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.

Principal Alternative Credit

Principal Asset Management℠

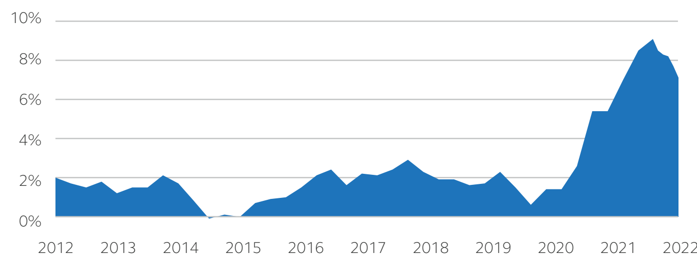
MIDDLE MARKET DIRECT LENDING

Finding opportunity in the midst of uncertainty

With market and economic uncertainty seemingly growing by the day, 2023 may provide more of what investors faced in 2022. Inflation remains persistently embedded in the economy and credit conditions are tightening with more restrictive central bank policy and the associated higher interest rate environment. After over a decade of unprecedented market and economic expansion post the Global Financial Crisis, could the coming economic downturn and uncertainty provide a meaningful test, and potentially an opportunity for investors? We think so.

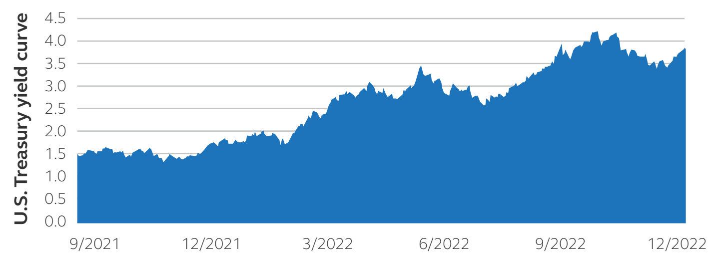
For many years, the credit creation process has rewarded lenders that emphasized production and volume over prudency. Lenders increasingly took risk tied to macro conditions rather than idiosyncratic opportunities. Borrowers have benefitted from the market's somewhat indiscriminate access to debt capital. A strong and steady economy, low interest rates and expanding access to capital contributed to very low default experience that normally results from such frothy conditions; and even the short-term increase in defaults resulting from COVID-19 were quickly abated by central banks and policymakers. Globalization, declining interest rates, accommodative central bank policy and an economy awash in excess liquidity has rewarded market risk-takers post GFC, but all those supportive trends are now being challenged and reversed.

Inflation



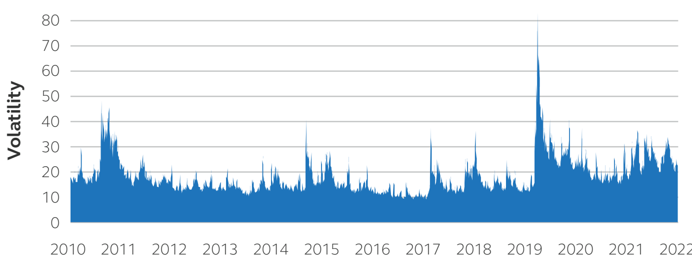
As of November 30, 2022. Source: Principal Global Investors, Bloomberg Finance L.P., CPI YOY Index (U.S. CPI Urban Consumers YOY NSA).

Rising rates



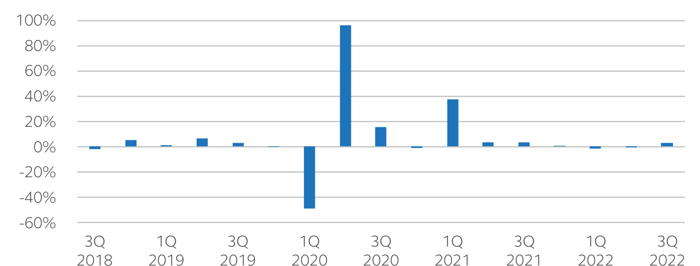
As of December 31, 2022. Source: Bloomberg Finance L.P. H1510YR index. (U.S. Treasury yield curve rate T-note constant maturity 10 year)

Public markets volatility



As of December 31, 2022. Source: Bloomberg Finance L.P. Chicago Board Options Exchange Volatility Index

Declining gross domestic product (GDP)



As of September 30, 2022. Source: Bloomberg Finance L.P. Quarter over quarter GDP change.

