification in the upper middle market is harder, given bigger transaction sizes and the potential overlap across transactions in large managers' strategies.

2 Greater lender control

A common misconception is that lending to smaller companies means more credit risk. In practice, lower and core middle market borrowers typically operate with lower leverage, stronger maintenance covenants, and meaningful equity cushions. In addition, lenders in these segments are either the sole provider of debt financing or part of a small club, giving them close access to management and a higher level of influence.

Combined, these features have historically translated into attractive credit performance. Historical default rates for middle market direct lending average approximately 2.1% annually, with recent levels around 1.5%, well below the 3 – 4% typical of broadly syndicated loans and high yield bonds. Recovery rates also exceed public market averages, reflecting their senior-secured positioning in the capital structure.

[*1] Debtwire, 9M US Direct Lender Rankings, December 2025.

The role of lower and core middle market direct lending in client portfolios

1 Income and yield enhancement

The inherent advantages of lower and core middle market direct lending—reduced competition, diversification, enhanced lender control—combine to deliver an inefficiency premium on top of the liquidity premium inherent in private credit markets. Typical yield ranges vary by market segment and structure:

- **Lower middle market (first lien):** Historically, approximately 9.25 – 11.50% yields.
- **Core middle market (first lien):** Historically, approximately 8.5 – 10.50% yields.
- **Non-senior and subordinated structures:** Historically higher yields reflecting additional structural risk, often in the 11 – 14% range depending on leverage and covenant protections.

The floating-rate nature of most loans provides a natural hedge in rising interest rate environments, with interest payments adjusting monthly, quarterly, or semi-annually based on reference rates. Many loans include Secured Overnight Financing Rate (SOFR) or equivalent floors, establishing minimum interest rates regardless of base rate movements.

2 Capital preservation

Middle market direct lending structures typically include multiple layers of downside risk mitigation:

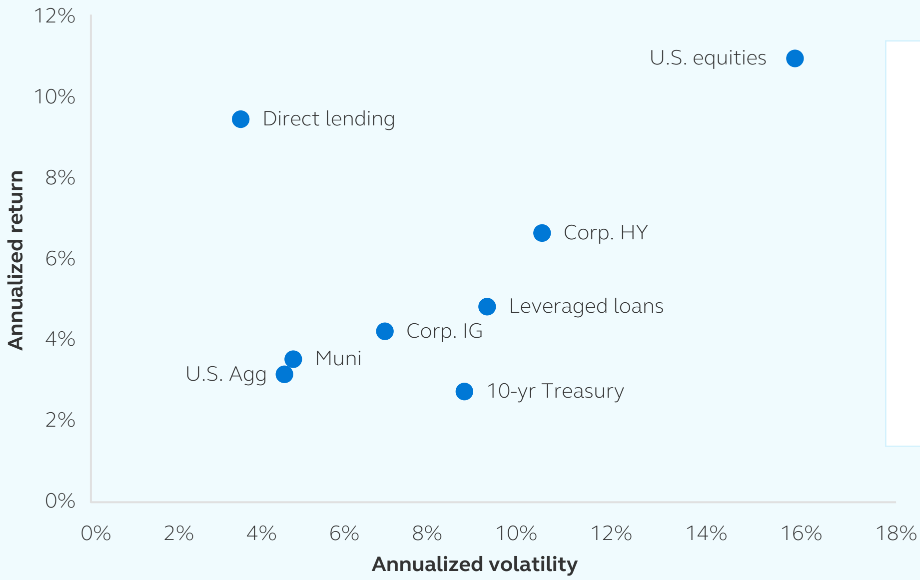
- **Senior-secured:** Priority security interests over specific assets, typically all or virtually all of the borrower's assets, including accounts receivable, inventory, equipment, property, and intellectual property.
- **Equity cushion:** Lower and core middle market loans typically maintain loan-to-value ratios of 35 – 45%, providing mitigation against enterprise value decline.
- **Maintenance covenants:** Financial covenants (typically maximum leverage and minimum fixed charge coverage) tested quarterly, enabling early intervention if performance deteriorates.
- **Conservative leverage:** Total debt-to-EBITDA ratios of 2 – 4.5x for lower middle market and 2.5 – 5.5x for core middle market, compared with 4 – 7x or higher in larger transactions.
- **Negative covenants:** Restrictions on additional indebtedness, liens, asset sales, investments, and distributions help protect lender interests and preserve collateral value.
- **Reporting and oversight:** Monthly financial statements, annual audits, budget reviews, and management access enable proactive monitoring.

