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PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

Direct lending in a higher rate environment

FEBUARY 2024

Executive summary

Many investors have been asking us about how higher rates have impacted our portfolio and the middle market direct lending investment climate going forward. Our continued emphasis on investing in the lower middle market, particularly in higher margin and less capital-intensive businesses, while often favoring less global and more local, service-oriented businesses will continue to be a compelling strategy in a higher rate / inflationary environment.

Principal Alternative Credit loan portfolio profile

- **18.6% - Health Care Equipment & Services**
- **14.4% - Commercial & Professional Services**
- **9.8% - Software & Services**
- **7.8% - Consumer Services**
- 7.6% - Technology Hardware & Equipment
- **7.3% - Food & Beverage**
- 5.8% - Other
- 5.0% - Materials
- **4.1% - Packaging**
- 3.3% - Household & Personal Products
- 3.2% - Pharmaceuticals, Biotechnology & Life Sciences
- 3.0% - Media & Entertainment
- 2.8% - Retailing
- **2.7% - Utilities**
- 2.4% - Diversified Financials
- 2.3% - Transportation

As of December 31, 2023. Source: Principal Asset Management. Principal Alternative Credit believes that the sectors in bold are the more resilient / most recession resistant industries. The Principal Alternative Credit loan portfolio refers to middle market private loans originated by the Principal Asset Management's direct lending area for Principal Life Insurance Company's General Account. The loans originated are all discretionary loans.

Higher rates benefit our investments as 98%+ of our portfolio is floating rate with yields now reaching 13% for our investors. That said, higher rates also reduce borrower cash flows given the additional debt service cost. From our perspective, in a higher rate environment it's important to finance high free cash flow-oriented businesses with capital structures that can absorb the higher rate impact, such that borrowers remain liquid and solvent despite the higher interest burden. A stated coupon increase doesn't do an investor any good if the borrower can't pay it.

The level of debt across companies varies considerably and thus results in very different borrower debt burden as interest rates have risen. The leverage level of core and lower middle market companies tends to be less than that of upper middle market and high yield public company counterparts. Thus, focusing investing in the core and lower-middle market where capital structures are generally more lightly levered compared to larger companies can result in very different borrower debt burdens as interest rates have risen. Using the illustrative structures below, it becomes clear how the increased leverage of the upper middle market shifts the fixed charge coverage ratio (FCCR) to perilous levels when secured overnight financing rate (SOFR) equals 5.3% on some of the higher levered unitranche deals in that market segment.

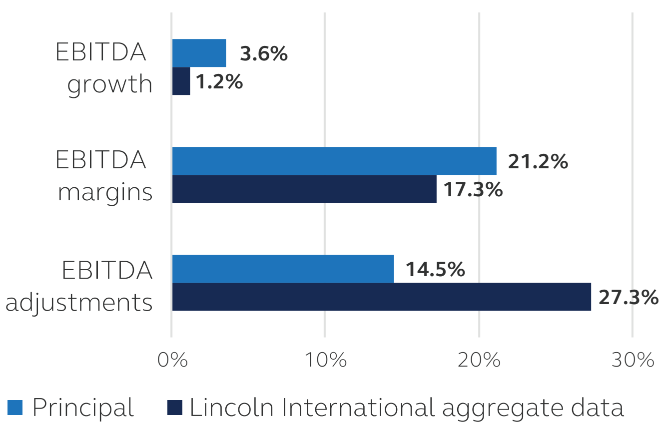
	Lower middle market	Core middle market	Upper middle market
EBITDA ($ in millions)	$7.5	$25.0	$50.0
Leverage	4.0x	5.0x	6.0x
Spread (basis points)	600	550	500
Interest coverage	2.2x	1.9x	1.6x
FCCR	1.3x	1.2x	1.1x

Notes:

