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PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

Direct lending in a rising rate and inflationary environment

JUNE 2022

Executive summary

Many investors have been asking us about how inflation and rising rates will impact our portfolio and the middle market direct lending investment climate going forward. While there are some obvious direct impacts that we highlight below, we also discuss some of what we view as key second order impacts. Overall, we believe our continued emphasis on investing in the lower middle market, particularly in higher margin and less capital-intensive businesses, while often favoring less global and more local, service-oriented businesses will continue to be a compelling strategy in a rising rate / inflationary environment.

- **Health care equipment & services, 17.4%**
- Commercial & professional services, 12.4%
- **Consumer services, 12.4%**
- **Packaging, 12.3%**
- **Technology hardware & equipment, 7.3%**
- Media & entertainment, 5.9%
- Transportation, 5.8%
- **Software & services, 5.5%**
- **Food, beverage & tobacco, 4.2%**
- Diversified financials, 4.0%
- **Materials, 3.9%**
- Household & personal products, 3.8%
- Parmaceuticals, biotechnology & life sciences, 2.9%
- Capital goods, 2.1%

As of March 31, 2022. Source: Principal Global Investors

Rising rates

Direct impacts

As the vast majority of investments in middle market direct lending portfolios are floating rate in nature, rising rates most directly impact these portfolios by increasing realized yields. That said, rising rates also reduce borrower cash flows given the additional debt service cost. So, the key to success in a rising rate environment is to finance businesses with capital structures that can absorb the rising rate impact, such that borrowers remain liquid and solvent despite the higher interest burden. A stated coupon increase doesn't do an investor any good if the borrower can't pay it.

The level of debt across companies varies considerably and thus results in very different borrower debt burden as interest rates rise. The leverage level of core and lower middle market companies tends to be less than that of upper middle market and high yield public company counterparts. Thus, focusing investing in the core and lower-middle market where capital structures are generally more lightly levered compared to larger companies can result in very different borrower debt burdens as interest rates rise. Using illustrative structures below, it becomes clear how the increased leverage of the upper middle market shifts the fixed charge coverage ratio (FCCR) to perilous levels when SOFR equals 3% on some of the higher levered unitranche deals in that market segment.

	Lower middle market	Core middle market	Upper middle market
EBITDA ($ in millions)	$7.5	$25.0	$50.0
Leverage	4.0x	5.5x	7.0x
Spread (basis points)	600	575	550
FCCR - Today	1.5x	1.3x	1.2x
FCCR - SOFR @ 3%	1.3x	1.1x	1.0x

Notes:

(i) Assumes 1% amortization and SOFR floor, CapEx and D&A equal to 25% of EBITDA, and an LLC tax rate of 40%

(ii) LMM is Lover Middle Market: CMM is Core Middle Maraket, and UMM is Upper Middle Market

(iii) FCCR defined as (EBITDA- CapEx) / (Interest + Scheduled Amort. + Taxes)

Of course, credit selection within each of these markets also becomes extremely important. Favoring higher margin and less capital-intensive businesses can greatly improve a lender's ability to realize higher rates of return for investors as interest rates rise, as companies with that profile can generally better withstand cost pressures and higher rates, compared to lower margin, more capital-intensive businesses. Running the same example as above, but with a less capital-intensive borrower where capital expenditures equal 10% of EBITDA instead of 25%, results meaningfully improved FCCR cushion, as show below.

	Lower middle market	Core middle market	Upper middle market
EBITDA ($ in millions)	$7.5	$25.0	$50.0
Leverage	4.0x	5.5x	7.0x
Spread (basis points)	600	575	550
FCCR - Today	1.6x	1.4x	1.3x
FCCR - SOFR @ 3%	1.4x	1.2x	1.1x

Notes:

(i) Assumes 1% amortization and SOFR floor, CapEx and D&A equal to 10% of EBITDA, and an LLC tax rate of 40%