The arguably overly accommodative monetary and fiscal policy that stoked economic growth and market risk taking has clearly shifted. This shift has been well telegraphed and has provided market participants a reasonably long runway to introduce greater discipline and prepare for the tougher credit conditions that we believe are on the horizon.

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.

Direct Lending market conditions

As public high yield credit markets have become more dislocated, with key funding mechanisms such as collateralized loan obligation (CLOs) breaking down, traditional direct lending middle market investors have sought to opportunistically provide capital to borrowers by buying "hung" broadly syndicated loans that were unable to find traditional buyers as market volatility increased in 2022. The spread widening in the syndicated market filtered into the direct lending market, as this dynamic played out over the second half of 2022. Spread widening resulted in anemic prepayments – a key driver of direct lending capital in ordinary times, as one-quarter to one-third of loans typically prepay each year. Add to the lack of prepayments, General Partner (GP) expectations for a more challenging 2023 fund raising environment and increased direct lending capital flowing into companies typically served by the broadly syndicated market, and the result was a significant tightening of credit conditions in the fourth quarter of 2022.

Though recessionary fears, persistently high inflation, rising interest rates and public market volatility may cause investors to pause when considering a new or incremental allocation to middle market direct lending, we believe the loans originated during the current and upcoming period will potentially prove to deliver attractive value. The direct lending market's (i) continued focus on less cyclically vulnerable borrowers, (ii) increasing focus on funding add-on acquisitions over new platform activity, and (iii) further discipline around pricing, covenants, restricted payments, and other key credit agreement terms should all result in favorable 2023 vintage performance.

Less cyclically vulnerable borrowers

Borrowers accessing the private middle market continue to be heavily focused in resilient, generally non-cyclical industries. With the current economic and market outlook, lenders continue to be very selective, while private equity (PE) sponsors are also focused on pursuing financing for companies they expect to realize strong financial performance through more challenging economic conditions. In addition, discerning middle market lenders have not and will likely not be lending to industries and borrowers that seek excess leverage or are likely to face significant negative financial consequences if the economy does move into a recession.

	Last twelve months mergers and acquisitions volume	High yield index weights
Top 3 M&A		
Healthcare	14.4%	7.1%
Business service	14.3%	5.7%
Technology	11.0%	6.6%
Top 3 high yield		
Consumer	10.5%	32.2%
Energy	3.3%	7.5%
Technology	11.0%	6.6%

Increasingly add-on driven market

We expect deal flow to moderate in the coming quarters, with a decline in new leveraged buyout (LBOs), and a shift to a greater proportion of add-on acquisitions for existing business platforms. Access to capital and the cost of debt capital will be a driver of some of this moderation, along with sellers and buyers resetting clearing valuation multiples for new transactions. Add-on acquisitions for existing platforms can be very attractive during more challenging economic conditions, as enterprise valuations of the add-on acquisition typically decline more relative to the acquiring platform. Additionally, add-on acquisitions typical deliver additional business diversification. Prudently growing inorganically during an economic downturn can be attractive for both the PE sponsor/owner and lenders. Add-on acquisitions can be especially attractive for new lenders coming into a deal, because often terms are restruck to current market conditions (increase pricing, decreased leverage, etc.), but the borrower is achieving larger scale and diversifying. Further, many of these companies have been PE owned for several years and made it through some of the riskier earlier periods of PE ownership where validation of the private equity investment thesis is ongoing and infrastructure/management teams are being built-out.

Increased discipline

Additionally, increased discipline by lenders in the direct lending middle market has resulted in generally more favorable credit structure and deal terms for loans originated in the second half of 2022. Covenants are standard in core and lower middle market transactions and the cushion for covenant levels has tightened over the past two quarters. Since mid-year 2022, market spreads have widened 50 to 100 basis points. In addition to the spread widening, the original issue discount (OID) on new deals has improved over the past quarter, with the standard OID increasing from around two points ($98 original issue price) to now closer to three points on many deals. The increased spread premium along with further increases in SOFR have shifted all-in yields higher by over 5% since the beginning of 2022. Average yields are now over 10% for direct lending middle market loans, and yields being realized in the less competitive lower middle market are over 11%.

