

PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

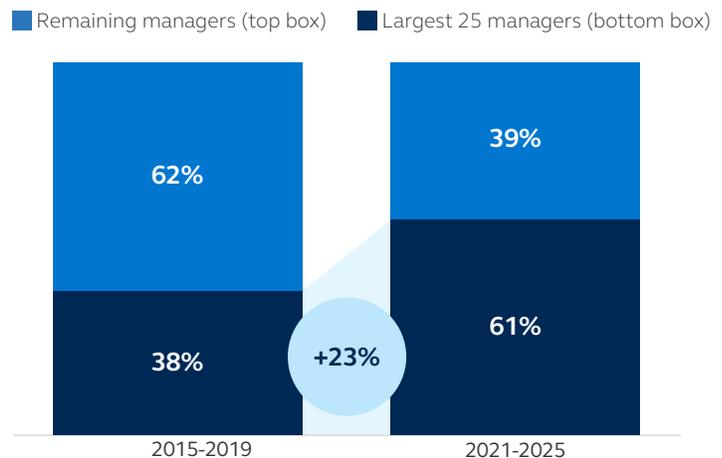
Value drivers in lower middle market origination

AT-A-GLANCE

- Lower middle market origination has historically remained relatively stable in times of distress
- Non-sponsored deal origination can stabilize origination volume when sponsored activity is slower
- Upper middle market managers are increasingly vulnerable to declines in public market spreads
- Principal Alternative Credit's warehouse facility has allowed the team to maximize deployment and provide transparency to clients

Many upper middle market direct lending managers are competing for relatively few private equity-to-private equity new platform related loans. These managers are also competing with the broadly syndicated loan market for those same loans, and thus the largest managers are struggling to deploy all the capital they've raised over recent years.

Private debt fundraising



As of 31 December 2025. Source: Preqin

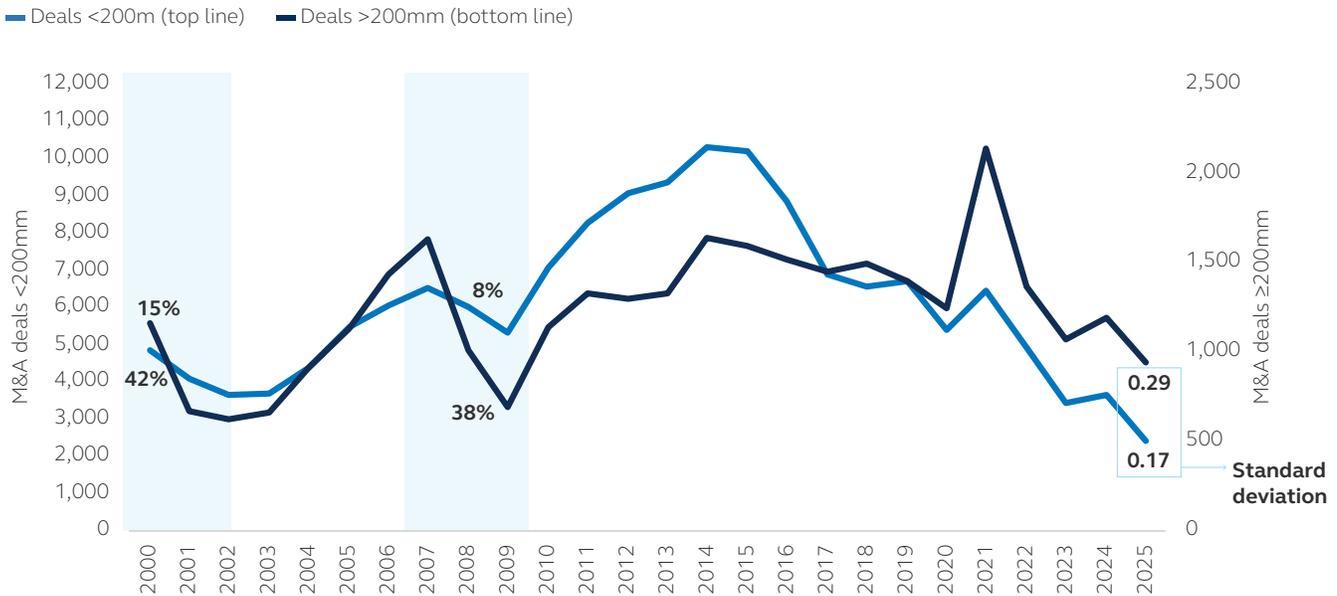
We increasingly hear from clients that business development company (BDC) portfolios are holding relatively large amounts of broadly syndicated loans (BSL) as a placeholder until more direct lending supply is available. That allocation to lower yielding BSL, when combined with lower SOFR base rates and upper middle market spread tightening, has driven distribution yields down for the BDCs and / or those BDCs have increased leverage to maintain distribution yield (investors are taking on more risk for the same or even lower return). While the lower middle market is certainly not immune to origination pressures from geopolitical shock events, interest rate changes, or other macro events, it has proved more resilient over time. Principal Alternative Credit (PAC) offers clients the benefits we realize by operating in the lower middle market, along with a number of other firm specific advantages, that when combined result in robust client capital deployment across our client portfolios—no client has ever been less than 70% invested at initial capital deployment and almost all are 100% deployed today.

