

PRINCIPAL ALTERNATIVE CREDIT MIDDLE MARKET DIRECT LENDING

Exterminating misperceptions in private credit

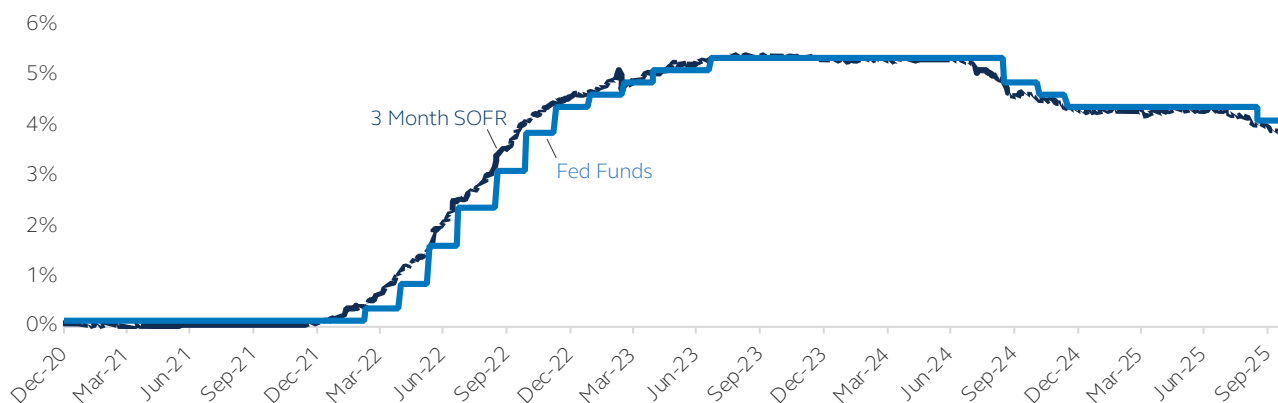
AT-A-GLANCE

- Recent credit events in the headlines are part of the broadly syndicated market and not directly relevant to private credit and specifically middle market direct lending
- The noted deals seemed to have questionable lender underwriting and oversight along with purported fraud committed by the borrowers
- It's natural to see some credit events with a shift from accommodative policy to more restrictive monetary policy, but indications suggest private credit is healthy and should further benefit as the Fed pivots back to accommodative policy
- The key for investors is to understand credit structures, underwriting standards and manager alignment/incentives when discerning true private credit from the broadly syndicated loan market

Historically, when there have been excesses in the financial system for some time followed by Fed tightening, an increase in credit events have typically followed. The credit conditions and cycle post COVID have been anything but ordinary, as central banks became uber accommodative and fiscal stimulus poured into the system. This easy money was most noticeable in consumer behavior with spending up and an increased likelihood by employees to quit their job given their improved confidence.

This accommodative environment also supported inflation, which was a lot more persistent than transitory. The ultimate reaction by the Fed and other central banks was to raise target rates in a nearly unprecedented fashion (back to the late 1970's anyway). In the Fed's case, it began raising rates in March 2022 and 500 basis points later it paused by July 2023. The shock of higher rates combined with higher labor costs and other persistent inflation quickly reduced financial flexibility of borrowers.

A steep rise in rates reduced borrower financial flexibility



As of November 3, 2025. Source: Bloomberg.

In middle market direct lending, senior first lien loans are floating rate, and the Fed rate increase immediately passed through to create a higher interest burden for companies. With the dramatic increase combined with inflation factors, both sponsor-owned middle market companies and non-sponsored companies strived to drive operational efficiencies, pass through labor inflation to maintain margins, and tightly manage cash flow. Companies with lower leverage clearly managed more successfully than higher levered companies. That difference in leverage is one factor that will affect the health of companies, while the structure of transactions also has a direct impact on the credit worthiness of companies. Not all structures are created equal, and as is typically the case in easier economic conditions (post COVID) the quality of credit structures, and potentially underwriting standards, were quite varied across different segments of the market and also across different lenders.

As a result, it's not surprising to see some credit headlines in the current market with the residual effect of shifting from accommodative policies to more restrictive monetary policy filtering through credit performance. When evaluating private credit investments, investors should carefully consider key factors like borrower creditworthiness, loan structure, underwriting practices, and management incentives rather than broadly dismissing the sector based on recent negative headlines.

The transactions that are making headlines are a part of the broadly syndicated loan (BSL) space, so 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 like First Brands or Tricolor. In true private credit, such as lower and core middle market direct lending, we and other lenders are "underwriting to own" the loan exposure, whereas in broadly syndicated loans, the sponsoring bank is "underwriting to syndicate or sell" the loan exposure and generate fee income from the syndication. That eagerness to generate fees and sell risk may contribute to looser underwriting standards along with weaker credit structures. Banks that syndicate loans often pursue other fee-oriented business with the borrower, such as cash management, trust and custody services. This means they may expect to generate much of the returns from

fees rather than coupon payments to cover credit risk. In our case, since Principal owns a meaningful portion of all the loans we originate, underwrite and close on Principal Life Insurance Company's balance sheet, our interests are directly aligned with our clients who invest in these same loans. Often, Principal holds a substantial amount of each loan along with the exposure relative to other clients.

