Principal Alternative Credit

Principal Asset Management℠

MIDDLE MARKET DIRECT LENDING

Finding opportunity on the horizon

2025 OUTLOOK

The past year was filled with plenty of events, but their market impact turned out to be less eventful than many would have expected. Economic uncertainty and geopolitical risks failed to derail steady performance across most asset classes. Public markets performed well, with credit spreads marching tighter and equities climbing higher throughout the year. The markets belief in a soft landing and the Federal Reserve's (Fed) ability to engineer a move toward target inflation, along with reasonable employment growth, spurred the positive sentiment.

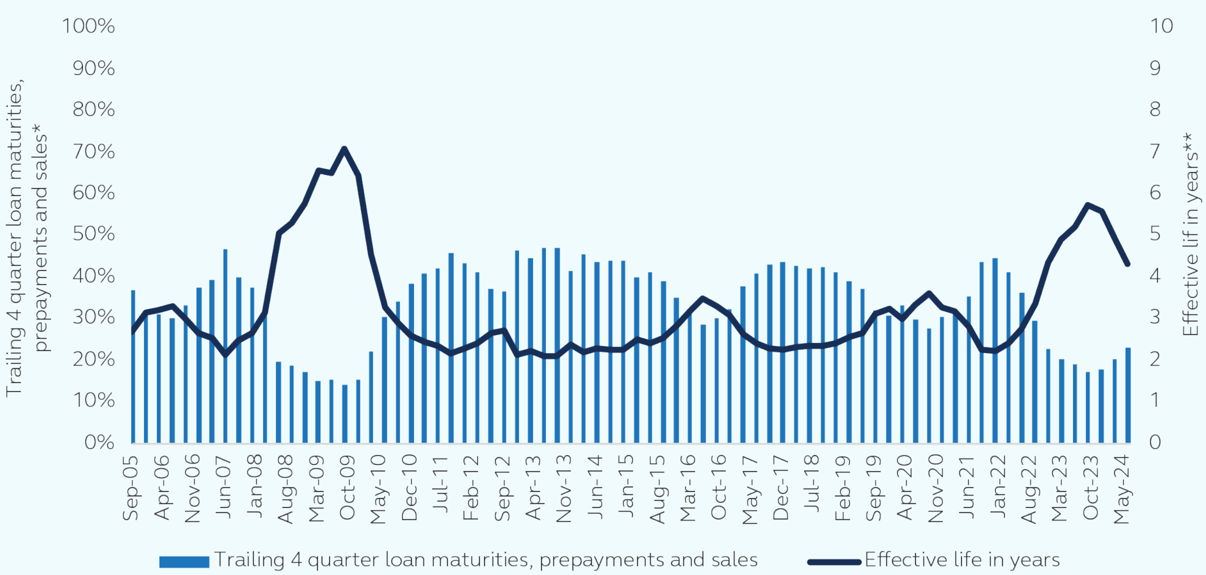
That may have been the easy part—the early stages of declining inflation and modestly rising unemployment. Now that the Fed is moving along its path to a lower Fed Funds target rate, the standard playbook doesn't seem to be in play. With interest rates remaining elevated, the market seems to be struggling to digest the ability of the Fed, in conjunction with continued fiscal stimulus, to really curb inflationary pressures back to the desired long-term target.

What does this mean for private assets and specifically middle market direct lending? Though the picture is never as vivid as we would like, it's likely the path to achieve economic recovery and resiliency in the new year will have its challenges. However, given the current state of the economy and markets, along with expectation for conditions to remain "reasonable" supported by an easier Fed, loan repayment and capital recycling has begun to increase, something we expect more of in 2025. This aligns with an expected increase to more typical levels of mergers & acquisition (M&A) and leveraged buyouts (LBO) activity.

> "That may have been the easy part—the early stages of declining inflation and modestly rising unemployment."

