Principal Asset Management℠

PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

Separating the froth from opportunity in the middle market

The past several quarters have highlighted to us and our clients the value of focusing in the lower and core middle market. As the upper middle market (UMM) increasingly competes with the broadly syndicated loan market, $50 million+ EBITDA businesses are often being financed covenant-lite and at such high leverage levels that payment-in-kind (PIK) toggles are becoming increasingly common as borrowers can't afford the interest burden, if the loan were to be paid in cash. Synthetic PIK structures, where interest is paid in cash but by drawing on a delayed draw term loan (DDTL) provided by the same term loan lender, have continued to proliferate as well.

Add to that slower sponsor-to-sponsor M&A activity in the UMM, whereas the LMM has experienced more stable volume driven by the idiosyncratic nature of found / owner operator sales relative to the highly correlated drivers of sponsor-to-sponsor sales.

AT-A-GLANCE

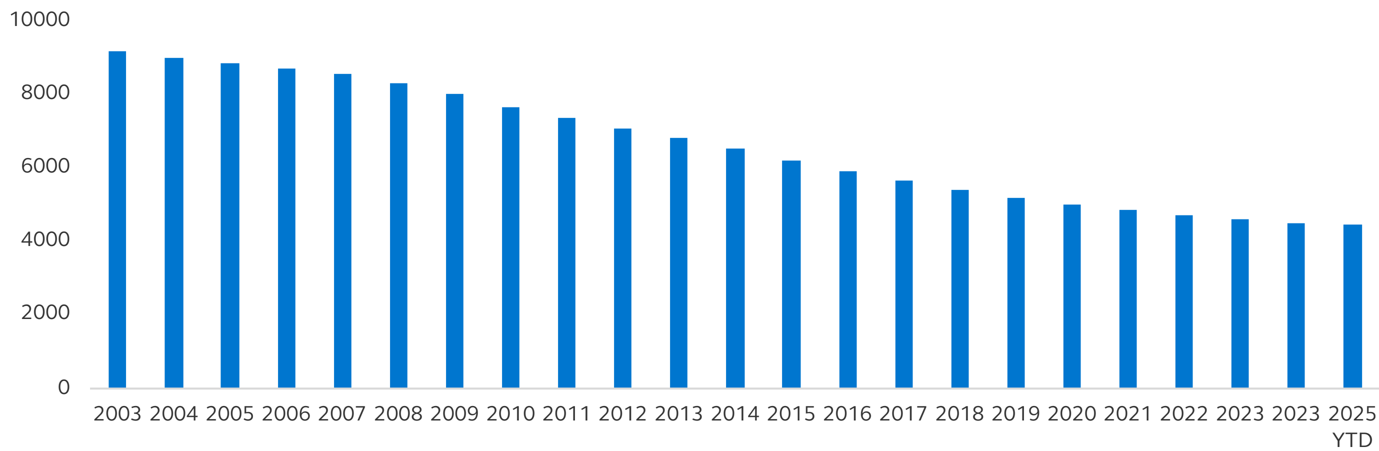
- Banks continue their retreat from commercial lending with the number of FDIC Insured institutions down by nearly 50% since 2003 and the remaining banks have positioned their balance sheets away from commercial lending.[1]
- Over a similar time period, private equity has proliferated with AUM up ~10x since the Global Financial Crisis creating a supply demand imbalance in middle market lending.[2]
- Capital has flowed into the direct lending market, but over half has flowed to the largest managers, forcing managers so up market that they increasingly compete with the broadly syndicated loan and public high yield market.
- These larger deals are typically higher levered than historical standards and don't feature the same covenant protections typically present in the direct lending market.
- While upper middle market managers expect the risks of weaker capital structures to be offset by the size of the underlying borrowers and their perceived resilience, third-party studies indicate that size is a smaller contributor to default expectations than fundamental credit metrics like leverage and debt service coverage.

[1] As of 31 March 2025. Source: Federal Deposit Insurance Corporation (FDIC).
[2] As of 30 June 2024. Source: Preqin.