The lower middle market origination advantage

While M&A markets and the resulting demand for direct lending are always subject to economic conditions and interest rate volatility, the lower middle market has exhibited relative resilience.

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 the chart below 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 for large deals versus 8% and 11% respectively for smaller deals.

U.S. M&A deals over time



30 September 2025. S&P Capital IQ.

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.

Some smaller company M&A activity is driven by strategic buyers looking to acquire smaller businesses despite the economic environment as the smaller deal size remains digestible even during times of stress. This is a core component of Principal’s underwriting strategy—identifying those businesses that have value to strategic buyers beyond financial engineering. Since inception, half of Principal’s M&A related exits have been to strategic buyers.

The advantages of non-sponsored deal flow

We believe non-sponsored deals when underwritten well can offer a strong source of alpha for client portfolios (see [Benefits of robust non-sponsored deal sourcing in middle market direct lending](#)). However, non-sponsored origination is also 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.

As an example, during the Q2 2025 Liberation Day related M&A slowdown, nearly one-third of Principal Alternative Credit's closed deals were non-sponsored. While our close rate has always remained conservatively lower on the non-sponsored side of our business at ~2% versus ~4% for sponsored transactions, the non-sponsored book can provide stability in times when sponsored activity slows.

Principal Alternative Credit - strategic advantages

The Principal warehouse facility enables Principal Alternative Credit to deploy clients' capital more efficiently, while increasing transparency to clients. Principal closes a portion of each loan into its warehouse facility. Loans in the warehouse facility are available for sale into investor vehicles and allow for the matching of fund inflows with loans available for sale to maximize deployment. This facility reduces the j-curve for our clients considerably, for example Principal Alternative Credit has never had a client less than 70% deployed at initial funding. It also increases transparency/reduces blind pool risk, and allows for efficient season-and-sell (no skimming the loan price/full economics passed along to clients).

Additionally, Principal continues to invest in origination capabilities, adding significant origination capacity through new hires over the past twelve months, ensuring our business is fully scaled ahead of growing demand from clients. Clients are able to benefit from our expanding origination capabilities and the natural ramp of originators relative to more static direct lending platforms.

CONCLUSION

Building a strong origination platform is critical to the success of any direct lending organization. By having the widest funnel possible, origination and underwriting can help us to identify and select the most compelling opportunities for our investors. Further, by operating in the lower middle market and pursuing non-sponsored transactions, investing in Principal Alternative Credit's vehicles may offer a more stable source of capital deployment. Our origination approach when combined with our unique warehouse facility, has enabled clients to largely avoid the j-curve in Principal Alternative Credit funds despite several years of M&A volume below peak 2021 levels.

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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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