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Principal Asset Management℠

PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

Measuring risk in the private credit markets

The direct lending market has experienced significant growth and has become an important part of institutional investors' portfolios, offering potentially attractive risk-adjusted returns with higher current income than most fixed income alternatives. For middle market direct lenders ("MMDLs") such as Principal Alternative Credit ("PAC"), the ability to properly analyze the underlying risk profile of a borrower and protect against principal loss is the primary determinant of future returns.

Investors in corporate bonds and broadly syndicated loans often benefit from external ratings to help assess the relative credit quality of borrowers. Because many middle market borrowers do not have external ratings, MMDLs rely more heavily on investment team member assessments of credit risk and proprietary credit rating frameworks.

Principal Alternative Credit draws on Principal's 65 years of experience assigning internal credit ratings to derive its rating for directly originated middle market loans[1]. Underpinning those ratings are third-party resources like Moody's Risk Calc and Nationally Recognized Securities Ratings Organizations (NRSRO) ratings, but perhaps most importantly our own objective quantitative internal ratings framework, which we refer to as PAC CreditIQ.

When we constructed this framework, we reviewed years of various financial metrics in an effort to identify the factors that best explain the credit risk of a borrower. We included many popular time-tested credit metrics along with numerous additional ratios often cited by fixed income investors or ratings agencies—all metrics tested are noted in Exhibit 1. We compared the results of this research to the methodologies of Moodys and Standard & Poor's.

Our goal was to construct a framework, backed by empirical data, that can be consistently applied across all middle market transactions and inform our assessment of a borrower's risk profile expected throughout the life of a loan, focusing on the key determinants of business and structural risks.

EXHIBIT 1: Metrics tested for Principal Alternative Credit (" PAC CreditIQ") risk framework

- Scale: total revenues
- Scale: total assets
- Operating income ROA (EBIT/total assets)
- EBITDA margin
- Loan-to-value: total debt / total enterprise value
- Free Total debt / total enterprise value
- Tangible assets / total debt
- Liquidity: (cash + marketable securities)(total debt)
- Liquidity: (cash + marketable securities)(current liabilities)
- Sharp ratio of operating income margin: 3 and 5 years
- Sharp ratio of sales growth: 3 and 5 years
- Enterprise value/EBITDA
- Business profile: growth CAGR[2] (3/5 years average)
- Operating income ROA[3]=(EBIT/ tangible assets)
- Cash / total liabilities
- (EBITIDA –CapEx) interest expense
- Gross debt / EBITDA
- CapEx / revenue
- Inventory / revenue
- Net working capital / revenue
- Total acquisitions: 3 and 5 years of total mergers & acquisitions

(1) Experience includes investment management activities of predecessor firms beginning in the investment department of Principal Life Insurance Company.

(2) Compound annual growth rate

(3) Return on assets

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Drivers of credit risk

The results from our research highlighted key drivers of risk that we captured in our framework. Here are some of the notable themes and how we have captured them in PAC CreditIQ.

A borrower's risk profile is heavily influenced by loan-to-value (tranche-level debt to enterprise value)

Rating agency ratings frameworks exclude this metric due to the changing value for many publicly traded issuers whose equity market valuation fluctuates daily. However, private markets remove these fluctuations and allow equity owners to focus on long-term value creation.