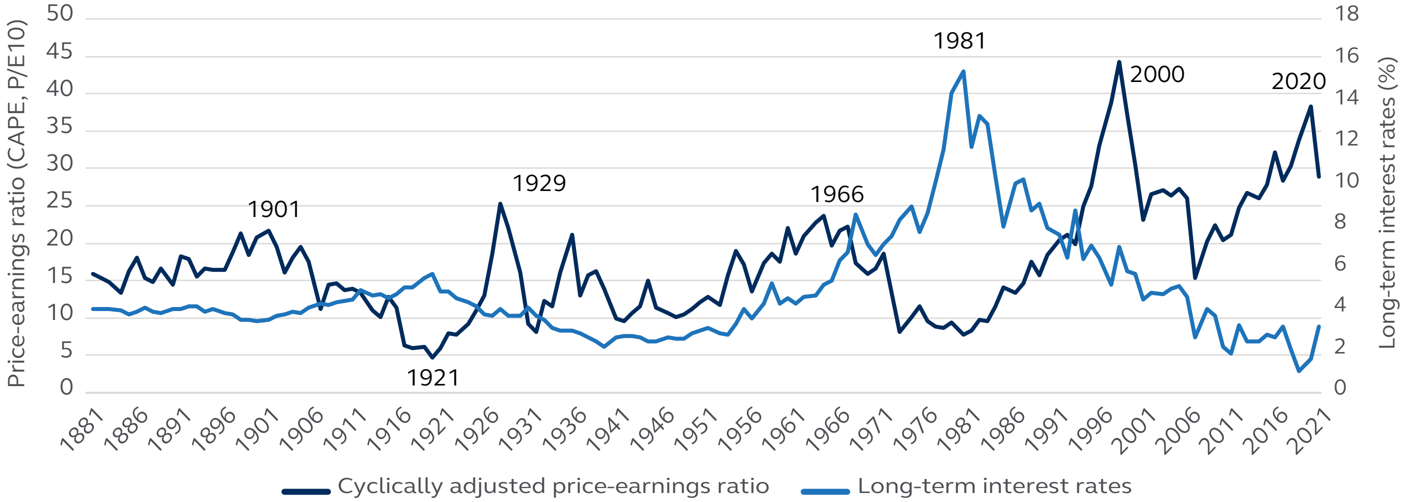
(ii) LMM is Lover Middle Market: CMM is Core Middle Maraket, and UMM is Upper Middle Market

(iii) FCCR defined as (EBITDA- CapEx) / (Interest + Scheduled Amort. + Taxes)

Principal Alternative Credit borrowers average a 1.6x FCCR providing ample room for rising rates and illustrates our focus on less capital-intensive businesses. In each deal we underwrite, we use the forward curve for rates in our base case model, and run stress test analysis on rates rising over 200 basis points above the curve.

Indirect implications

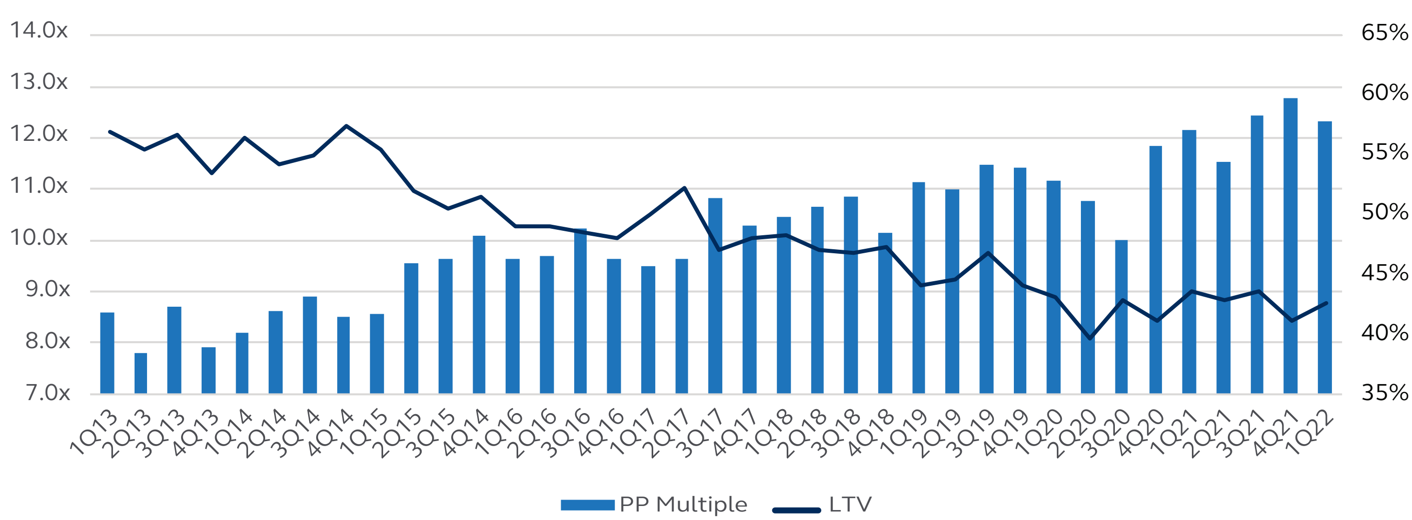
Rising rates oftentimes lead to lower valuations. As the chart below depicts, there tends to be an inverse relationship between the level of rates and a company valuations, with this relationship being most pronounced since the late 1970s.