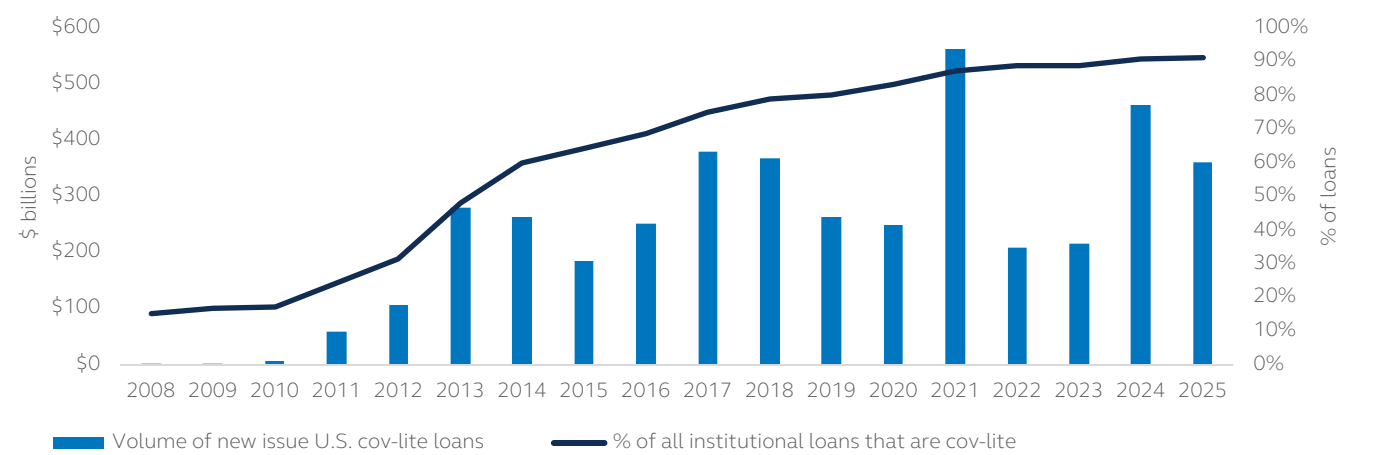
Furthermore, the First Brands transaction involved off-balance sheet factoring and trade finance, which allegedly may have allowed the company to pledge the same collateral more than once. More may continue to become apparent but it seems the underwriting and oversight was questionable as lenders claim to have not been aware of a significant history of litigation and potential asbestos claims, in addition to the hidden off-balance sheet liabilities. Tricolor, which was an asset-based lending structure and not direct lending, may have also double-pledged auto loans that were funded with a form of factoring or securitization. Lower and core middle market direct lending has much tighter documentation and seldom permits such factoring. Additionally, the borrowers (especially ours) tend to be more domestically focused and don't require trade financing or other forms of factoring.

For additional context, trade finance factoring refers to a financing arrangement where a business sells its accounts receivable to a private lender or specialized finance company (known as a factor) at a discount. This allows the business to access immediate cash flow rather than waiting for customers to pay. The factor typically advances a portion of the invoice value upfront and collects payment directly from the customer. Once the invoice is paid, the remaining balance is returned to the business, minus a finance charge and fees. Factoring is commonly used by companies with limited access to traditional bank financing or those operating in industries with long payment cycles. Also, perfecting the security interest for factoring is much different than for true middle market direct lending in which lenders providing first lien loans utilize the Uniform Commercial Code (UCC) system to ensure no lenders have a claim on the assets ahead of the direct lending firm at the time of filing and thereafter.

As it relates to both First Brands and Tricolor, the credit events purportedly were partly a result of fraudulent activity by management. In our view the broadly syndicated loan market features considerably less ability

to perform due diligence than direct lending transactions, and this is especially notable in the lower and core middle market where lenders have access to the management teams of the business being underwritten, as well as significantly more data from the borrower and third parties. Management alignment, character, and incentives are a key focus of due diligence. Also, regular engagement with management teams continues beyond the initial due diligence to monthly and quarterly communication between borrowers and direct lenders. To the extent a company’s performance deteriorates, we can pursue proper remedies given all of our middle market direct lending loans have true financial maintenance covenants, while the broadly syndicated loan market is now nearly all covenant-lite.