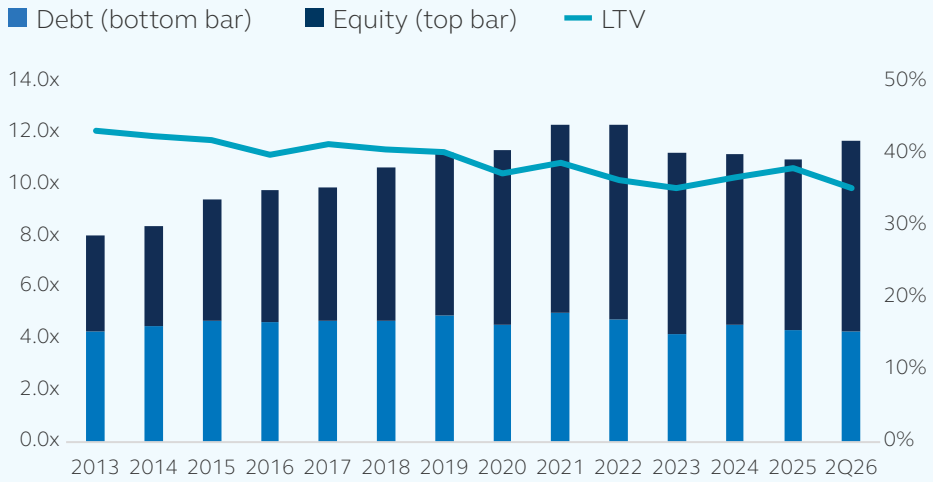
To capture loan-to-value ("LTV"), we not only include the ratio in our framework but also financial metrics which have a highly predictive relationship to enterprise value ("EV") multiples in order to test valuations against their historical drivers. While EV is a point in time and subject to changes in market conditions, the investment team analyzes historical multiples throughout a business cycle along with capturing a forward-looking view of key business drivers which will impact the expected borrower's equity cushion for a proposed loan.

The investment team also monitors changes in public and private market valuations, which might result in LTV changes and thus rating changes throughout the life of the loan, providing transparency to investors regarding the quality of their portfolio over time. Exhibit 2 specifically illustrates the general increase in middle market buyout multiples which have largely been funded with additional equity.

Volatility in financial results significantly impacts risk

Fluctuations in operating performance caused by macro factors (i.e., economic cycle, shifts in industry demand drivers) or company-specific factors (i.e., integration challenges, customer loss) have a material impact on a borrower's risk profile. The data highlighted a notable bias towards companies with a low standard deviation in past results. Lenders desire a steady and predictable stream of cash flow to support their debt, but fluctuations in past performance increase the potential that future trends might also be volatile and could weaken the ability of a borrower to service its debt. We have captured this risk through several factors in our matrix including end-market cyclicality, competitive barriers to entry, and customer concentration.

EXHIBIT 2: Middle market debt & equity buyout multiples and loan-to-value



Although debt levels have moved slightly higher since 2013, the expansion of buyout multiples has been supported by a significant increase in equity contribution.

As of 30 June 2026. Source LSEG LPC. Past performance is not a guarantee of future results.

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Capital intensive businesses carry embedded risk factors

Businesses with sizable capital outlays carry notable risk factors that challenge a borrower's credit profile. Along with the adverse impact to cash flow due to capex requirements, these businesses often carry lower margins and sizable fixed cost structures. In order to underwrite an investment in capital intensive industries, the investment team focuses its diligence on the strength of customer relationships, barriers to entry (e.g., patents, geographic proximity to customers, a high degree of integration in customers' design and manufacturing processes, etc.), customer contracts, fleet age and utilization, and the replacement cycle.

Benefits of an internal ratings framework

The benefits of having an internal risk framework are many—here are some of the most impactful.