Loan repayment and effective life

September 2005 - June 2024



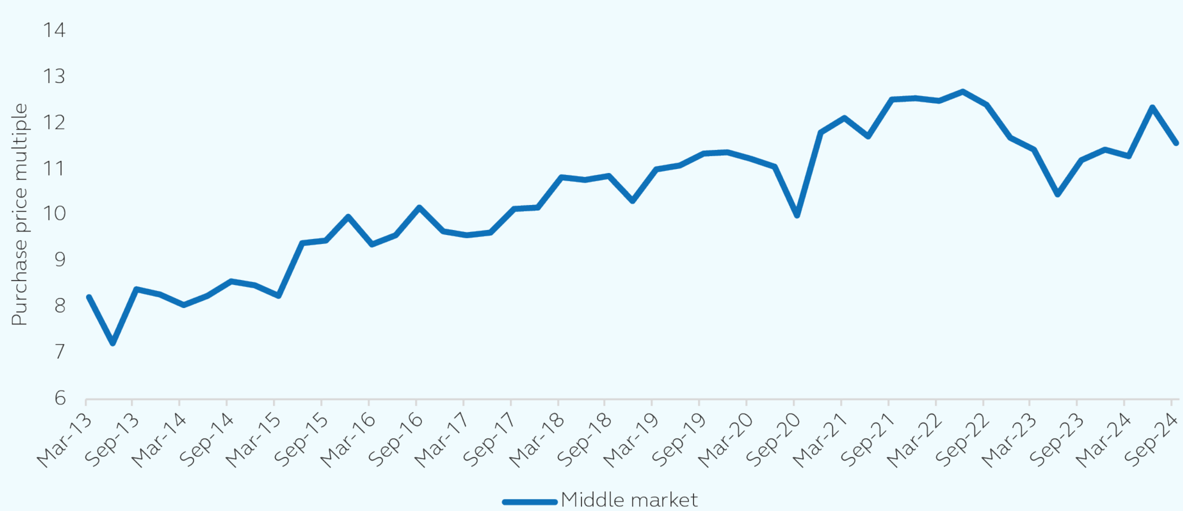
Source: Cliffwater. As of 30 June 2024.
*Cash inflows from maturing loans, prepayments, and sales divided by total investment cost.
**Equal to the reciprocal of the first footnote.

After a couple years of stalled deal activity for private equity sponsors and middle market direct lenders, as well as investors being frustrated with capital recycling trends, deal flow is on track to a more normal pace. Conditions that are technical in nature, such as a building of dry powder (investors wanting capital to be deployed) and investors getting impatient for investment realizations (capital recycling), are a significant factor to incent more deal activity.

Somewhere between technical factors and realized fundamental improvement, is the expectation for a more favorable environment for businesses and deal activity now that the U.S. election is behind us. Simply having clarity on policies, with many policies shifting more business friendly, should support greater investment by companies as well as increased investor appetite. With the Trump administration along with a Republican controlled House and Senate, it's reasonable to expect several pro-business policies will be passed and implemented. An expected continuation or reduction of corporate and personal tax rates (many businesses are taxed as personal income, such as with an LLC) should be supportive of stronger borrower financial health. That coupled with a more business favorable regulatory environment may provide for reduced costs, as well as incremental innovation and growth. With greater clarity and a supportive business environment, LBO and M&A activity should stand to benefit along with the middle market direct lending deals to finance those transactions.

The fundamental factors are also shifting to be more supportive of increased deal activity. More economic clarity along with the shift to lower rates and, potentially lower rate volatility with Fed easing on track, contribute to more confidence for both buyers and sellers of businesses. This clearer outlook has stabilized enterprise valuations, after some resetting to lower levels in 2023.

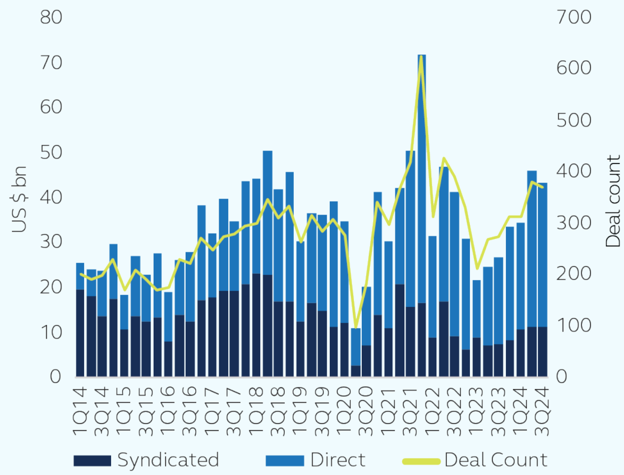
LBO purchase price multiple



Source: LSEG LPC. As of 30 September 2024.