	2021 typical terms	Current market conditions
Market tone	Credit bull-market; increased capital raising; healthy levels of prepayments	Concerns over economic cycle and capital raising; low prepayment activity given increase in spreads
Expected yield	7.0%–9.0%	11.0%–14.0%
SOFR spread*	500 to 750 bps	600 to 850 bps
SOFR floor	1.0%	1.0%+
OID	Up to 2.0%	2.5% - 3.0%
Debt multiple	2.5x – 6.0x	2.0x – 5.0x
Loan-to-value	Less than 50%	30 - 45%
Covenants	Trending towards looser covenants; Upper Middle Market Deals cov-lite	Tighter covenants; renewed focused on FCCRs
Unfunded commitments	Unfunded commitments could be a significant portion of overall transaction size	Delayed draw term loans (DDTLs) rare; Ability to provide is highly valued in the market
Competitive changes	Larger players shifting significantly up-market	Trend continues with focus on taking share from shuttered syndicated market, but with decreased hold sizes
Borrower profile	Typical direct lending borrower profile	Highly selective

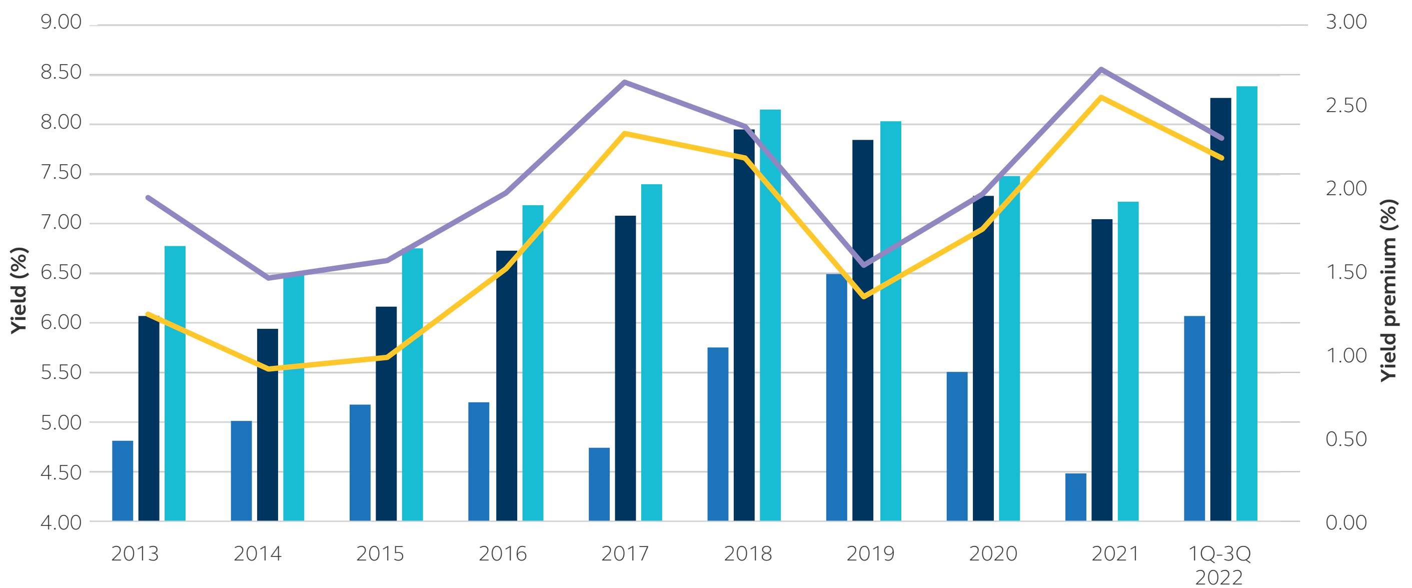
*Estimated range based on 1st lien position. Sources: Principal Global Investors as of 31 December 2022. The information shown above is for illustrative purposes only and are based on current market conditions and observations, which will fluctuate and may change over time and are not guaranteed. This material is not intended to forecast or predict future events, but rather to indicate the characteristics that Principal Alternative Credit has observed on the market generally. References to yields other characteristics are not promising or even estimates of actual returns a client portfolio may achieve.

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.

Attractive prospective returns

We expect loan yields to remain at very attractive levels in the coming year, with risk premium spreads remaining elevated along with a high base rate (SOFR). This higher income, along with improved call protection and greater OID, is expected to drive greater returns and more quickly lowers the basis in direct lending assets, thereby reducing risk of loss.

1st lien term loan (TL) yield and middle market (MM) yield premium, annual



As of September 30, 2022. Source: Refinitiv. The above are the current views and opinions of Principal Global Investors and are not intended to be, nor should they be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general. Left hand side (LHS). Right hand side (RHS).