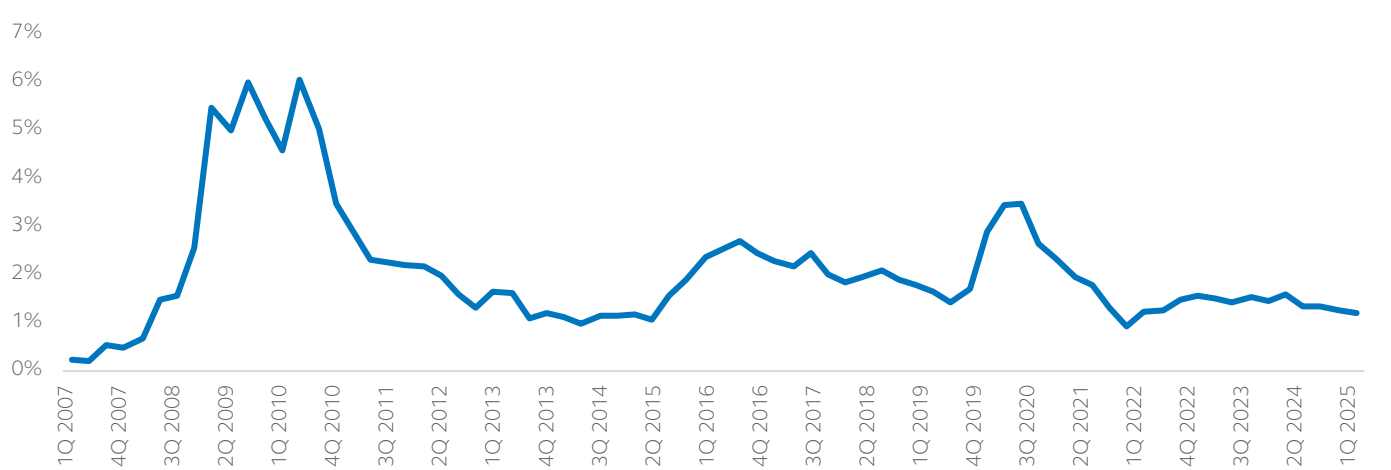
Growth of covenant-lite loans in BSL market



As of September 30, 2025. Source: Pitchbook

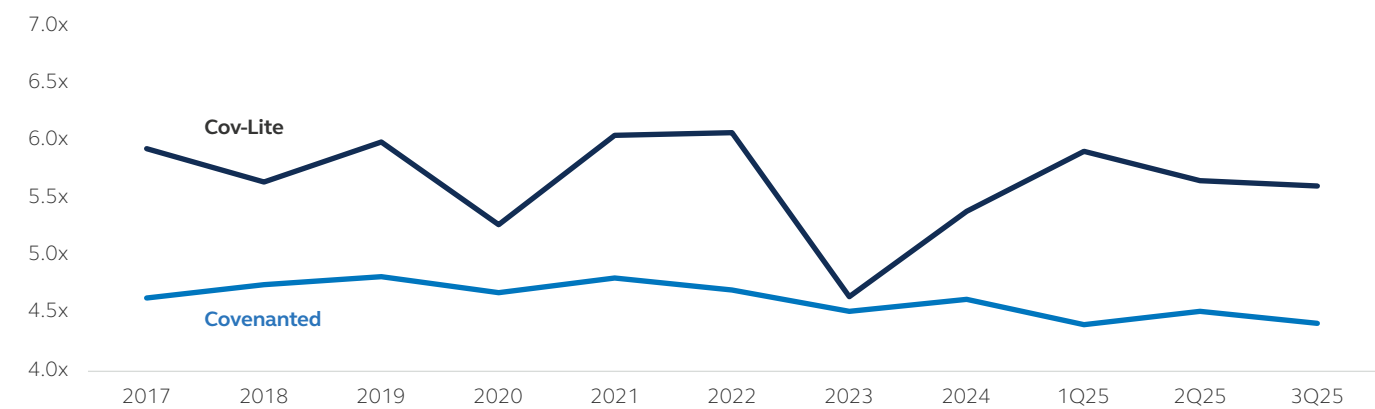
In addition, the various market indicators we observe in middle market direct lending suggest the market remains healthy, and underlying borrowers are performing well on average. The level of non-accruals (defaults) continues to be well below the long-term average according to various indices and compares favorably relative to public high yield default rates. The level of payment-in-kind (PIK) interest being accrued also continues to be in a consistent and typical range decline by most industry accounts. On average, middle market companies continue to realize strong revenue and EBITDA growth. New transactions are also generally funded at reasonable levels of leverage and typical loan-to-values are below 50%. Also, the absolute level of leverage continues to trend lower for direct lending middle market loans that have financial maintenance covenants, and the level of leverage is considerably lower than the average leverage of covenant-lite transactions typical in the broadly syndicated loan market.