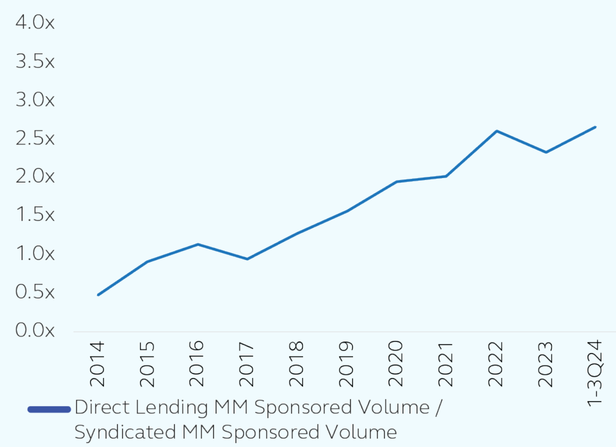
Also, when valuing businesses there should now be less distortion of financial performance that may have been caused by the Covid impact, supply chain disruptions and inflationary pressures. Combining greater economic clarity with the "pent up" demand could readily result in LBO and M&A activity moving above the long-term pace back to levels last observed in 2021. With greater LBO and M&A activity, there will be a direct increase in the volume of middle market lending deals. And the trend for these deals to be primarily funded in the direct lending market will most likely continue, which has been the case in recent periods with over 3x as many middle market deals being funded in the direct lending market compared to the public market.

Sponsored middle market loan volume (US$bn) & deal count



Source: LSEG LPC. As of 30 September 2024.

Sponsored middle market (MM) direct lending volume relative to sponsored syndicated MM volume (x:1): annual



Source: LSEG LPC. As of 30 September 2024.

Now this supply of direct lending deals, along with the higher LBO and M&A activity, will not occur unless middle market company fundamentals remain favorable or improve. Direct lending borrowers rarely hedge their floating rate obligations to fixed rate, so those borrowers with outstanding loans faced the sharp rise in interest rates over 2022 and 2023, and they have weathered the "rate shock" through improved operating efficiency, pricing power and organic and add-on growth that spurred business diversification. In addition, for the new loan origination that occurred in the second half of 2022 and 2023, with the higher rate environment and tighter credit conditions, the deals were most often structured with attractive leverage levels, as lenders and borrowers alike wanted comfort that debt service would be reasonable even in an elevated rate environment. Also, as economic uncertainty was looming during that time, the deals in the lower and core middle market were typically structured with strong credit agreements (tighter covenant cushion, lower restricted payment baskets, etc.). Now with rates falling and the economy expected to be transitioning to more favorable long-term growth, the recent vintages of loans should perform well. Though the recent level of rates, inflationary pressures, and economic impact have shifted the broad middle market borrower profile a bit less favorable, as measured by loan scoring highlighted from middle market Business Development Corporations (BDCs), non-accrual or default levels remain below long-term averages. A fraction of the underperforming loans (many of which were originated with higher leverage levels from the late 2020 through 2021 vintages. when rates were assumed "lower for longer") will move to non-accrual or default. The current level of defaulted loans remains below long-term average of 2.00 -2.50%, and we anticipate the rate to only modestly move higher, if at all, over the next year. The default rate reaching the long-term average appears reasonable based on our assessment and compares favorably to the current default rate in public high yield of approximately 4% as measured by Moody's.

It's quite likely some of the same factors driving greater supply of direct lending deals will also impact the level of investor demand. In fact, demand, and the investor confidence that goes along with greater demand, tends to "pull through" greater supply or at least provide a good foundation for more supply. Some of these factors include:

1: Investors search for return and incremental yield.

With falling rates and extended equity valuations, investors will be seeking diversification and incremental returns where they can find value. Historically, as rates fall and spreads of conventional credit asset classes tighten, the demand for incremental spread and yield from middle market direct lending will increase. With falling rates, naturally the spread becomes a greater portion of the overall yield, and the spread offered by middle market direct lending continues to be significant and around the long-term average.