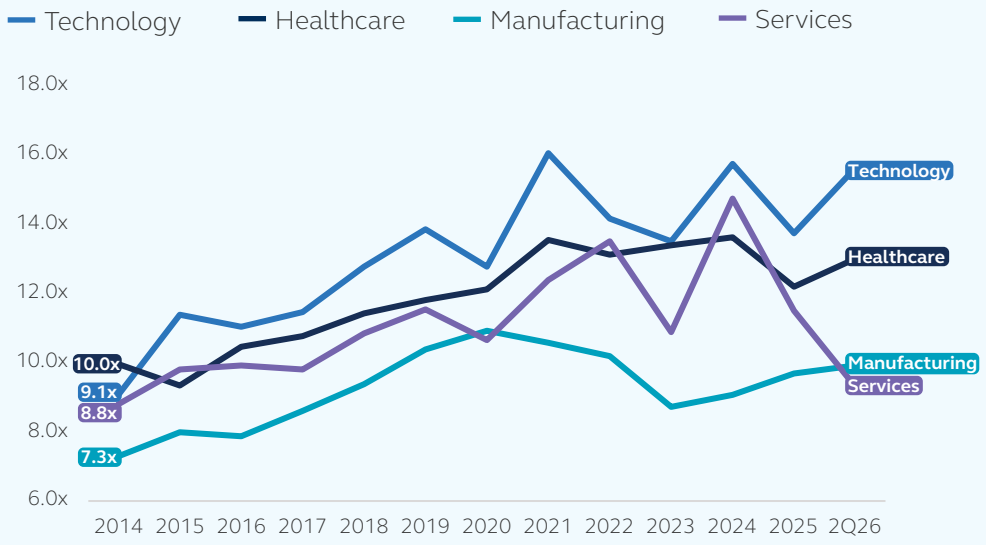
Transparency of key risk considerations

By focusing on what matters most and having a discussion on underlying drivers of a rating, the PAC investment team can center its diligence plan on gaining a deeper understanding of key risk considerations. There is typically a period of one to three months where the team is working through due diligence on a prospective borrower, gathering data and insights that will inform our view on credit strengths and key risk considerations. The more accurately risks (all companies have them) can be understood, the better the investment team can structure legal documentation and covenant levels to serve as effective guardrails for lenders if business performance declines.

Comparability across industries

Risk can be challenging to measure when comparing industries with completely different end-markets. To solve for this limitation, we focused our efforts on constructing a framework which transcends industries while giving the appropriate quantifiable consideration for attributes (e.g., cyclicality, barriers to entry, expected growth profile, margin structure, capital intensity, and EV multiple support) which make some industries more attractive than others. Exhibit 3 shows how EV multiples have trended across various industry groups.

EXHIBIT 3: Acquisition enterprise value multiples by industry



Industries with attractive long-term growth expectations have experienced the greatest multiple expansion over the last decade

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Exposure sizing and pricing guidance

A common way to measure risk through ratings helps provide a basis for sizing exposure in client portfolios along with providing insight into expected pricing. Without a consistent lens for comparing risk, portfolio construction can lack the discipline and structure necessary to preserve against outsized future losses with investment size often being determined by transactional need rather than risk profile. Additionally, a common rating allows the team to define yield requirements as it compares various investment alternatives.

Removal of investor bias

Historical perspectives and lessons can be beneficial to the investment process, but they can often come with negative side-effects including biases shaped by past experiences which can lead to flawed decision-making. A consistent and objective framework helps guard against this and creates a platform for open and objective discussion on key risk considerations. Our ratings serve as a basis for comparability and can provide insights into diverging viewpoints of a borrower's risk.

Structural considerations for a rating

A credit rating should give consideration to some transaction-specific criteria which can impact a borrower's risk profile and ability to repay lenders. These factors are a combination of quantitative and qualitative factors that combine ownership structure and transactional details.

Equity ownership

A unique aspect of the private markets is the concentrated ownership structure of borrowers, which allows lenders to complete due diligence on the impact that this could have on a borrower's risk profile. Private equity sponsors benefit from pools of capital that incentivize long-term decision making. Sponsor ownership can benefit lenders through additional capital support, but sponsor behavior, including liability management actions, can also alter the risk profile and ultimate recovery when a loan encounters challenges.

PAC focuses on allocating our clients' capital to companies backed by sponsors who have a history of treating lenders favorably by supporting their portfolio companies when they encounter the proverbial bump in the road. Additionally, we assess a sponsor's historical investing track record and expertise to favor those with a proven history of attractive risk-adjusted returns.

Document protection

The benefits of lending in the lower-middle markets are many, but near the top of the list is the ability to draft a credit agreement which provides meaningful lender protections. Tighter covenant cushions serve as a protection for lenders by helping address early signs of problems sooner to help ensure a borrower is taking the necessary steps to improve underperformance. Ratings universally fail to give significant consideration to these protections, which serve as the basis for helping protect lender interests. Tighter covenant cushions help address early signs of problems sooner to help ensure that a borrower is taking the necessary steps to potentially improve underperformance. Additionally, more timely reporting requirements, broader rep and warranty coverage, limits on restricted payments, and protections against additional debt are just a few of the protections standard in most middle market direct lending transactions that should help lead to lower losses in the event of a default.

EBITDA adjustments

Many transactions in the private markets are to support buyout or acquisition-related financing. There are often diligence or transaction-related adjustments to the EBITDA used to set the amount of leverage for the structure. These adjustments include anything from normalized compensation (e.g., a founder earning a market salary and bonus going forward after paying his or herself an outsized salary), pro-forma cost synergies, or an adjustment to acknowledge a one-time event unlikely to be repeated in future years.

