Principal Alternative Credit

Principal Asset Management℠

How U.S. middle market direct lending complements and enhances European portfolios

Direct lending continues to expand across Europe as institutional and sophisticated high-net-worth investors recognize the attractive opportunities available. Demand for private credit, and specifically middle market direct lending, is growing faster than supply, prompting investors to look beyond their domestic markets.

This paper outlines why a complementary allocation to U.S. middle market direct lending may enhance portfolio diversification, and potential returns.

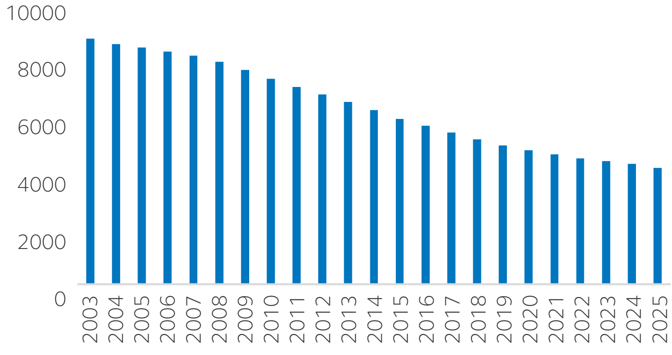
Why look beyond Europe

Cash is the lifeblood of any business, and access to financing – particularly for small and medium-sized firms – is essential to support growth.

In Europe, middle-market companies have traditionally relied on banks, which still dominate the lending ecosystem. However, following the Global Financial Crisis (GFC), the regulatory environment in the U.S. tightened, which created space for non-bank lenders to gain additional market share.

The dis-intermediation of U.S. direct lending from banks to non-bank lenders began more than a decade earlier and accelerated following the GFC. Driving some of this evolution was the substantial decline in the number of U.S. commercial banks (see Exhibit 1).

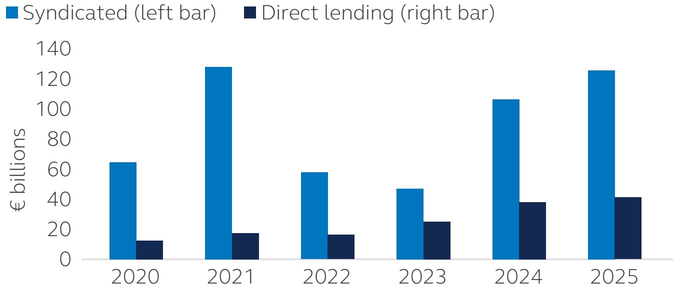
Exhibit 1: FDIC insured institutions



Source: Federal Deposit Insurance Corporation (FDIC), as of 31 December 2025.

Today, banks still account for much of middle-market lending in Europe, as represented by considerable exposure of commercial banks holding loans directly on balance sheet. In addition, the broadly syndicated loan (BSL) market in Europe is substantially larger in terms of capital deployed as compared to the size of capital deployment for direct lending (see Exhibit 2).

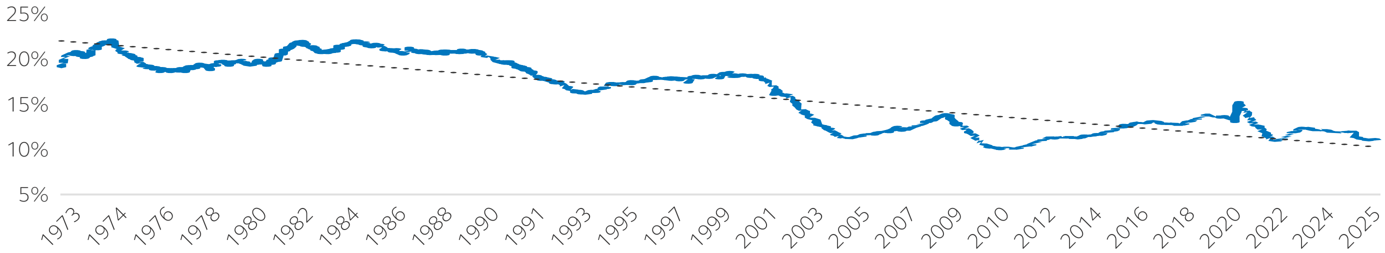
Exhibit 2: New-issue volume of deals financed via BSL vs direct lending (€ bn)



Source: PitchBook, LCD, Data through 31 December 2025. BSL refers to broadly syndicated loan market; direct-lending count based on deals covered by LCD News.