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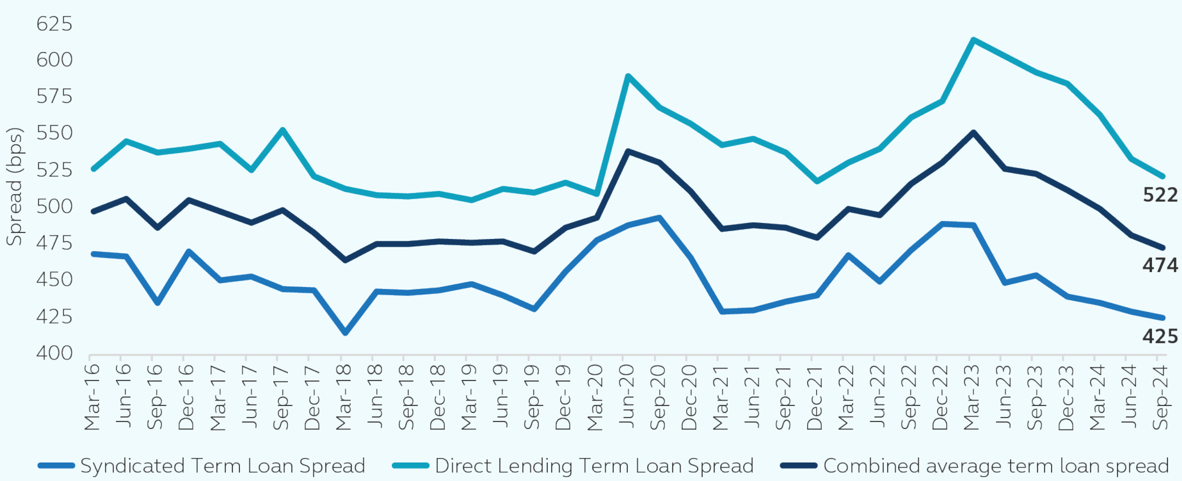
Average first-lien sponsored middle market term loan spread (bps)



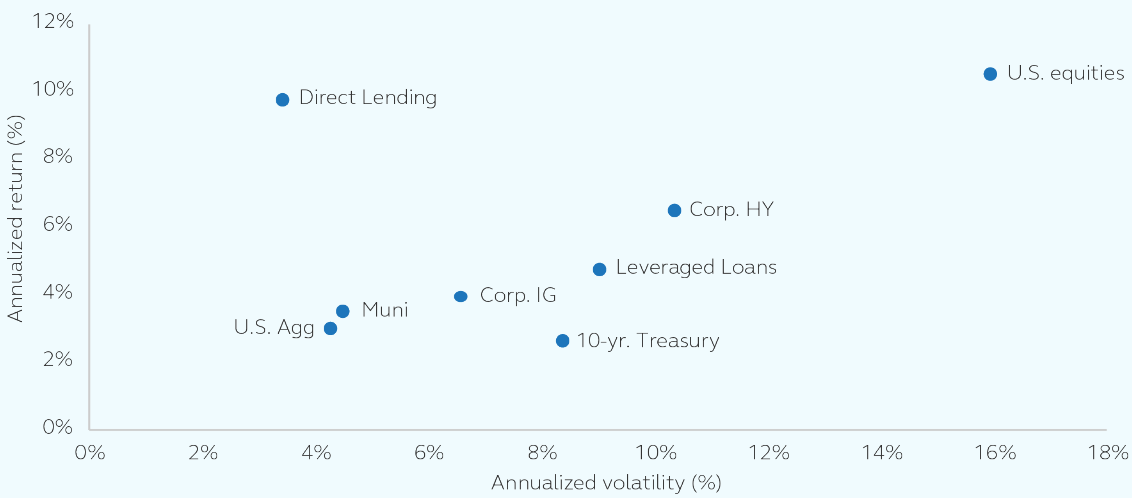
Source: LSEG LPC. As of 30 September 2024.