Middle market direct lending non-accrual rate



As of June 30, 2025. Source: Cliffwater Direct Lending Index.

Sponsored middle market: average total debt to EBITDA - covenanted vs. cov-lite

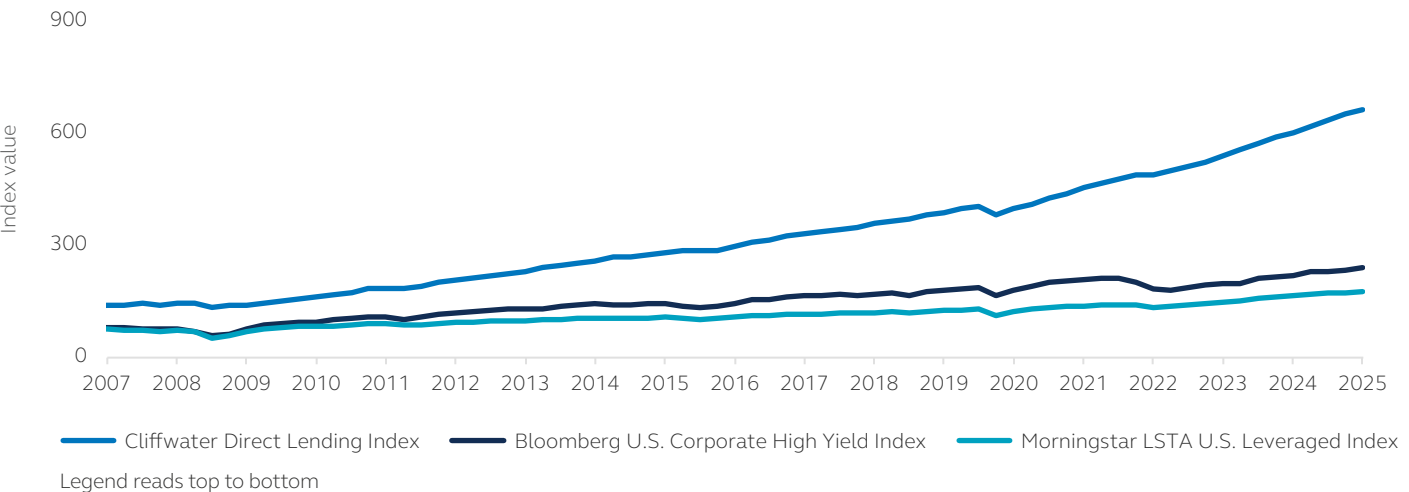


As of September 30, 2025. Source: LSEG, LPC.

It is prudent to be aware of credit events and the potential for a significant credit cycle shift. Interestingly, even a small number of high-profile negative stories could shake investor confidence and potentially affect market flows. The committed and funded capital in middle market direct lending is 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 broadly syndicated loans there can be immediate liquidity so flows can have a significant affect 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 broadly syndicated loans. As we’ve learned through many credit cycles, the loosening of standards can result in a pickup in credit losses and also accommodate an environment where unethical company management can push the boundaries into fraudulent practices.

Resilience and return of middle market direct lending through recessions and systemic market events
Total returns, indexed to 100 as of 9/30/2004



As of June 30, 2025. Sources Bloomberg U.S. Corporate High Yield Bond Index, Cliffwater Direct Lending Index, S&P/LSTA Leverage Loan Index. 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.

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

As of June 30, 2025. Sources Bloomberg U.S. Corporate High Yield Bond Index, Cliffwater Direct Lending Index, S&P/LSTA Leverage Loan Index. 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. *Drawdowns are reflective of quarter end index values.

Investors and lenders should remain vigilant, and each deal we underwrite factors in the potential of a recession through the life of the loan. However, we believe that it is unlikely that a recession or systemic credit event is on the near-term horizon. With the Fed's easing cycle well underway and a focus on supporting employment (and inherently supporting business confidence to incent keeping employment at a healthy level) with inflation now in a reasonable range, the interest burden for middle market companies borrowing from direct lenders should continue to ease. This will provide companies with greater financial flexibility and allow for more growth investment.

Accommodative Fed policy through lower rates also supports a significant increase in LBO and M&A activity, as more business owners look to sell with improved valuations and buyers seek to deploy capital with greater certainty of economic conditions and lower cost of capital. With the lower rates and improved clarity, we expect enterprise values (EV) to expand for private companies

and most notably for companies in the service-based industries benefitting from 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. And even with some spread tightening, the yield premium of lower and core middle market direct lending continues to be attractive relative to larger deals and broadly syndicated loans. Furthermore, we maintain strong protective measures including substantial financial covenants, appropriate leverage levels, and rigorous underwriting practices, while keeping regular dialogue with management teams. Those factors should deliver an attractive risk-adjusted return for this vintage of loans.

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