Principal Asset Management℠

Principal Alternative Credit

MIDDLE MARKET DIRECT LENDING

Finding opportunity on the horizon

2026 OUTLOOK

For Public Distribution in the United States. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

An environment ripe with attractive investment opportunities in 2026

The environment was quite constructive to start 2025, with significant deal flow carrying over from 2024 and expectations for improved business conditions. That momentum was paused with the unveiling of tariff policy in early April.

Expanding transaction activity, supported by the lower rate environment and clarity on economic and regulatory conditions, gave way to a new uncertainty and middle market direct lending deal flow slowed considerably. Sellers had been actively seeking transactions with expectations for somewhat higher enterprise values (EV), but buyers pulled back with the newfound uncertainty while sellers continued to hold out for their “right” price.

Throughout much of 2025, the clouds of policy uncertainty slowly cleared, which led to a notable resumption of U.S. middle market deal flow post Labor Day.

The transaction environment is now back to the favorable setting experienced at the beginning of 2025, and there is even more reason to believe that growth will continue.

We believe the improving and supportive market and economic backdrop, coupled with appealing credit structures, should create an environment ripe with attractive investment opportunities in 2026.

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Increased transaction activity expected

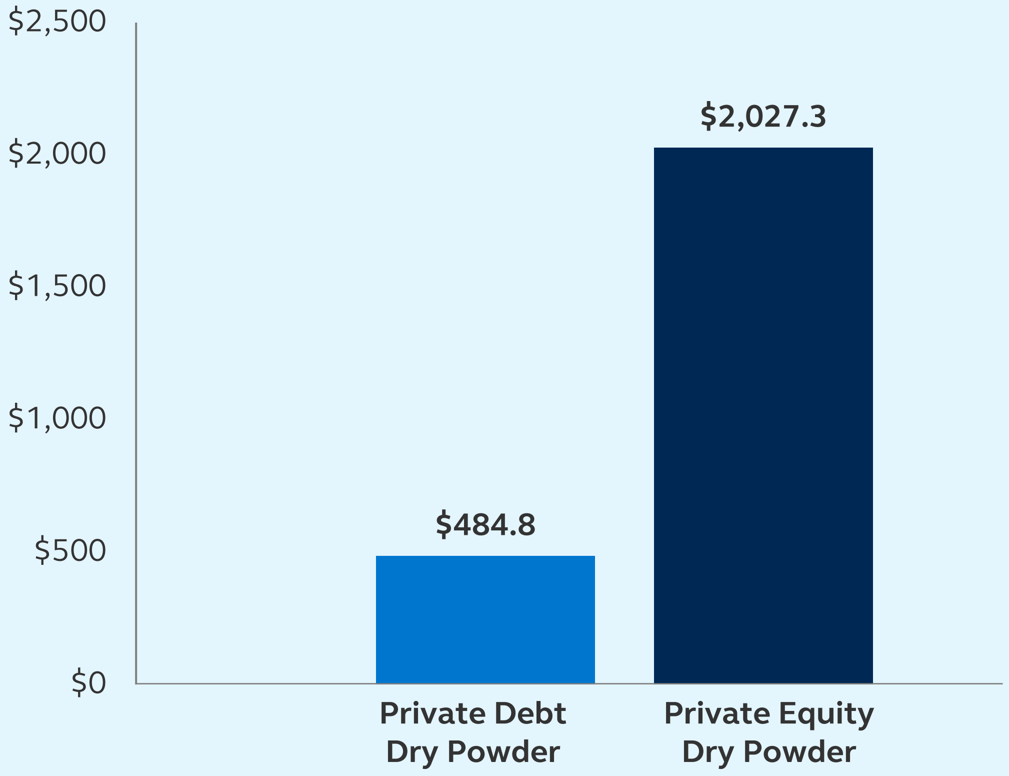
Our belief that growth of transaction activity is likely to continue is based on the improved clarity regarding market and economic conditions, along with significant deal flow momentum and pipeline. After a couple of years of slower investment realizations, private equity (PE) sponsors are eager to deliver returns and recycle capital.

Another key factor is the secular pent-up demand for PE sponsors to deploy capital into attractive investments. That "dry powder" for private equity far exceeds the dry powder of committed capital for private credit, but nonetheless the capital to be deployed is expansive.