This spread level for middle market direct lending, which includes a significant inefficiency premium, has also been more stable than public market spreads, thus providing investors greater assurance to realize a considerable risk premium through time. The overall spread level is impacted by different segments of the middle market. Lower and core middle market direct lending deals continue to represent attractive value, while spread tightening has been more dramatic for upper middle market deals, which competes more with the public loan market.

2: Greater confidence in the economic environment.

There is economic clarity and hope on the horizon. More coordinated global central bank easing, less inflationary pressures and generally easy credit conditions should be key drivers to support economic activity through 2025. However, it's likely the public markets won't continue the uneventful and robust pace of performance without experiencing some market volatility or systemic risk. With public equity and credit market positioning getting crowded, the market patience for any policy missteps or disappointment if policy becomes less accommodative seems likely to result in increased volatility with potential for some significant performance drawdown. If public market volatility bouts do occur, middle market direct lending has a history of outperformance.

Historical risk/return since 2004*



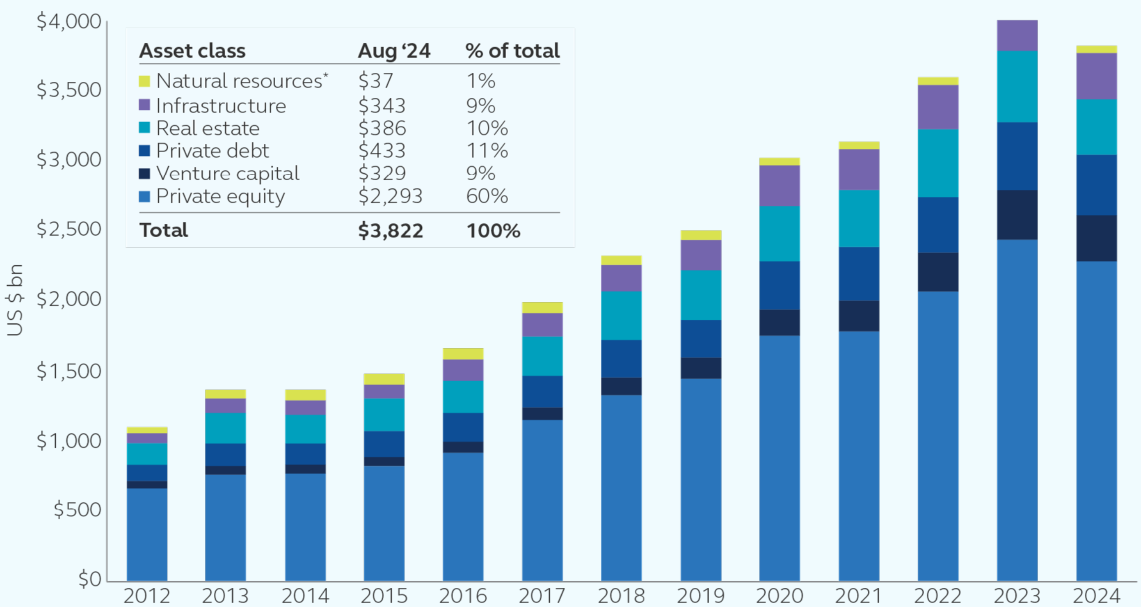
As of June 30, 2024. *Since inception of Cliffwater Direct Lending index on September 30, 2004. Sources: Bloomberg, Cliffwater Direct Lending Index, S&P 500 S&P/LSTA Leverage Loan Index, Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Municipal Index, Bloomberg U.S. Corporate Bond Index, Bloomberg 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.

In addition to more steady performance, volatility in the public markets often supports direct lenders' ability to realize attractive pricing and structure on new loan origination. And if the volatility would trend into more challenging economic conditions, as has been the case in the past middle market direct lending loans would likely have better fundamental performance compared to public high yield. Factors supporting this better relative performance include exposure to a less cyclical industry mix, generally lower leverage, financial maintenance covenants, and small lender groups to help ensure early and proactive engagement with a borrower and PE sponsor if there is underperformance.

3: Investor desire to realize more capital deployment for existing commitments.

Many investors have made their frustration known regarding the slow pace of capital deployment for their private equity as well as private debt commitments. Their patience during the uncertain economic times of the second half of 2022 and 2023 is clearly wearing thin based on our discussions with investors and consultants around the world. This suboptimal pace of deployment not only weighed on return assumptions, but for many investors fulfillment of their strategic asset allocation has been put on hold. Some investment managers have developed solutions to enhance the capital deployment for investors.