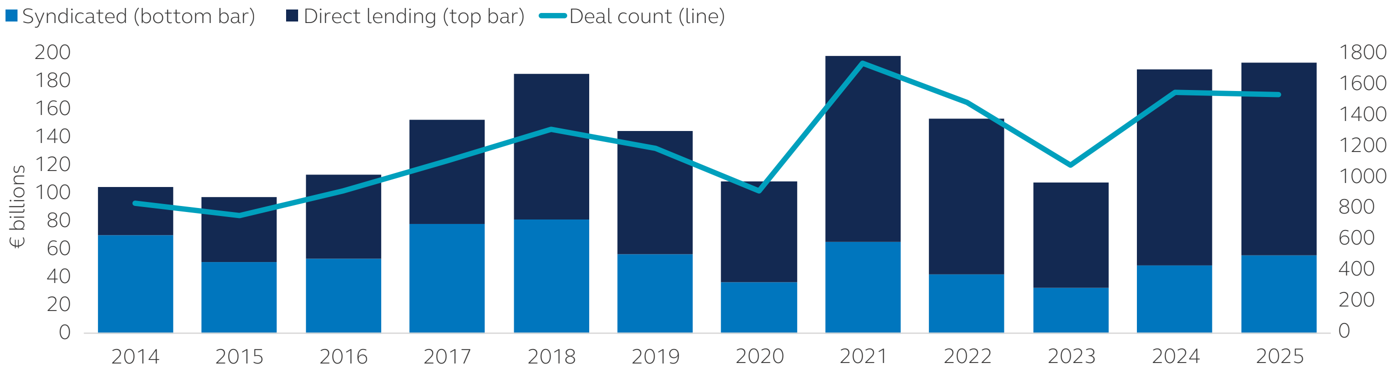
Banks are a small fraction of buyout financing in the U.S. , either through holding loans directly on balance sheet or through broader syndications, having shifted away from holding significant commercial and industrial loans in favor of less capital-intensive assets (see Exhibit 3). Alternatively, U.S. middle market direct lending has substantially grown its share of private equity sponsor backed loans to a level that is now around 2.5x larger than the BSL market (see Exhibit 4).

Exhibit 3: Commercial and industrial loans as a percentage of total bank assets



Source: Federal Reserve Board as of 31 December 2025.

Exhibit 4: Annual sponsored MM loan volume ($ bn) & deal count (right axis)



Source: LSEG, LPC. As of 31 December 2025

Different markets, different dynamics

Comparing the United States to Europe on a like-for-like basis is challenging given the latter's fragmented legal, regulatory, and cultural landscape. Direct lending is something of an exception, however, as many European deals are structured under U.K. law. In the table below, we outline some key distinctions between U.S. and European direct lending that investors will encounter. The terms are generally more investor favorable in the U.S., which is in part a result of lender friendly precedents established over the U.S. direct lending market's history.

Provision/concept	U.S. position	Europe position
Amortization	Limited (typically ~1% per year) until repayment at maturity	Typically no amortization; repaid at maturity (bullet loans)
Mandatory prepayments	Required from asset sales, insurance proceeds, and excess cash flow (often with step-downs over time)	Similar, but generally fewer cash sweep requirements and higher thresholds
Covenant cushion (headroom)	Typically ~25–35%	Typically ~35–40%
Financial covenants—equity cure	Usually through paying down debt; flexibility is limited	More flexible; can reduce debt or increase earnings (EBITDA)
Working capital facilities	Revolving credit facilities often pari passu to the term loan; priority sometimes achieved through an agreement among lenders	Usually structured as top-priority (super senior) or allowed through separate capacity for future facilities

Source: Principal Asset Management, Proskauer, Carlsquare, Q1 2026.

Another point of distinction is how transactions are sourced. In Europe, intermediaries such as debt advisors are routinely involved in placing loans with investors through a broader outreach to prospective lenders, resulting in more competitive terms. In the U.S., sponsor relationships tend to be more established, reducing reliance on these intermediaries. These bilateral transactions provide a more streamlined capital raising process, which is often preferable to private equity sponsors and also benefits lenders with proven origination relationships. While European banks continue to control much of the non-sponsored loan market, U.S. non-sponsored loan origination is well established and growing as direct lenders continue to take share from banks. Importantly, the non-sponsored channel represents an attractive source of potential alpha for investors given the transactions are often structured with lower leverage, tighter covenants, and attractive pricing compared to the sponsor origination channel.