Capital flows and drivers of increased competition in the upper middle market

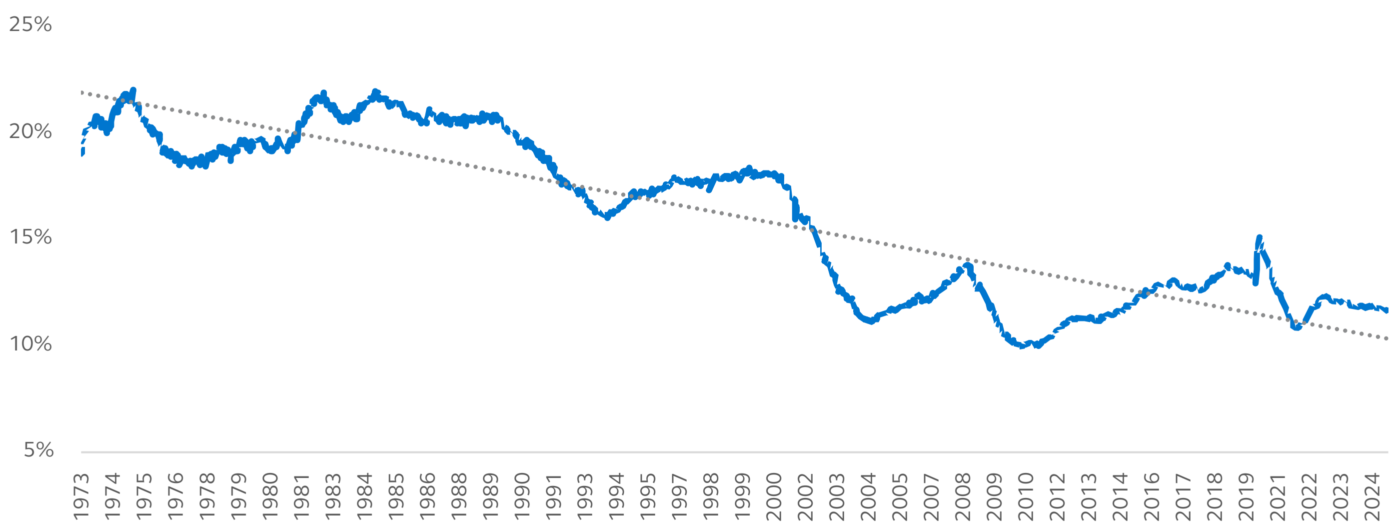
As banks have stepped out of the leverage lending market and private equity has proliferated, a void was left for private credit to fill.

FDIC insured institutions



As of 31 March 2025. Source: Federal Deposit Insurance Corporation (FDIC).

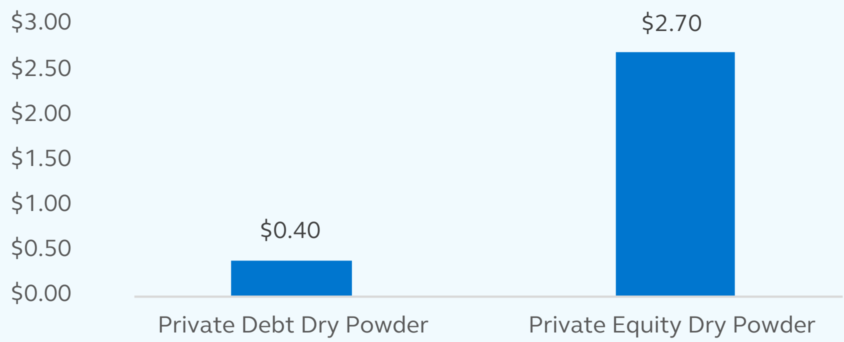
Commercial and industrial loans as a percentage of total bank assets



As of 07 July 2025. Source: Federal Reserve Board.

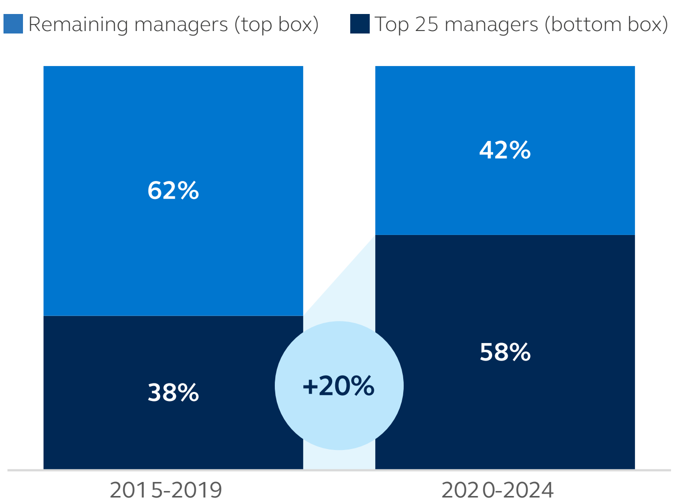
While both private debt and private equity markets are characterized by significant levels of dry powder, since the global financial crisis, private equity dry powder is notably higher and presents challenges related to deployment speed, valuations, and potential competition for deals. Private debt dry powder, while smaller, reflects strong investor interest and a potential opportunity to finance the significant dry powder in the private equity market.