However, with higher rates and associated cost of debt capital for borrowers, debt service should be a key focus. In addition to the quality of a borrower's business, leverage levels and credit structure will be very important. The lower leverage and better credit structure (with meaningful financial covenants) associated with lower and core middle market companies should provide investors with meaningful benefit compared to upper middle market deals that are often much more levered and thus have higher interest burdens to meet in a rising rate environment. Further, lower middle market transactions typically have a Fixed Charge Coverage Ratio (FCCR) covenant, which is increasingly becoming the operative covenant on deals rather than leverage covenants.

	Lower middle market	Core middle market	Upper middle market
EBITDA	$7.5 million	$25.0 million	$50.0 million
Leverage	4.0x	5.0x	6.0x
Spread	675	625	575
Interest coverage	2.3x	1.9x	1.7x
FCCR – Today	1.3x	1.2x	1.1x
FCCR – SOFR @ 5%	1.2x	1.1x	1.0x

Notes:

(i) Assumes 1% amortization and SOFR floor, CapEx and D&A equal to 20% of EBITDA, and an LLC tax rate of 40%

(ii) FCCR defined as (EBITDA – CapEx) / (Interest + Schedule Amortization + Taxes)

The combination of higher rates and slowing economic conditions have many investors considering an opportunistic allocation to distressed debt and special situation lending. While there will most likely be some opportunities to provide capital and liquidity for distressed companies, we believe these investments will be sporadic. In this somewhat unique cycle, financial challenges for certain companies will be a direct result of interest rates remaining high even as economic conditions become more challenging. Oftentimes, interest rates decline considerably when the economy slows providing some natural relief for borrowers, and these more accommodative conditions can provide a positive return tailwind for investors providing capital to distressed companies as compared to performing loans. Some key considerations of investing in distressed/special situations compared to performing loans during this cycle compared to a more standard credit cycle include:

1. Situations in which the company is facing liquidity challenges due to higher rates will most likely be handled by the borrower's existing lending group, rather than introducing new capital. The PE sponsor and lender group will work to support the borrower's focus on operational issues and won't likely grant an outside distressed lender a priority position to solve rate induced liquidity pressure.

2. There were very few distressed or special situation lending opportunities at the onset of COVID as the existing lender group provided sufficient accommodation. This accommodation comes at a price to the borrower and many lenders realize a step-up in coupon to waive covenant defaults and also realize structural enhancements, such as an increase of call protection, improved original-issue discount (OID) for incremental capital and in select opportunities may be granted some equity interest, such as penny warrants.

3. Even in deeper credit cycles, such as the Great Recession, the existing lender group typically has maintained full control of the entire debt facility when borrowers face financial challenges, but continue to have a strong business thesis. Distressed and special situation lenders have access to deals when the existing lender group determines the business risk is too great and the risk/reward less compelling. These deals may have a negative selection bias.

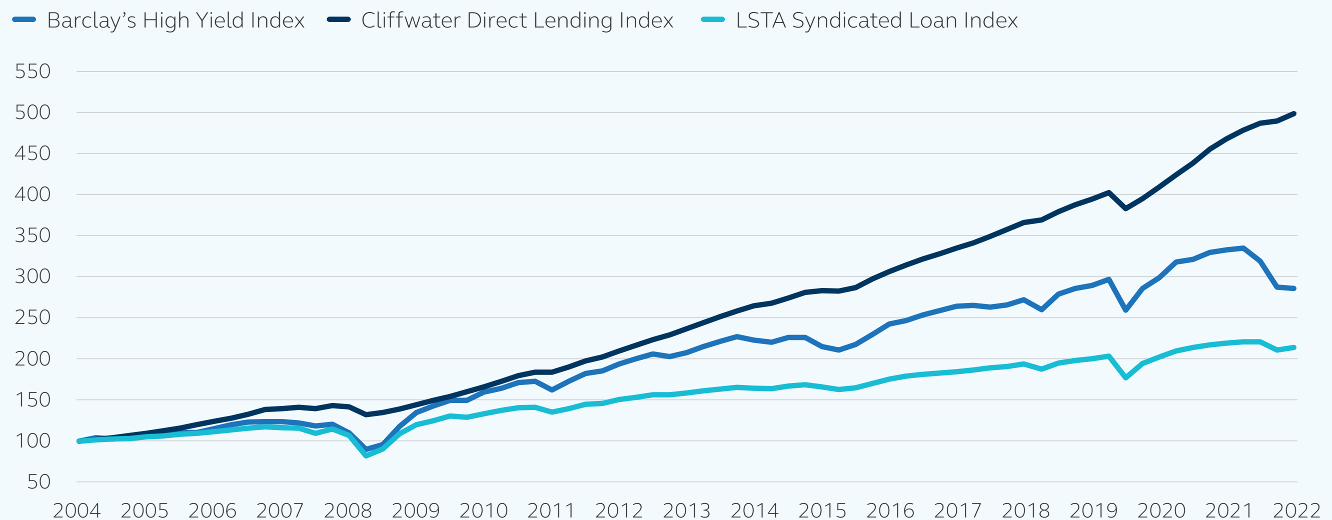
4. Capital deployment is much less certain for distressed and special situation lenders in a normal cycle and this cycle seems far from normal. As the cycle is extended and capital continues to be made available to borrowers affected by higher rates, it seems unlikely there will be any predictable cadence to capital deployment for distressed investors.