Dry powder by asset class

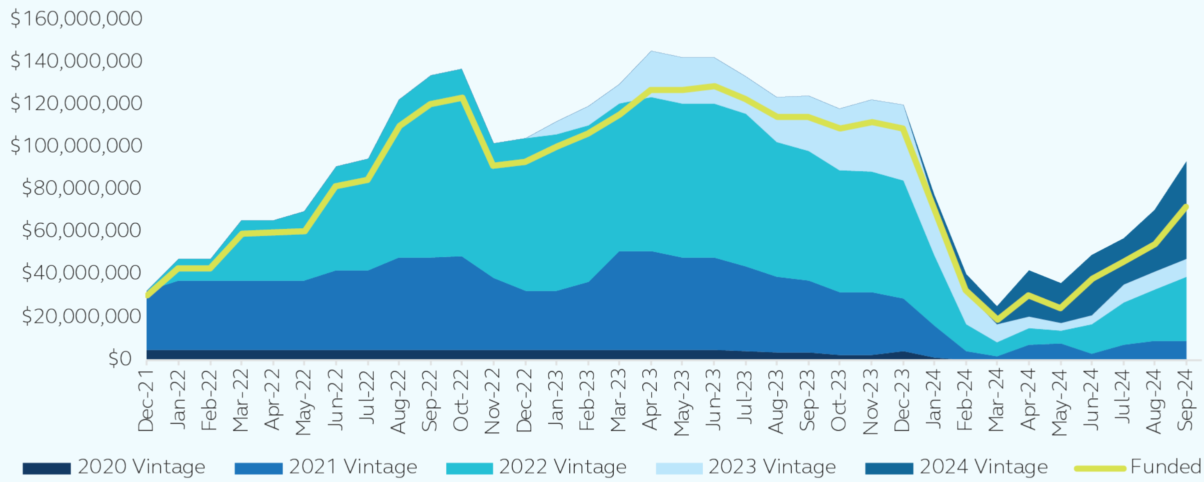


Asset class	Aug '24	% of total
Natural resources*	$37	1%
Infrastructure	$343	9%
Real estate	$386	10%
Private debt	$433	11%
Venture capital	$329	9%
Private equity	$2,293	60%
Total	**$3,822**	**100%**

Source: Prequin, J.P. Morgan Asset Management. As of 31 August 2024. Dry powder refers to committed but uninvested capital. Fundraising categories are provided by Prequin. *Natural resources including energy, timberland, agriculture and farmland, metals and mining, water and diversified business. Data updated through 31 August 2024.

A solution we utilize that aligns with client interests is our Principal warehouse facility. It has been instrumental to support quickly ramping an investor's portfolio or incremental exposure to our lower and core middle market loans. This warehouse also provides "season and sell" benefits for non-U.S. investors. In addition to the warehouse providing an ability to quickly ramp a diversified portfolio of lower and core middle market loans, investors are provided transparency regarding our underwriting of the loans, current borrower performance, loan price and yield, and a variety of other attributes.