Historical yields are based on market observations and are presented for discussion purposes only. They are not projections of results for any investor. The actual results may differ materially from those depicted above based on numerous factors, including market changes.

3 Diversification with low correlation

Direct lending performance is typically influenced more by company-level operations and credit fundamentals than broader market sentiment or liquidity conditions. Historically, this has led to low correlation with public fixed income and other asset classes.

HISTORICAL RISK/RETURN SINCE 2004*



Correlation

DIRECT LENDING VS

Corp. IG	0.21
Muni	0.12
U.S. Agg	-0.15
10-year Treasury	-0.50

As of September 30, 2025. *Since inception of Cliffwater Direct Lending index on September 30, 2004. Sources: Bloomberg, Cliffwater Direct Lending Index, S&P 500 S&P/LSTA Leveraged Loan Index, Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Municipal Index, Bloomberg U.S. Corporate Bond Index, Bloomberg U.S. Corporate High Yield Index, Private Equity Total Return Index USD. Risk measured as standard deviation of quarterly returns. This chart is designed to show the amount of volatility compared to the annualized returns of the asset classes and is not intended to show the credit quality of the asset class itself. Past performance is no guarantee of future results.

Several factors contribute to the diversification benefits of direct lending, including steady capital supporting the direct lending market, mark-to-model valuations based on underlying borrower credit risks and not subject to daily trading, exposure to thousands of companies not accessible through public markets, different risk drivers, and contractual cash flows.

4 Low volatility

Direct lending exhibits several characteristics that contribute to reduced portfolio volatility:

- **Emphasis on stable businesses:** Underwriting focuses on companies with recurring revenue and cash flow, sustainable margins, limited customer concentration, and defensive industry positioning.
- **Avoidance of binary risks:** Disciplined lenders exclude credits with regulatory uncertainty, undue customer concentration, key person dependency, technological obsolescence risk or single product reliance.
- **Conservative leverage:** Lower debt-to-EBITDA ratios (typically 3 – 5x for first lien positions) provide a cushion against operational challenges or market deterioration.
- **Structural capital stability:** Direct lending funds are structured around committed, long-term capital with clearly defined investment and realization periods. Unlike public credit markets, where funds can experience large redemptions due to technical factors or systemic risk concerns, direct lending portfolios are insulated from mark-to-market volatility and managers can remain focused on underwriting, cashflow generation, and ultimate recovery.

Understanding risk across the spectrum

Direct lending encompasses a range of structures and risk profiles. Understanding these helps investors align allocations to their specific return objectives and risk tolerance.

	LOWER MIDDLE MARKET	CORE MIDDLE MARKET	UPPER MIDDLE MARKET	BROADLY SYNDICATED
Company size (EBITDA)	\$5 – 5m	\$15 – 50m	\$50 – 100m	Above \$100m
Loan size	Below \$100m	Below \$200m	Above \$200m	Above \$300m
SOFR spread	500 to 725 bps	450 to 625 bps	350 to 500 bps	250 to 350 bps
Leverage	2-4.5x	2.5-5.5x	4.0-6.5x	Up to 7.0x
Loan-to-value	35 – 45%	Less than 50%	Less than 60%	Less than 65%
Expected yield (gross)	9.25 – 11.50%	8.50 – 10.50%	7.25 – 9.00%	6.25 – 7.50%
Expected avg. annual default rate	Less than 2.5%	Less than 2.5%	Less than 2.5%	3-4%
Expected recovery rate	70%+	70%+	60%+	50%+
Financial covenants	2+ maintenance covenants	Often 2 maintenance covenants	Often no covenants	Often no covenants

Source: Market observations and industry data as of 2025. Ranges shown are for first lien senior secured positions. Expected returns, default rates and recovery rates are based on historical observations and forward-looking estimates.