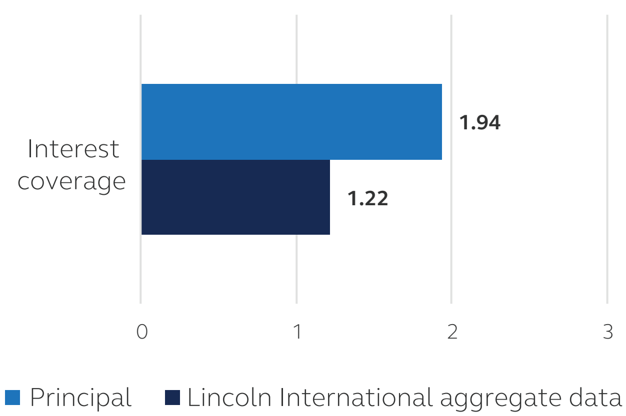
(i) Assumes 1% amortization and SOFR floor, CapEx and D&A equal to 20% of EBITDA, and an LLC tax rate of 40%
(ii) Interest coverage defined as EBITDA/Interest
(iv) FCCR defined as (EBITDA- CapEx) / (Interest + Scheduled Amort. + Taxes)

Of course, credit selection within each of these markets also becomes extremely important. Favoring higher margin and less capital-intensive businesses can greatly improve a lender's ability to realize higher coupons, as companies with that business profile can generally better withstand cost pressures and higher rates, compared to lower margin, more capital-intensive businesses. Principal Alternative Credit's portfolio is growing faster than the market and has higher EBITDA margins than peer portfolios due to its intentional focus on more recurring, recession resilient services businesses. As shown below, that focus combined with its focus on the lower middle market has resulted in much higher interest coverage ratios than peers.

High free cash flow borrowers



Interest coverage at higher rates



As of December 31, 2023. Source: Lincoln International 2023 year over year growth rate. Lincoln International aggregate data is provided by Lincoln International which provides a valuation of the direct lending market and collects information directly from investment management firms and other sources. The Principal Alternative Credit loan portfolio refers to middle market private loans originated by the Principal Asset Management's direct lending area for Principal Life Insurance Company's General Account. The loans originated are all discretionary loans. Peer group comparisons based on the available information, are for information purposes only and should not be relied upon as a significant basis for an investment decision. The comparisons provided above have been prepared as a guide and they are not intended to be exhaustive.

Many borrowers are facing some degree of headwinds resulting from inflationary pressures. Those with pricing power have passed along necessary price increases (albeit sometimes on a lagged basis), while others are forced to endure margin compression. The inflationary environment favors many of the same types of borrowers that will be able to withstand higher rates—less capital-intensive, higher margin businesses. More capital-intensive businesses have had to spend additional cash on capital expenditures and working capital needs to support revenue growth, as they attempt to keep up with inflation. The Principal Alternative Credit portfolio averages capital expenditures to equal to 12% of EBITDA. In addition, many of our most capital-intensive borrowers are spending on deferrable, growth-oriented capital expenditures rather than necessary maintenance capital expenditures. Beyond the capital-intensive nature of a borrower, the inflationary environment also highlights the need for careful competitive analysis, with an objective to select borrowers that have pricing power and benefit from barriers to entry.

It is also worth noting that many of the largest direct lending transactions in recent years have been annual recurring revenue loans (ARR) where the borrowers are cash flow breakeven or negative, resulting in very low interest coverage ratios. Further, those companies are inherently dependent upon additional debt or equity capital or exits to operate, making them more subject to the whims of future venture capital (VC) and private equity (PE) fundraising and capital market conditions.

Another benefit of the lower middle-market in a higher rate environment is the presence of fixed charge coverage covenants in almost all deals. These covenants have increasingly become the operative (tightest) covenant in the credit agreement, as rates have risen. Even for performing businesses these covenants can help bring sponsors to the table to help finance growth with equity injections. The result of the equity infusion is often a more committed sponsor and typically a more diversified and larger business, enhancing the credit profile of the borrower.

Conclusion

Navigating the higher rate environment offers opportunities and challenges. A successful path will require an intentional and nimble approach to portfolio construction, combined with thoughtful origination and proper underwriting. Firms that can benefit from a wide range of experiences through market cycles most likely have the process and approach that can benefit investors. At Principal Alterative Credit, our team combines the credit heritage of Principal with professionals that also provide experience from 15 different direct lending firms, and our senior investment professionals average 20 years of experience across multiple credit cycles. We are investing balance sheet capital alongside our clients in the lower and core middle market in businesses with strong margin profiles, relatively low capital-intensity and strong competitive positions.

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.

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