The case for the U.S.

Unlike Europe, the U.S. benefits from a single legal and regulatory landscape, with a relatively homogeneous culture. It is the world's largest economy, with middle-market firms contributing roughly one-third of private sector GDP and employment.[*1]

U.S. direct lending provides numerous key advantages for European investors including:

- **A deeper and more diverse investment universe.** More than 200,000 middle-market companies operate across a broad range of industries.
- **Attractive risk and return profiles.** Default rates remain below long-term averages and transactions tend to be more lightly levered in this higher-for-longer rate environment. Long-term historical default levels also remain attractive at approximately 2%.
- **Strong structural protections.** U.S. lenders often benefit from stronger covenant protections and have greater influence in workout scenarios.
- **Reduced exposure to supply chain volatility.** Most middle-market firms operate almost entirely in their home market (locally-focused), limiting exposure to global geopolitical disruptions and international logistics issues.

More broadly, the U.S. has a reputation for being business friendly and it is recognized as one of the easiest places in the world to set up a company. The current administration has also lifted some of the regulatory burden that disproportionately impacted small to medium-sized companies.

One example of this is a provision in President Trump's One Big Beautiful Bill Act, which was signed into law on 4 July 2025, allowing firms to fully expense many forms of investment. Business owners are now incentivized to invest more in capital equipment and drive greater efficiencies.

The U.S. middle market is also incredibly dynamic, with simultaneous trends toward consolidation and robust new business formation. The market's significant size, depth, and dynamism provides companies the opportunity to scale domestically without needing to navigate different legal systems or regulatory frameworks.

Navigating key concerns for European investors

Investing carries risk, and every investor has their own appetite for stomaching market volatility. Here we address some of the key concerns European-based investors have expressed regarding allocations to U.S. investments.

U.S. politics

President Donald Trump's return to office in 2025 reintroduced policy unpredictability.

However, as evidenced by his One Big Beautiful Bill Act, he has consistently prioritized deregulation, tax cuts, and business-friendly measures that benefit middle-market companies. Despite the broader geopolitical noise, these policies support business profitability and U.S. economic growth. Also, policy moves to support on-shoring more manufacturing and operations creates increased demand for many small to medium-sized U.S. businesses, potentially providing even more support for middle market companies as compared to multi-national companies.

[*1] Source: National Center for the Middle Market, Q4 2025

Global politics

Global tensions, conflict, and commodity price fluctuations remain top of mind for investors, some of whom have flocked to so-called safe havens, such as gold. While gold saw a strong rally in 2025, a big correction in early 2026 highlighted the challenges of relying on global commodities as a hedge.

The U.S. middle market, especially the lower and core end of the market, has some built-in immunity to external shocks. These firms typically operate domestically with a regional focus and often within the services sector, which is supported by strong business and consumer demand.

Though there has been some recent relief, energy prices are a universal challenge. However, the U.S. government has multiple levers it can pull to lower oil and gas prices in the short term and ease the economic impact on businesses. In addition, the U.S. oil supply substantially meets domestic demand, creating a more sustainable economic environment when compared to other regions more reliant on imports for meeting demand. This potential imbalance creates a higher risk of recession in countries and regions with less certain supply, making them more vulnerable to price shocks.

> *"I think we're at the beginning of an even more favorable loan vintage, so when everything seems darkest in the geopolitical scheme, oftentimes that's the best opportunity to begin or increase your allocation in a meaningful way."*
>
> **Tim Warrick,**
> Group Head, Principal Alternative Credit

Tariffs

Markets dislike uncertainty, and that is what President Trump's tariffs have delivered. Negotiations with trading partners are ongoing and many deals remain unresolved. In February 2026, the U.S. Supreme Court declared many of the tariffs unconstitutional, adding further uncertainty for U.S. companies reliant on imports.

Understanding a borrower's supply chain is critical to assessing their tariff risk and predicting the impact of any future changes from the White House.

It's important to recognize, however, that higher import costs have created competitive openings for some U.S. companies. In addition, the negative repercussions of tariffs on non-U.S. producers and economic conditions of trading partners highlight the importance of and benefits that come from a diversified portfolio.