Committed capital



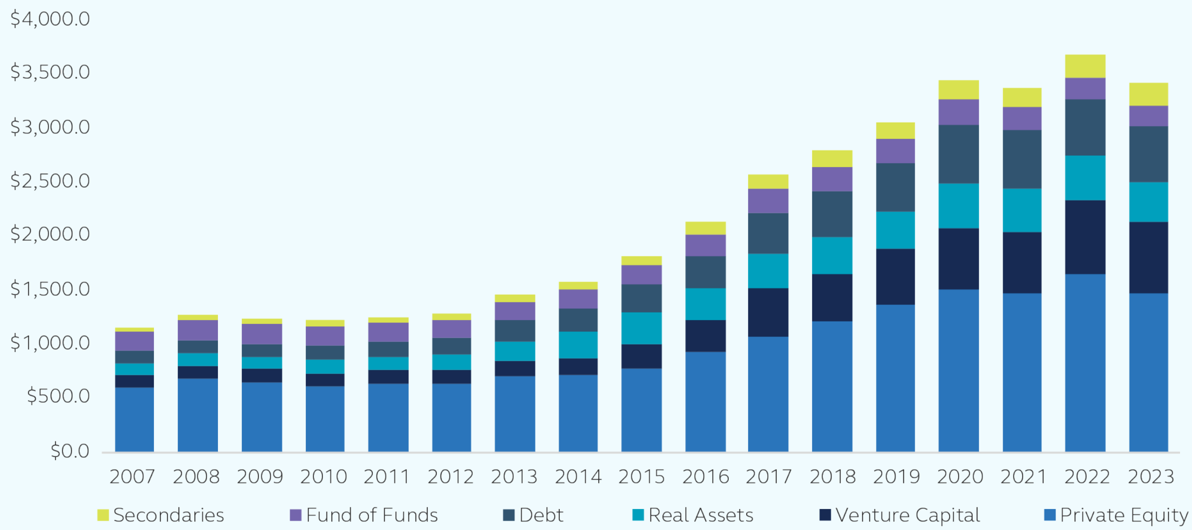
Source: Principal Alternative Credit. As of 30 September 2024.
Note: The size of each calendar year vintage may grow after the year of reference if "add-on" financings are provided to the borrower and the term remains unchanged. Decreases in the warehouse represent transfers to fund client portfolios.

4: Desire to achieve strategic asset allocation objectives.

Some investors paused the pursuit of an increased allocation to middle market direct lending over the past couple years. It's easy to understand why, as investors' returns across most asset classes (other than middle market direct lending) were negatively impacted by sharply higher rates in 2022, then with continued economic uncertainty through much of 2023 and 2024, and at the same time an extraordinary run of performance in public markets, investors were content to ride the current allocation. Of course, less private capital recycling and capital deployment in private markets also helped drive a slower path to a more optimal and planned asset allocation. Now with private market deal flow improving, public market valuations being near all-time highs for equity and tight public high yield and investment grade credit spreads that haven't been seen for more than a decade, it's hard to envision a better time to seek further diversification and the strong value proposition of middle market direct lending.

In fact, many investor groups that had not typically allocated much, if any, to middle market direct lending are pursuing an allocation. Some of these more notable investor groups include family offices and endowments & foundations; both of which are often thought to have return thresholds that may eliminate direct lending as an investment option. That's turning out not to be the case for a variety of reasons. The return profile for first lien middle market direct lending remains in the double digits even with base SOFR rates declining. And that's without fund or portfolio leverage, which many investors utilize to boost returns given the first lien nature of the asset class and reasonable leverage profile of the borrowers. Investors have many private asset classes to choose from, but middle market direct lending provides the "ballast" of significant income driving total return. Some investors will likely search for distressed or special situation opportunities for potential incremental diversification and alpha. With the improved credit conditions, some economic clarity and the continuation of a lot of capital supporting middle market deals, it's doubtful that the volume of distressed opportunities will be significant or predictable for those investors seeking to deploy capital.

Dry powder by fund class



Source: PitchBook. As of 31 December 2023. Dry powder refers to committed but uninvested capital

5: The continued democratization of private credit broadening the investor base and asset class segmentation.

With the expansion of product offerings from traditional closed-end drawdown funds and BDCs, to evergreen institutional funds and interval funds along with significant middle market Collateralized Loan Obligation (CLO) offerings, as well as more secondary funds, middle market direct lending is being made accessible to more investors and investor groups. Many investors have not begun to pursue their allocation to the asset class, and some haven't had direct access previously. However, with the expansion of middle market direct lending into more broadly accessible products, such as semi-liquid alternative products like interval funds, many new investors are beginning the process of evaluating the best way to access middle market direct lending.