Business and economic conditions are now becoming clearer with reasonable economic growth and steady to declining inflation levels. Tariff policy has been applied in a manner that is more bilateral than macro, and implementation is generally more gradual than stark. Tariff policy has proven to have little impact to ongoing inflation or inflation expectations, so the Fed not only began the shift to easing policy but should also have runway to continue to ease in a gradual manner. In addition, market participants gained clarity that tariff policy was not significantly impacting the economic environment or expected to have long lasting negative ramifications. This is especially true for middle market companies that are more oriented to U.S. customers and suppliers, and those in focus by direct lenders also tend to be more service-oriented. This backdrop is supportive of increased transaction activity for both PE sponsored and non-sponsored deals.

Staying dry

$ billions



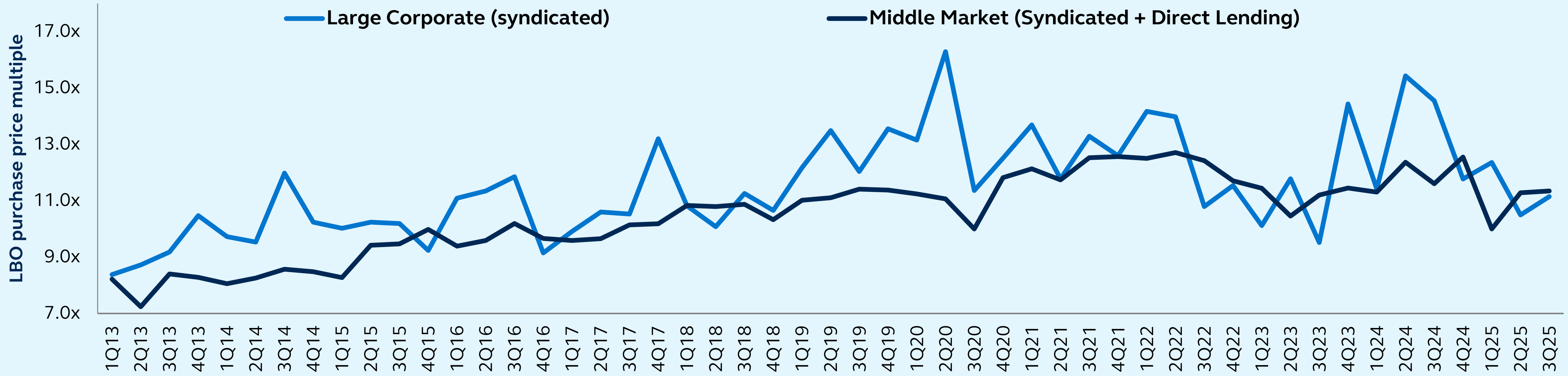
Source: Preqin, 31 December 2025. Preqin tracks institutional commingled fundraises and this generally excludes BDC capital, SMAs and other types of private capital.

Fed support should fuel deal making momentum

Accommodative Fed policy also supports a significant increase in leveraged buyout (LBO) and mergers and acquisitions (M&A) activity, as more business owners look to sell with improved valuations and buyers seek to deploy capital with greater confidence in economic conditions and lower cost of capital. With the lower rates and improved clarity, we expect EVs to expand for private companies and most notably for companies in the service-based industries benefitting from positive secular trends in the U.S. economy.

At Principal Alternative Credit, we focus on lending to lower and core middle market companies in these industries, so an increase in enterprise valuation provides additional support for our first lien senior secured loans. With that increase in EV, some PE sponsors and borrowers may seek additional debt. For now, leverage requests remain quite reasonable given middle market company EVs and cash flow generation.