Staying dry, $ trillions



As of 30 June 2024. Source: Preqin.

Private debt fundraising

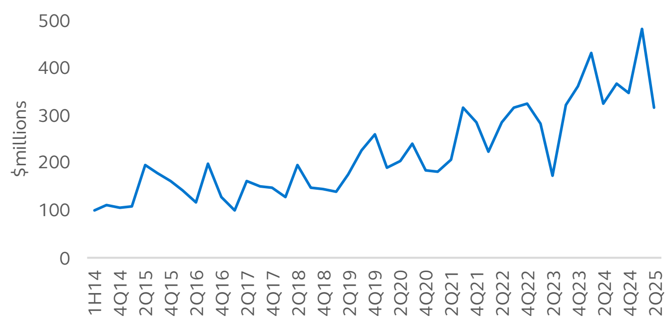


As of 31 December 2024. Source: Preqin

Within that private debt dry powder, much of the AUM raised has flowed to the top 25 managers, and that's increasingly become the case over the past four years.

This has led to a new large cap direct lending space with multi-hundred million and billion dollar deals becoming the norm. As shown on the right, average deal sizes are up approximately three times since a decade ago and are up considerably even in the last twelve months. These large deals increasingly are competing with the broadly syndicated public loan market more so than other direct lenders.

Average deal size



As of 30 June 2025. Source: LSEG LPC

While often UMM direct lending competitors point towards an expanding definition of what it means to be a middle market company given the growth in the market, we think that misses the point. Investors are often asking to define market segments to ascertain competitive pressures and better understand the underlying loan characteristics of each market segment. On page 4, we breakdown our definition of each segment of the market and define the lower-middle-market as sub $15 million of EBITDA, where we see only a handful of regular competitors in the market. We then define the core middle market as companies generating between $15 million and $50 million EBITDA, because $50 million is where we start to see covenant lite and PIK toggle with more frequency due to the public syndicated markets being open to businesses starting around $50 million of EBITDA.

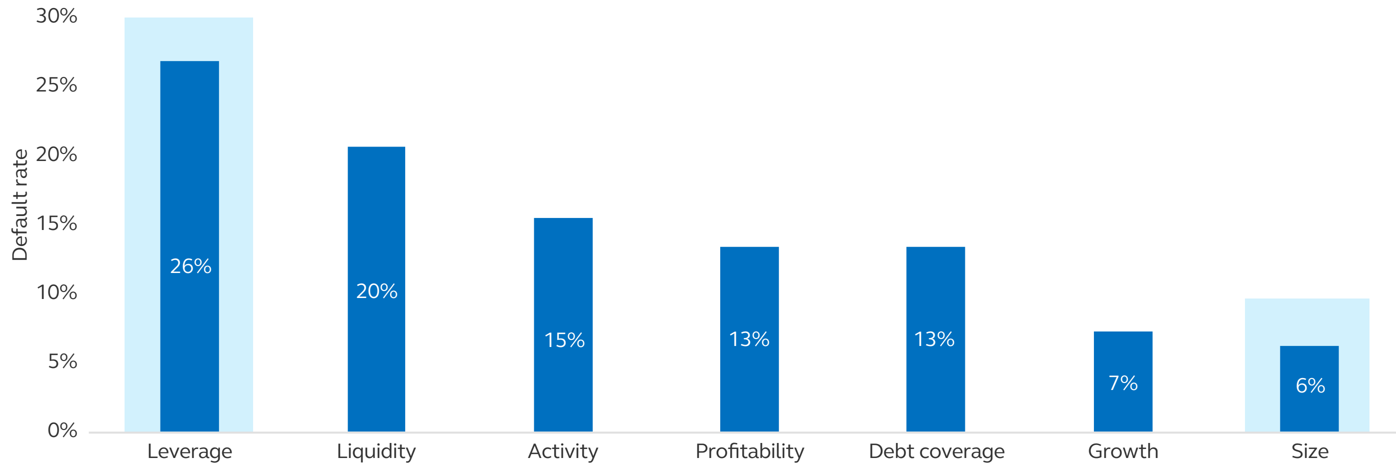
	Lower middle market	Core middle market	Upper middle market	Broadly syndicated
Company size (EBITDA)	\$5mm–\$15mm	\$15mm–\$50mm	\$50–\$100 million	Above \$100 million
Facility size	Below \$100mm	Below \$200 million	Above \$200 million	Above \$300 million
Market participants	Select group of direct lending firms and BDCs, especially in the \$5mm–\$10mm EBITDA range	Direct Lending firms, BDCs, Funds	Regional and commercial banks, Direct Lending firms, BDCs, Funds	Commercial banks, broker dealers, CLOs, Mutual Funds, other HY market participants
SOFR spread*	525 to 725 bps	450 to 650 bps	375 to 500 bps	275 to 375 bps
SOFR floor	1.00%+	0.75–1.00%	0.75–1.00%	Depends
Original issue discount (OID)	1.75 - 2.00%	1.25–1.75%	0.00- 1.00%	0.00–1.00%
Debt multiple	2.00x–4.50x	2.50x–6.00x	4.00x–6.50x	Up to 7.00x
Loan-to-value	Typically 35–45%	Less than 50%	Less than 60%	Less than 65%
Borrower reporting	Monthly	Monthly/quarterly	Quarterly	Quarterly
Financial covenants	2+	Often 2	1 or less	None