Currency

The U.S. dollar has weakened considerably over the past couple of years. That said, the recent U.S. dollar strengthening against the backdrop of macro uncertainty reminds investors of its safe-haven status.

First and foremost, investors exiting dollar denominated strategies are in danger of locking in currency losses if they allocate to non-dollar strategies. There is a strong argument that maintaining exposure ties investors to an economy that is strong, structurally, resilient, and well-positioned to navigate a shifting global backdrop stemming from geopolitical transitions and technological innovation. As evidence, U.S. productivity is continuing to pick up and is on course to realize additional gains as AI-advancements become further integrated into the operating model of U.S. companies.

Asset class considerations

Investors' pursuit of the attractive return and diversification benefits of middle market direct lending remains in the early stages with many institutional and retail investors considering initial or additional allocations. Even with considerable allocations on the horizon, many managers have experienced tremendous capital flows, with significant concentration across the largest managers. In an effort to deploy the outsized capital flows, many managers have pushed into larger transactions that would be considered upper middle market or "large cap" private credit. These larger deals often have terms and pricing more comparable to public high yield and broadly syndicated loans (BSL) than to lower or core middle market direct lending.

A growth engine for many managers has also come through the advent of "semi-liquid" structures such as Business Development Corporations (BDCs). Certain managers are working through communication and structural challenges they are facing, and the headlines are causing some investors to wonder if there are broad private credit issues. This has and continues to be more of a mismatch of investor liquidity expectations than a systemic downturn impacting private credit. Non-listed BDCs (public BDCs can be traded to provide investor liquidity) and other semi-liquid credit structures have stated limitations on quarterly redemptions. This helps ensure investors can realize the benefit of the illiquidity or inefficiency premium offered by private credit, while protecting investors in the vehicles from negative price realization caused by forced liquidations of private credit loans. This message and investor expectations will become clearer with continued education over time, but for now those headlines have created opportunities in the direct lending market. Greater scrutiny should help ensure proper discipline of underwriting and credit structures. The headlines and concerns are also improving investor understanding of the different segments of lower, core and upper middle market along with large cap private credit and BSL. Also, the headlines along with some macro uncertainties are supporting improved pricing and terms suggesting this loan vintage will provide the opportunity to deliver attractive results for investors.

True middle market direct lending should provide investors with considerable risk-adjusted yield premium that lenders can achieve through the inefficiency of the market and ability to provide a superior lending solution to borrowers. Borrowers and private equity sponsors are quite willing to pay this premium for the certainty they realize working with a direct lender.

As lenders grow, we often see strategy and style drift – both in Europe and the U.S. They move away from the value proposition they originally brought to their investors, as well as from their original strategy and capabilities. For larger managers, this style drift is driven by the need to deploy so much capital that they pursued larger deals that were more homogeneous and probably less value for the investor as well, especially on a risk-adjusted basis. It is vitally important that investors seek an asset manager with a clear and consistent approach, that stays true to their value proposition. Investors need to fully understand what their manager is doing with their money, where they are investing, and whether it is truly in middle market deals.

Conclusion

The European market is maturing and offers investors a growing selection of deals. However, by also allocating to U.S. direct lending, investors can benefit from:

- A broader and deeper opportunity set
- Higher spreads and more attractive terms
- Greater idiosyncratic deal flow
- Diversification that complements their existing European allocation

In private markets, timing matters and opportunities emerge when uncertainty is high. Adding U.S. direct lending exposure positions investors to capture attractive returns across a resilient and dynamic segment of the world's largest economy.

Principal Alternative Credit: Approach to direct lending

Our approach to direct lending is grounded in true lower and core middle market direct lending. It is founded on a disciplined process, targeting borrowers in recession resilient industries and requiring strong credit structures with meaningful financial covenants. We avoid unnecessary complexity, prioritize first lien lending, and maintain close alignment with investors' interests.

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. Fixed Income investments are subject to interest rate risk; when interest rates rise, the price of debt typically declines.

Investors should be aware that alternative investments including private equity and private debt are speculative, subject to substantial risks including the risks associated with limited liquidity, the use of leverage, short sales and concentrated investments and may involve complex tax structures and investment strategies. 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, which will reduce profits.

Alternative investments are not appropriate for all investors and should not constitute an entire investment program.

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