LBO purchase price multiple: large corporate (syndicated) vs. middle market (synd. + direct)



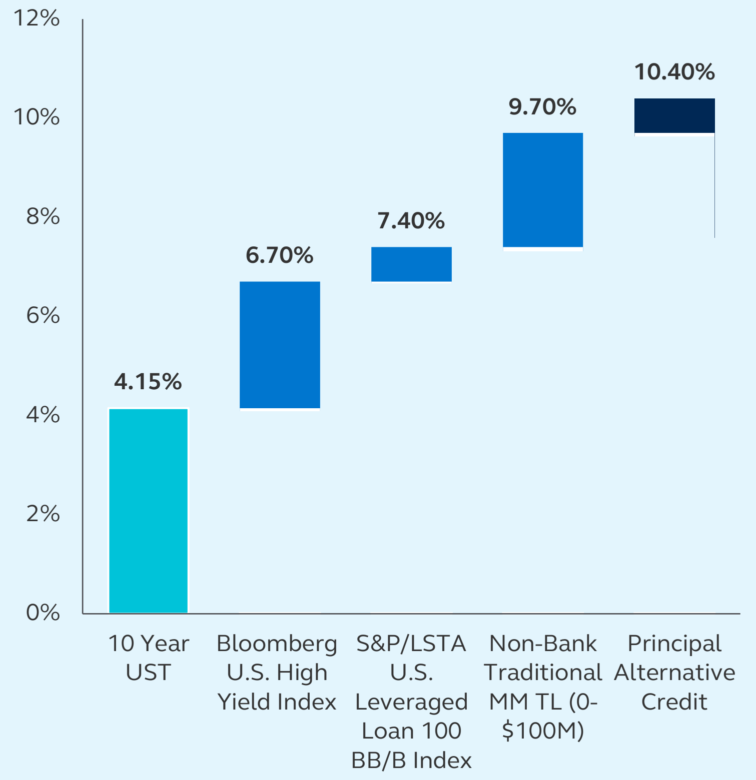
Source: LSEG, 30 September 2025.

Investors' search for attractive risk-adjusted yield takes center stage

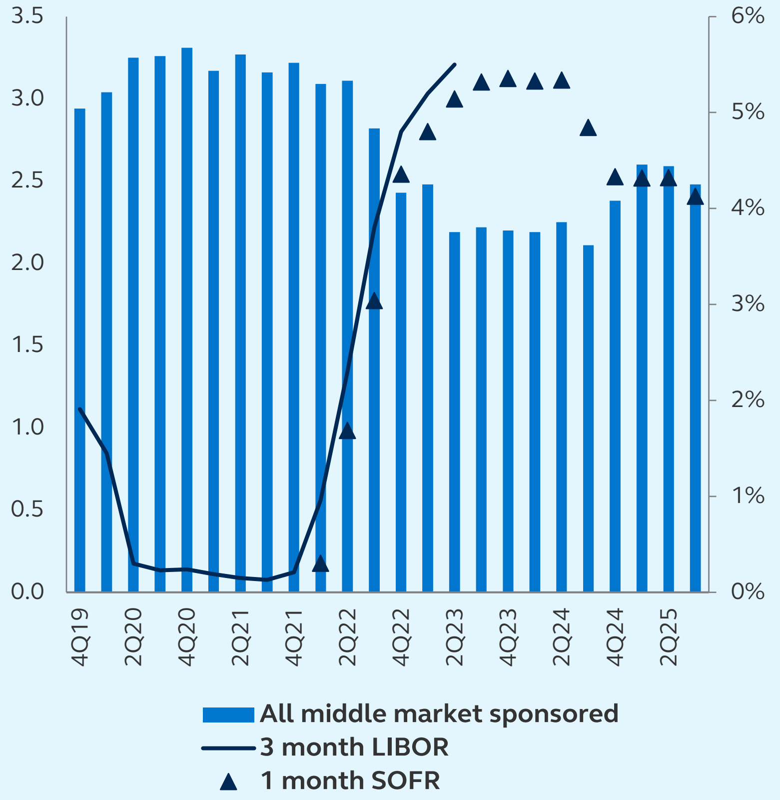
With Fed and global central bank policy gradually shifting to a lower interest rate environment, investors' search for attractive risk-adjusted yield will be even more in focus. As risk-free rates decline, the yield risk premium or spread will be a larger portion of total yield and a key determinant of investors reaching their return objectives. The yield premium of lower and core middle market direct lending continues to appear attractive relative to larger deals and broadly syndicated loans (BSL).

Furthermore, we maintain strong risk management measures, including substantial financial covenants, appropriate leverage levels, and rigorous underwriting standards, while keeping regular dialogue with management teams. Those factors may support attractive risk-adjusted opportunities in 2026. In addition, the increased supply of deals should support spread levels remaining in the current range or potentially widening in conjunction with base rates moving moderately lower through the new year.