As of 30 June 2025. Source: Principal Asset Management. These estimates are based on business plans, expectations and market conditions that Principal Alternative Credit has observed on the U.S. direct lending market generally. The ranges shown are for investments of institutional investment quality that Principal Alternative Credit would consider for client portfolios and are not inclusive of all loan origination opportunities from PE sponsors, other lenders, banks, advisors and Principal's proprietary network. *Estimated range based on 1st lien position.

Is bigger better?

We often hear from UMM competitors that bigger companies are better. First, there are great and not so great \$100 million+ EBITDA businesses and there are great and not so great \$10 million EBITDA businesses. Size is but one component of the analysis. We've seen \$100 million EBITDA businesses with customer concentrations and other binary risks, and we've seen \$10 million EBITDA businesses with highly diversified customer bases that are quite low risk. And of course, we've seen the opposite. The key is selectivity in each market. Further, size doesn't appear to be a key determinant of default history, according to analysis by Moody's Analytics. As shown in the chart at the top of page 5, leverage is more than four times as good of a predictor as size is for default probability. In fact, there are six factors that are more important in Moody's default probability model than size.

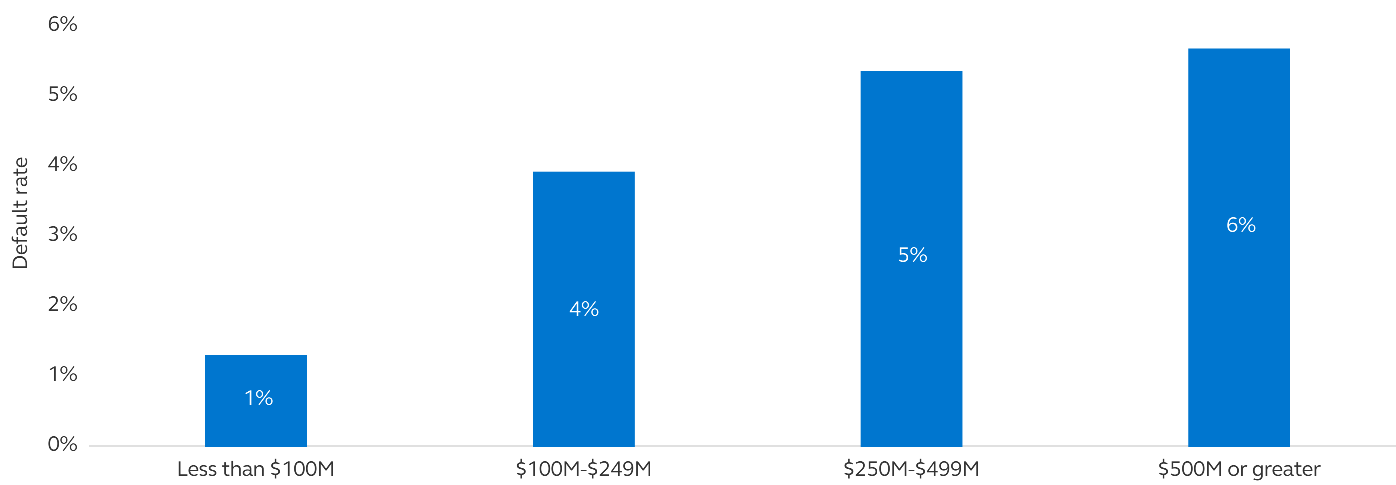
Default probability predictor in private debt market



As of 28 February 2019. Source: Moody's Analytics RiskCalc. Most recent available data used. For illustrative purposes only. Not to be construed as investment advice.