As the magnitude of these adjustments increases, so too does the borrower's risk profile as adjustments often rely on a set of assumptions that can fail to materialize post-close. We believe it's prudent to acknowledge the risk of adjustments not materializing into EBITDA when rating a loan.

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Rating agency limitations

The ratings agencies currently serve the need of providing investors with an assessment of risk to capture the probability of default (PD) of a borrower along with loss given default (LGD) in the event of a default. Despite the valuable service ratings agencies provide investors, there are critical limitations which can impact the accuracy of a rating. We outline in greater detail some of the key limitations.

Broad industry frameworks

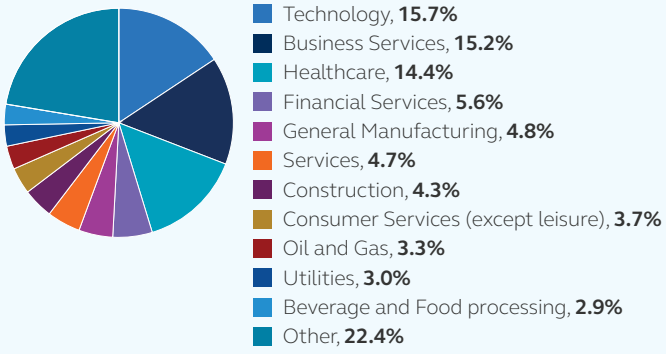
Rating agencies often rely on broad industry categorizations, which fail to give consideration to the many niche businesses that define the middle markets. Consider the example of a platform of veterinary clinics owned by a private equity sponsor. Would this business constitute a Healthcare company? Would it fall under Retail given the physical nature of locations? Or possibly Business & Consumer Services? There is a legitimate case for each of these three alternatives, but each fails to give full consideration to the stability of the end market (unlike Retail), the attractive cash payor profile (unlike much of Healthcare), or the high barriers to entry caused by a shortage of veterinarians (unlike Retailers or Services). This is one example, among many, of how a broad industry framework can be challenging to apply for middle-market borrowers.

Reliance on book value measures

Book value ratios pulled from financial statements aren't as useful in human capital businesses (like many MMDL borrowers) and fail to give consideration to changes in market valuations. Exhibit 4 notes how recent buyout volumes have been focused on capital-lite industries.

Recent market conditions have widened the dispersion in enterprise values as interest rates, financing availability, technology disruption, labor conditions, and supply-chain risks have evolved. Buyout multiples reflect changing valuation assessments by private equity sponsors, which may alter the loan-to-value of a prospective borrower (the greatest driver of a borrower's rating). To guard against the short-term fluctuations in EV multiples, the investment team gives consideration to business (and EV multiple) cyclicality along with analyzing the volatility of underlying credit metrics and over a prolonged period of time.

EXHIBIT 4: 2025 Middle market sponsor volume by industry



As of 31 December 2025. Source LSEG LPC. The data provided is aggregated from third party sources. As such, the combined total might not equal 100.

The middle market is moving towards asset-lite businesses which makes many book value metrics less relevant.

Lack of comparability across industries

There can be notable discrepancies of the perceived risk in comparably rated credits, which are evident when examining public credit spreads, or risk premia that investors charge a borrower above the risk-free rate. The vast range of credit spreads for like-rated investments points to the challenge of rating risk for companies in different industries. To solve for this limitation, we have constructed PAC CreditIQ around metrics with universal application such as loan-to-value, EBITDA margin, levered free cash flow to debt, or precedent enterprise value multiples, as examples.

Conclusion

There are notable benefits to having a proprietary ratings framework that can be used throughout the diligence process and over the life of a loan. Importantly, a transparent and consistent process allows the PAC team to focus on identifying relevant risks and incorporating protections into the drafting of credit agreements. The constant quest to better understand and measure risk of a borrower provides a depth of insights that can help enhance investment decision making.

Risk Considerations
Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Private credit involves an investment in non-publicly traded securities which are subject to illiquidity risk. Portfolios that invest in private credit may be leveraged and may engage in speculative investment practices that increase the risk of investment loss.

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