Yield premium for Principal Alternative Credit direct middle market loans



EBITDA/Interest: All middle market sponsored



Sources: Bloomberg, LSEG, Standard & Poor's, Principal Alternative Credit. Non-bank traditional middle market (MM) term loan (TL) is for issuers with a loan deal size of $0-$100M. 30 September 2025.

Idiosyncratic events or negative headlines won’t derail private credit stability

There will be idiosyncratic events in the credit market, but the health of middle market direct lending remains stable and showing signs of improvement with expanding cash flow and debt service coverage on average. The middle market direct lending non-accrual (default) rate of 1.35% as of 30 September 2025 (Cliffwater Direct Lending Index), compares favorably with the long-term average of 2.1% and is considerably better than the public high yield and BSL default rates of around 4%. We believe the default rate for middle market direct lending will remain below the long-term average in 2026, and well below default rate levels in the public high yield market.

Notably, most of the transactions that are making headlines are a part of the BSL market, and not directly relevant to true private credit and specifically middle market direct lending. The funds and portfolios managed by Principal Alternative Credit focus exclusively on middle market direct lending loans, which means we don’t consider larger syndicated deals whether in the BSL market, or larger deals in the direct lending upper middle market to larger cap market.

We believe the most appealing benefits of private credit are found in lower and core middle market direct lending. These benefits include better credit structure with meaningful financial covenants and lower leverage, call protection, substantial original issue discount (OID) and a significant spread premium. In addition, we are “underwriting to own” the loan exposure, whereas with BSLs, the sponsoring bank is “underwriting to syndicate or sell” the loan exposure and generate fee income from the syndication. In addition to the alignment with investors, we take the necessary and appropriate time to fully underwrite and structure each direct lending transaction, with timelines typically being 45 days or more. This underwriting timeline is significantly longer than BSL transactions that typically provide only a short time (oftentimes a matter of a few days) to analyze the borrower and structure from the time a deal is announced to when it clears the market. Additionally, direct lending transactions provide significant access to key diligence materials while the BSL market has very limited access to management and key underwriting materials.

It is prudent to be aware of credit events and the potential for a significant credit cycle shift. And skepticism in the market can be a healthy thing to keep lenders disciplined in their approach and investors asking the right questions. We don’t believe the idiosyncratic events or negative headlines represent the beginning of a credit cycle, but we are always considering that risk in our portfolio construction and underwriting. However, if there is a backdrop of concerning macro conditions and increased volatility, even a small number of high-profile negative credit stories could shake investor confidence and potentially affect market flows. A potential risk on the horizon is the Fed having a misstep in policy or persistent inflation tying the Fed’s hands as the public markets “demand” more accommodative policy.

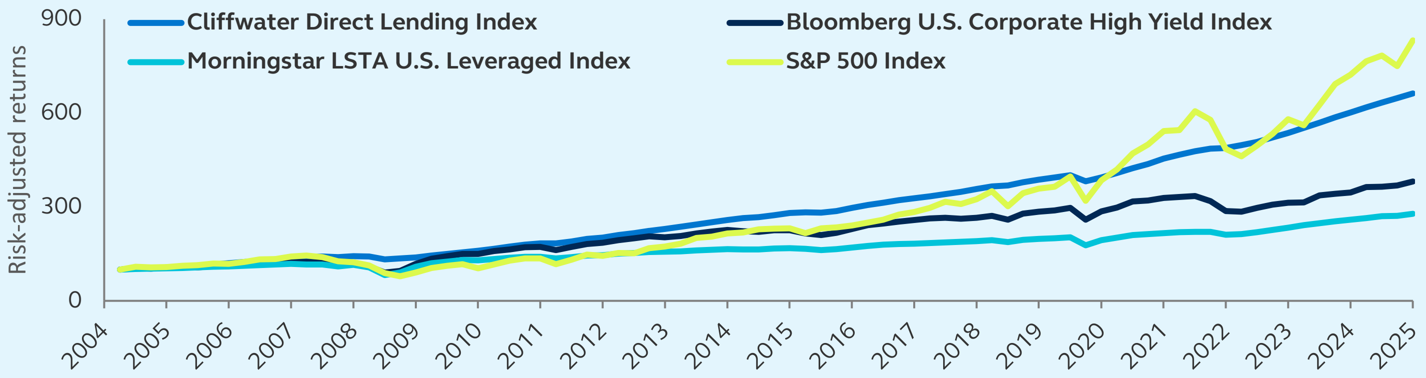
Middle market direct lending has shown structural strength