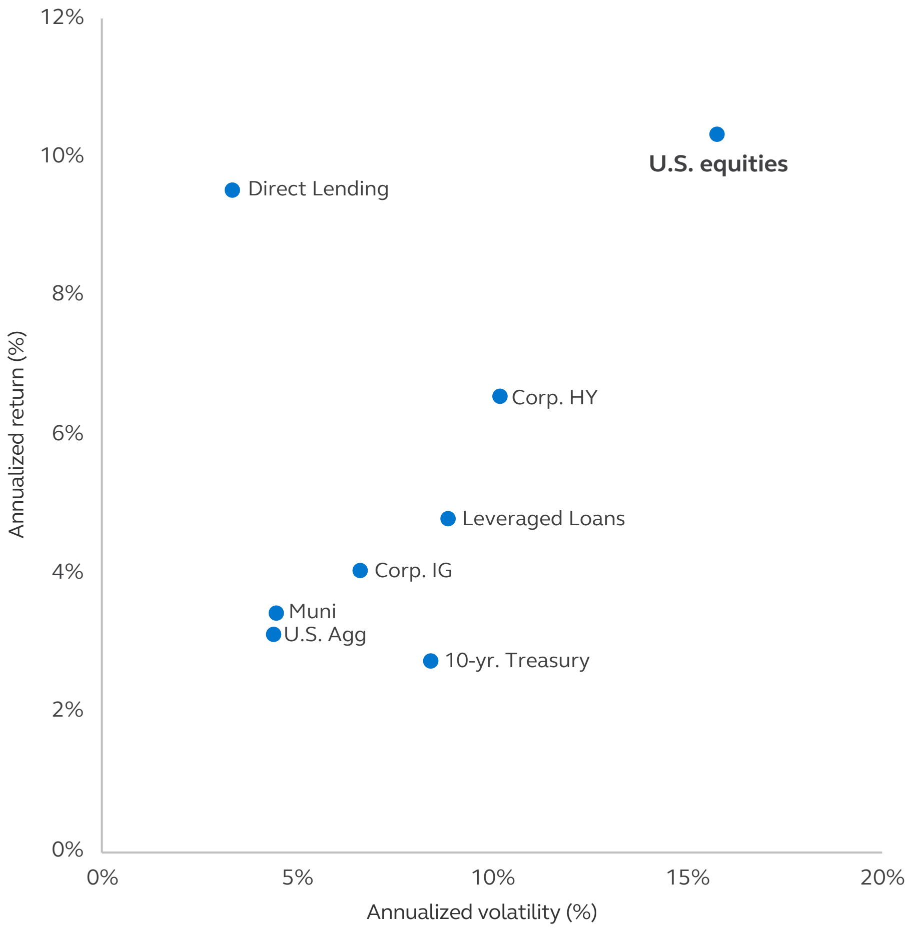
In addition, default risk is the intersection of business risk and structural risk. Smaller businesses are generally less levered, have tighter documentation, and have multiple financial covenants. Further, underwriting tends to be more selective on smaller businesses. A study by S&P on default rates of syndicated loans by size indicates that sub $100 million facility sizes default less frequently, likely as a result of more conservative leverage levels and greater borrower selectivity.

Default rate by deal size



As of 31 December 2023. Source: S&P LCD Institutional Loan Default Review; comprises all loans closed between 1995 and Q4 2022. Independent axis labels reflect loan amount ranges. Most recent available data used. For illustrative purposes only. Not to be construed as investment advice.

Historical risk/return since 2004*



Correlation vs. other asset classes	
Corp Investment Grade (IG)	0.21
Municipals	0.12
U.S. Aggregate	-0.15
10-year Treasury	-0.50

As of 31 March 2025 *Since inception of Cliffwater Direct Lending index on 30 September 2004. Sources: Bloomberg, Cliffwater Direct Lending Index, S&P 500 S&P/LSTA Leverage 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.

Investors looking to private debt historical returns should bear in mind that much of those returns were generated in smaller businesses than what are being financed today by the largest managers. Those deals featured the key structural protections of covenants and modest leverage that's typically only found in today's lower and core middle market. We believe the burden of proof is on upper middle market managers to explain why they believe they can generate the historical returns of the direct lending market, and not revert to the returns and risk characteristics of the market they increasingly compete with, the broadly syndicated public loan market.

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Risk Considerations

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