Source: Robert Shiller.
CAPE references U.S. companies.

As shown below, the average leverage, as measured by Loan-to-Value (LTV), of middle market companies has declined steadily in recent years. Though the average multiple of debt relative to EBITDA has marginally increased in the middle market from 4.8x in Q1 2013 to 5.1x in Q1 2022, valuations have risen several multiples of EBITDA over the same time. Recognizing that enterprise value and LTV demonstrates cushion and can provide confidence for lenders, the absolute amount of leverage is likely even more important in a rising rate environment. Companies with lower leverage (all else equal) will have greater cash flow available for debt service, greater ability to pay down debt as they may desire and also generate greater excess cash flow (compared to higher leveraged counterparts), a portion of which is often prescribed to be swept and pay down debt per the credit agreement. These structural benefits to the lender create aligned incentives as well as less concern regarding short-term fluctuations in enterprise value and provides lenders with increased cushion in a rising rate environment. Typical credit documentation for lower middle market deals forces de-leveraging through tighter limitations on incremental debt as well as meaningful leverage covenant step-downs, tight restrictions on cash flow leaving the borrower and other aspects to the overall covenant package. These factors should assist in further insulating lower middle market borrowers from leveraging themselves into structures vulnerable to rising rates.

Purchase price multiples and LTV



As of March 31, 2022. Source: Refinitiv
LTV references U.S. companies.

Inflation

Direct impacts

Many borrowers are facing some degree of headwinds resulting from inflationary pressures. Those with pricing power have passed along necessary price increases (albeit sometimes on a lagged basis), while others are forced to endure margin compression. The inflationary environment favors many of the same types of borrowers that will be able to withstand higher rates—less capital-intensive, higher margin businesses. More capital-intensive businesses will have to spend additional cash on capital expenditures and working capital needs to support revenue growth and attempt to keep up with inflation to potentially limit the degree of margin compression. The Principal Alternative Credit portfolio averages capital expenditures to equal to 13% of EBITDA. In addition, many of our most capital-intensive borrowers are spending on deferrable, growth-oriented capital expenditures rather than necessary maintenance capital expenditures. Beyond the capital-intensive nature of a borrower, the inflationary environment also highlights the need for careful competitive analysis, with an objective to select borrowers that have pricing power and benefit from barriers to entry.

Indirect impacts

Despite recent strength of the U.S. dollar, domestic inflation pressures can potentially lead to dollar devaluation. Devaluation of the dollar would put further pressure on U.S. based companies who source inputs globally. Global supply chains continue to experience strain and regardless of currency impact, we expect further input cost pressures for companies that source globally. Companies and management teams that emphasize diversity of supply sources and supply chain security over short-term profitability should continue to benefit in an inflationary environment. We also favor local, services business over complex global companies in this macro-economic environment.

Conclusion

Navigating the rising rate and inflationary environment offers opportunities and challenges. A successful path will require an intentional and nimble approach to portfolio construction, combined with thoughtful origination and proper underwriting. Firms that can benefit from a wide range of experiences through market cycles most likely have the process and approach that can benefit investors. At Principal Alternative Credit, our team combines the credit heritage of Principal with professionals that also provide experience from 16 different direct lending firms, and our senior investment professionals average 20 years of experience across multiple credit cycles. We believe our experience and focus on lower and core middle market businesses with strong margin profiles, relatively low capital-intensity and a strong competitive position will prove a compelling strategy for the direct lending market.

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.

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