Implementation considerations for advisors

Advisors should consider the following when evaluating middle market direct lending allocations for their clients:

- **Yield targets and credit quality:** Appropriate alignment with return requirements and risk tolerance across lower, core and upper middle market segments.
- **Diversification objectives:** Complementary exposure to public high yield, broadly syndicated loans, investment grade credit and private equity.
- **Liquidity profile and time horizon:** Alignment with 3 – 7-year average loan lives and hold-to-maturity strategies.
- **Sector and industry exposure:** Thematic preferences for defensive industries, industries benefiting from positive secular trends, recurring revenue models or cyclical value opportunities.
- **Structure and seniority preferences:** First lien, unitranche, second lien or opportunistic subordinated debt based on risk appetite.
- **Interest rate sensitivity:** Floating-rate exposure provides inflation mitigation and reduces impact of interest rate volatility but requires consideration within overall duration management.
- **Manager capabilities:** Origination networks, underwriting discipline, portfolio monitoring infrastructure, workout expertise, and alignment of interests through co-investment.
- **Market focus and capital discipline:** As capital concentrates among larger managers, understanding where and how a manager deploys capital, any "strategy drift", and their ability to remain disciplined in smaller, less competitive segments, is essential.

FOUR QUESTIONS TO ASK CLIENTS

1. How does middle market direct lending fit within your current fixed income and alternatives allocation? Which existing exposures might it complement or replace?
2. What kind of yield enhancement are you targeting, and how does that correspond to your expectations around credit risk, leverage and structural subordination?
3. How important are covenant protections, active monitoring and lender control in your credit allocation?
4. What is your tolerance for illiquidity, and how does the 3 – 7-year average investment horizon align with your income requirements?

Over the past decade, direct lending has become a core allocation for investors seeking attractive yields and diversification. But the market is far from uniform.

Differences in deal size, competition and structure are increasingly shaping outcomes. While parts of the market have become more competitive and commoditized, the lower and core middle market continue to offer structural inefficiencies that support attractive risk-adjusted returns.

For advisors, direct lending should be approached not as a homogenous allocation, but as a strategy where selectivity by segment, structure and manager can play a decisive role in pursuing resilient income and capital preservation over time.

For Public Distribution in the United States. For Institutional, Professional, Qualified, and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

Risk Considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Floating rate debt instruments are subject to credit risk, interest rate risk, and impaired collateral risk, which means that the value of the collateral used to secure a loan held by the fund could decline over the course of the loan. Private credit involves an investment in non-publicly traded securities which are subject to illiquidity risk. Investors should be aware that alternative investments including private equity and private debt strategies may magnify risk. Alternative investments may be illiquid, there may be no liquid secondary market or ready purchasers for such securities, and they may be subject to high fees and expenses. Alternative investments are not appropriate for all investors and should not constitute an entire investment program. Asset allocation and diversification do not ensure a profit or protect against a loss. The risk management techniques discussed seek to mitigate or reduce risk but cannot remove it.

Important information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account.

Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. All figures shown in this document are in U.S. dollars unless otherwise noted.

This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

"Cliffwater," "Cliffwater Direct Lending Index," and "CDLI" are trademarks of Cliffwater LLC. The Cliffwater Direct Lending Indexes (the "Indexes") and all information on the performance or characteristics thereof ("Index Data") are owned exclusively by Cliffwater LLC and are referenced herein under license. Neither Cliffwater nor any of its affiliates sponsor or endorse or are affiliated with or otherwise connected to Principal Life Insurance Company, or any of its products or services. All Index Data is provided for informational purposes only, on an "as available" basis, without any warranty of any kind, whether express or implied. Cliffwater and its affiliates do not accept any liability whatsoever for any errors or omissions in the Indexes or Index Data or arising from any use of the Indexes or Index Data, and no third party may rely on any Indexes or Index Data referenced in this report. No further distribution of Index Data is permitted without the express written consent of Cliffwater. Any reference to or use of the Index or Index Data is subject to the further notices and disclaimers set forth from time to time on Cliffwater's website at https://www.cliffwaterdirectlendingindex.com/disclosures.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- Europe by Principal Global Investors (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGII, PGIE or PGII may delegate management authority to affiliates that are not authorised and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID).
- United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA").
- This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
- United Arab Emirates by Principal Investor Management (DIFC) Limited, an entity registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as an Authorised Firm, in its capacity as distributor / promoter of the products and services of Principal Asset Management. This document is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation.
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001.
- Hong Kong SAR by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission. This document may only be distributed, circulated or issued to persons who are Professional Investors under the Securities and Futures Ordinance and any rules made under that Ordinance or as otherwise permitted by that Ordinance.
- Other APAC Countries/Jurisdictions, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

Principal Funds are distributed by Principal Funds Distributor, Inc.

MM14888 | 02/2026 | 5235896-12/2027