The committed and funded capital in middle market direct lending has been significant and stable, being in funds and structures with lock-up periods and long investment horizons (plus a lot of dry powder committed to be deployed). For public high yield bonds and BSLs there can be immediate liquidity so flows can have a significant impact on "technicals" and ultimately valuations if investors seek to reduce exposure in tandem.

We have seen that many times in history and some public market drawdowns are short-lived while others can have systemic effects on the market and economy. If there is an impact to the economic outlook, direct lenders will incorporate that into their underwriting. However, the credit events that have drawn recent headlines seem to be idiosyncratic events and more of a result of looser underwriting standards in those BSLs.

Source: Bloomberg U.S. Corporate High Yield Bond Index, Cliffwater Direct Lending Index, S&P/LSTA Leverage Loan Index, SPX (S&P 500 Index) MSCI ACWI Index, Bloomberg U.S. Corporate Investment Grade Index, Bloomberg U.S. Aggregate ABS, and Infrastructure (Dow Jones Brookfield Global Index).30 June 2025. Past performance is not a reliable indicator of future performance and should not be relied upon for an investment decision. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

Direct lending, specifically lower and core middle market credits, has historically provided attractive risk-adjusted returns throughout a cycle



	Drawdowns*			
	Direct Lending	High Yield	Leveraged Loans	S&P 500
Great recession (2Q 08 - 4Q 08)	-8%	-27%	-30%	-46%
COVID (4Q 19 – 1Q 20)	-5%	-13%	-13%	-20%
Return per unit of risk (3Q 04 – 2Q 25)**	2.80	0.66	0.55	0.68

Shown for comparative context across asset classes. *Drawdowns are reflective of quarter end index values. **Return per unit of risk is calculated by dividing the CAGR of the index from September 2004 to June 2025 by the annual standard deviation.

Stronger metrics signal deal quality

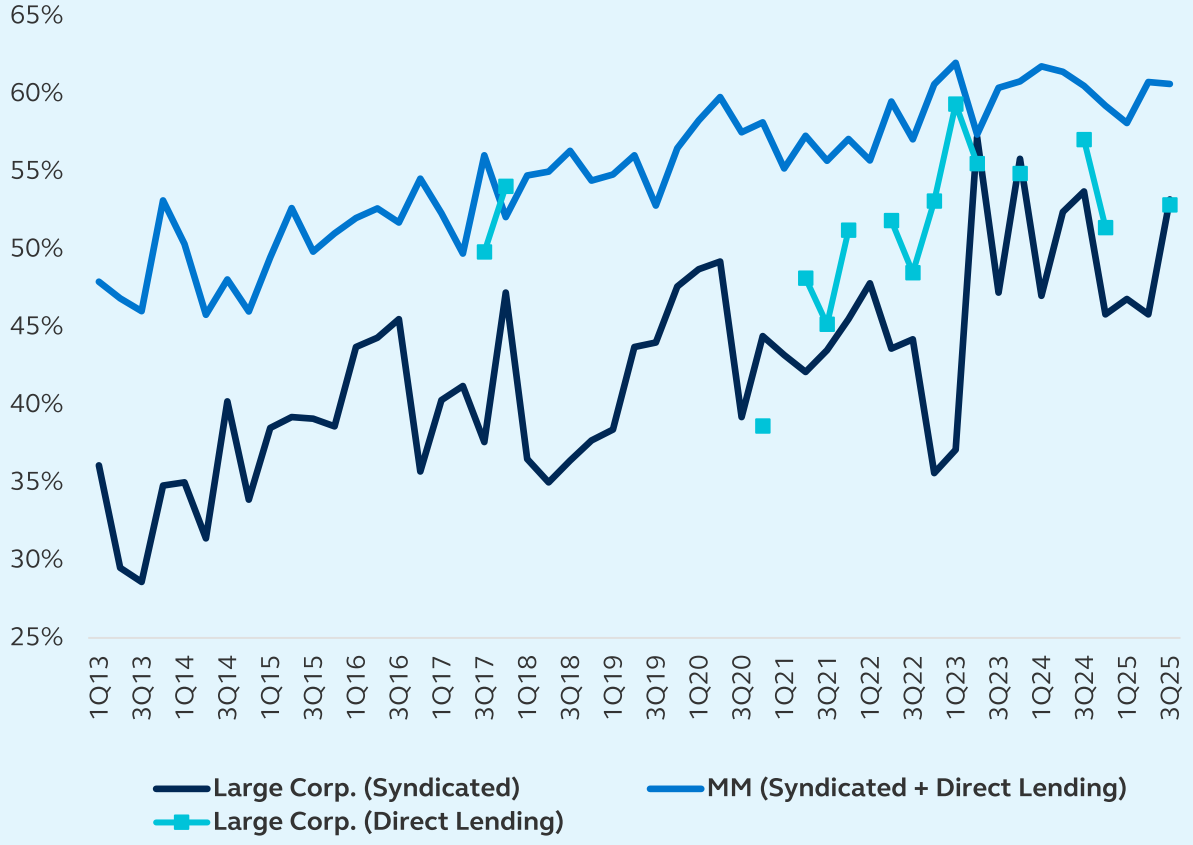
As we begin 2026, the economic and market backdrop is as favorable as it has been for a number of years. With inflation shifting back into an acceptable range and base rates moving lower, credit conditions should be favorable and support new LBO and M&A activity.