5. Return differences may not be compelling for distressed and special situation investing. When considering the double-digit return expectation for performing senior secured loans in the lower and core middle market, it's questionable whether the incremental pick-up to step into distressed companies will provide an improved risk-adjusted return, let alone an improved nominal return when considering potential losses. As discussed, lenders will often realize incremental returns through stepped-up coupons, improved call protection and enhanced OID if there are covenant breaches or need for borrowers to access incremental capital.

Conclusion

Whether through the rising rate environment prior to the Global Financial Crisis (GFC), the GFC, or COVID, direct lending has proven resilient. The direct lending market experienced drawdowns of 5% and 8% during COVID and the GFC, respectively relative to 13% and 27% drawdowns for high yield during those same time periods.

Direct lending relative to leveraged finance benchmarks



	Drawdowns		
	Direct lending	High yield	Syndicated loans
Great recession (2Q 2008–4Q 2008)	-8%	-27%	-30%
COVID-19 (4Q 2019–1Q 2020)	-5%	-13%	-13%
Sharpe ratio (3Q 2004–3Q 2022)	2.90	0.35	0.04

As of September 30, 2022. Source:Bloomberg U.S. Corporate High Yield Bond Index, Cliffwater Direct Lending Index, and S&P/LSTA Leverage Loan Index.

Further, good loans are made in challenging times. We believe combining the disciplined lending essential during uncertain economic conditions with senior debt yields north of 11% due to higher risk premiums and floating rates, should provide the environment for current and full year 2023 direct lending loan vintages to be among the best in terms of historical performance. We believe this performance will benchmark well to special situation and distressed strategies, as the high realized cash coupons not only provide for higher returns, but also provide a steady stream of cash flow to reduce an investor's cost basis relatively quickly. And if investors desire a higher return profile, while still focusing on performing loans and capital preservation, an investor can choose to apply some leverage to achieve mid-teens returns without having to stretch into distressed or special situation investing.

It's key in today's market environment to have a strong origination pipeline with a diverse set of opportunities reviewed (sponsored and non-sponsored; lead agent and non-agented; new platform and add-on) to capture the highest alpha opportunities. Further, by focusing on the lower middle market, managers can help ensure clients will receive the full benefits of the increase in rates, as loans in that market typically have lower levered, more serviceable debt burdens. That said, with economic uncertainty, strong underwriting and portfolio management is key. A focus on companies with strong secular tailwinds and strong competitive positions that are financed with serviceable debt capital structures, should result in attractive risk adjusted returns from the 2023 direct lending vintage.

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.

Risk Considerations

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.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

Proprietary model output is based upon certain assumptions that may change, are not guaranteed and should not be relied upon as a significant basis for an investment decision. Investment guidelines are subject to change.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is intent for use in:

The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.

Europe by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.

United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority ("FCA").

This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.

Hong Kong SAR (China) by Principal Asset Management Company (Asia) Limited which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.

Singapore by Principal Global Investors (Singapore)Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.

Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.

United Arab Emirates by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation.

Other APAC Countries, this material is issued for Institutional Investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

© 2023 Principal Financial Services, Inc. Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc. Principal Alternative Credit is an investment team within Principal Asset Mangement. Principal Asset Management℠ is a trade name of Principal Global Investors, LLC.

012023 | 2670216-012024