As investors begin to allocate or increase allocations to middle market direct lending an important consideration will be determining which direct lending segment(s) to consider for investment, in addition to selecting a proven manager and appropriate structure or vehicle. Not all middle market direct lending is equal. Looking back more than a decade ago when direct lending was expanding and taking share from banks post the Global Financial Crisis, the direct lending market was just beginning the evolution of any noticeable differences across lower (LMM), core (CMM) and upper middle market (UMM) segments. We define LMM to cover direct lending to companies with $5 to $15 million in EBITDA annually, with CMM borrowers generating $15 to $50 million of EBITDA and UMM borrowers realizing $50 to $100 million in EBITDA. Beyond that size would be large cap private credit (LCPC). Over the past decade several managers have realized tremendous growth and continue to attract much of the capital allocation to private credit. Though there are many direct lending managers, the concentration of capital raise has dramatically changed the landscape of direct lending and private credit. Out of necessity, many of the large firms have chosen to or been almost forced to seek larger deals, moving to focus on UMM and LCPC transactions where they can deploy capital in larger deals to better match the level of commitments that continue to come in the door. This natural migration seems logical and leaves the value proposition of LMM and CMM well intact as many of the lenders abandon these segments. However, there is one primary challenge; UMM and LCPC companies can readily seek financing in the public markets.

Though direct lending to UMM and LCPC companies offers value for investors compared to public market high yield, such as the benefits of true relational lending and improved terms, borrowers or the PE sponsor owners are only willing to offer so much value in pricing, leverage, other terms relative to what they can achieve in the public markets. So, lenders in the UMM and LCPC segments must compete with the public market, the same public market that is often a “price taker” with passive investors (e.g.. index funds) allocating capital based on macro risk conditions. Thus credit spreads can compress considerably, as is the case now with public high yield credit spreads at more than a decade tights, and terms get very competitive, such as deals offering higher leverage and covenant lite or covenant loose structures (covenant lite loans may have a financial incurrence test, but no financial maintenance covenants and covenant loose transactions may have a financial maintenance covenant, but set at a level unlikely to be meaningful until borrower is distressed). As many large managers and a variety of other managers focus on UMM and LCPC, the value proposition of LMM and select CMM transactions continues to be attractive. One aspect of that value is the diversification benefits that were once thought to be “universal” across direct lending, now truly being more concentrated in LMM and CMM transactions. This diversification comes from the investment performance expected to be independent of public markets, as well as UMM and LCPC, but also the more attractive credit attributes. These attributes include deals that have lower leverage, meaningful financial maintenance covenants and pricing that is set based on borrower credit risk with required premiums for the benefit direct lenders provide to borrowers and the PE sponsor owners.

The broadening investor base and ultimately demand could get ahead of the supply of direct lending deals, but with some managers expanding across segments of direct lending and direct lending continuing to take market share from the public markets and commercial banks, it’s likely demand and supply will remain in reasonable balance. The diversification benefits and return premium offered by middle market direct lending will continue to drive further increased allocation by investors along with commitments from new investors attracted to the asset class. Overall private credit and private asset classes not only fill the gap left by public markets, commercial banks and other historically traditional capital sources, the expansion of private capital and specifically middle market direct lending contributes to greater capital access for businesses, which can help drive greater economic growth and velocity.

There are several positive trends for the middle market direct lending industry that we believe support enhanced risk-adjusted returns. In addition to the balance of supply and demand trends, fundamental performance of borrowers should remain in a normal range with potential strengthening over the next year as policy and economic conditions become more favorable. Though public equity and credit markets may be over-anticipating these improvements as indicated by stretched valuations and historically tight credit spreads, middle market direct lending continues to provide its consistent value proposition. And if the public markets have a correction from the elevated valuation levels, the value of middle market direct lending will likely be even more beneficial to investors.

With investors looking for diversification and incremental return, some will search for other private asset classes that may be more esoteric than middle market direct lending. However, investors that stick with or begin an allocation to middle market direct lending should be rewarded and likely benefit from greater capital deployment in the coming year. The recent and current vintage of direct lending should also be attractive with good relative value and credit structures, along with an expected transition to a more constructive economic outlook. In addition, the secular support of this asset class is still in its early stage. Very few investors are at their target allocation, while many are planning to increase the allocation in coming years, and others are just beginning investment in the asset class. It is and will remain important for investors to evaluate and understand how different segments of middle market lending represent different diversification and alpha opportunities. With rates likely remaining elevated through 2025 compared to interest rate standards of the past decade, and the substantial spread relative to public high yield loans, the income from middle market direct lending should be quite attractive. This should result in yields remaining at or near double digits and a foundation for investor returns.

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