At the same time, LBO and M&A transaction activity has been below the expected trend in part due to economic uncertainty and the stark rise in rates the second half of 2022 through 2024, followed by the tariff policy uncertainty in 2025. The pent-up demand for PE firms to realize exits and deploy capital has continued to build over those years. With PE firms having over $2 trillion in dry powder to deploy, along with the higher rate environment (higher cost of debt), equity capital contribution for funding LBO activity has continued to consistently increase. That increase has also been greater than the increase in EVs, resulting in noticeably lower leverage levels.

For the middle market direct lending industry, leverage levels have declined approximately 0.5x as a multiple of earnings before interest, taxes, depreciations, and amortization (EBITDA) over the past few years. Along with that the average loan-to-value has decreased to around 40%, and even below that for lower middle market transactions.

Equity contribution for LBOs continues to steadily increase

LBO total equity contribution comparison

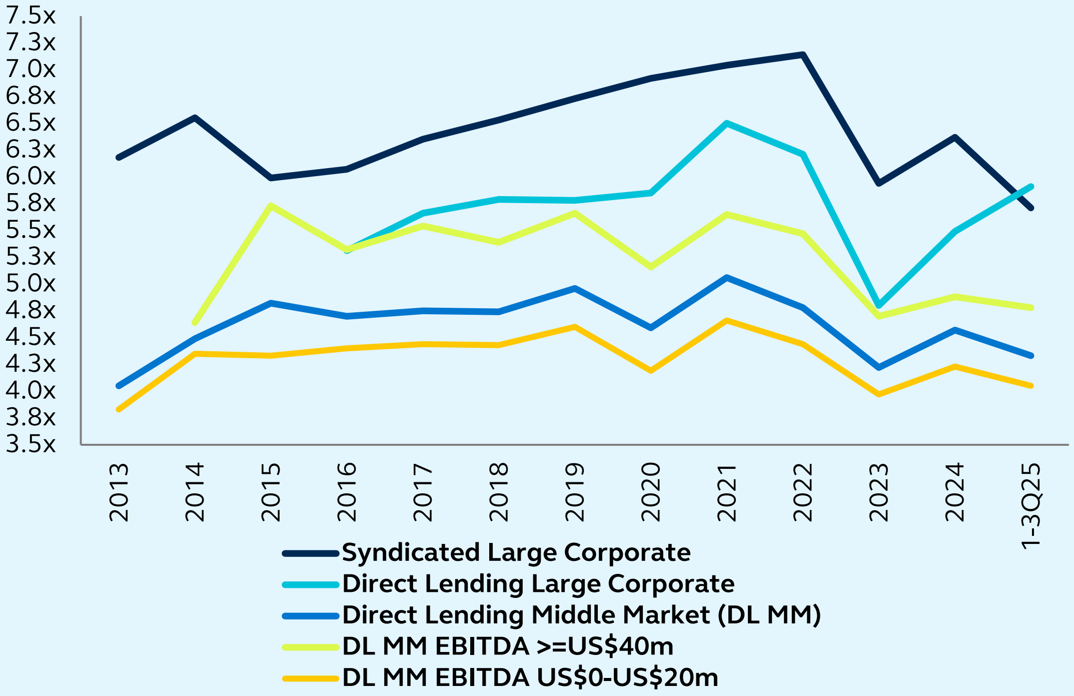


Source: LSEG, 30 September 2025.

Notably lower leverage in lower and core middle market

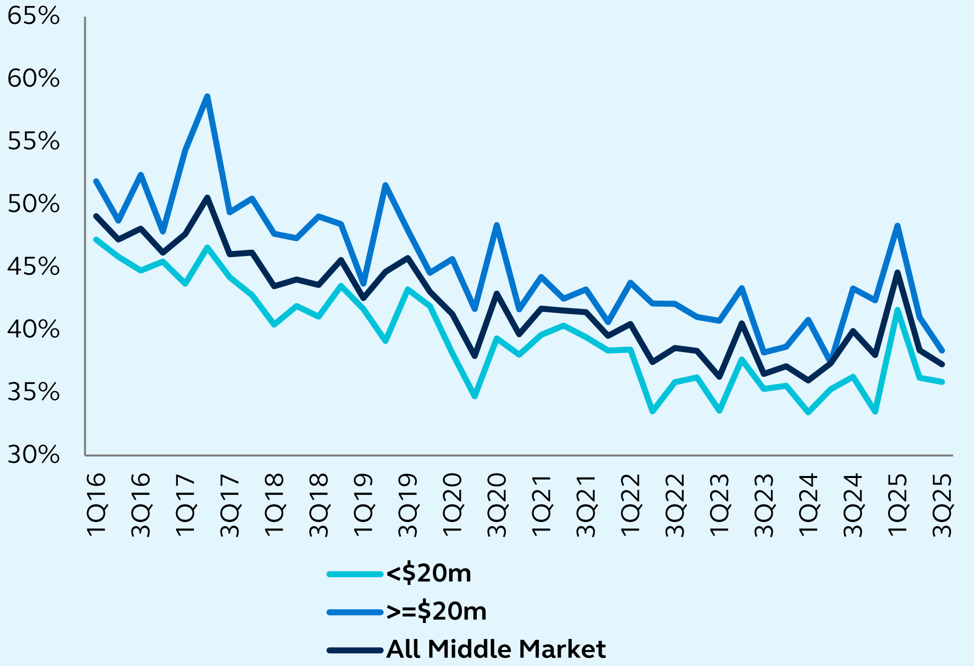
Total leverage for LBOs has continued to decline for middle market direct lending and appears attractive relative to large transactions

LBO total leverage across markets (annual)



Loan to value for middle market LBOs has steadily improved in recent years and remains relatively attractive

Loan to value for middle market LBOs by EBITDA size (%)



Source: LSEG, 30 September 2025.

Conclusion:

Improving market and economic conditions set the stage for 2026 investment opportunities

The improving and supportive market and economic backdrop, coupled with appealing credit structures, may create an environment ripe with attractive investment opportunities in 2026. And the discipline of the market continues to be intact with lower and core middle market direct lending transactions continuing to represent the credit structure and underwriting standard that has set middle market direct lending apart from the public high yield and BSL markets.

We are focused on alignment with clients and approach direct lending with an investor mindset, always seeking to achieve the strong value proposition that is available with lower and core middle market direct lending through both PE sponsor-backed and non-sponsored lending opportunities.

The path ahead in 2026 will likely take a few twists and turns along the way. At Principal Alternative Credit, we look forward to maintaining our disciplined process and pursuing strong, risk-adjusted outcomes.

Important information

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Past performance is no guarantee of future results. Investing involves risk, include possible loss of principal invested. 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.

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