

# Benefits of robust non-sponsored deal sourcing in middle market direct lending

## Introduction

The benefits of targeting sponsor-backed opportunities in direct lending are well known to investors focused on this strategy. They include additional capital support from sponsors, ability for the investing team to leverage the sponsors' sophisticated diligence, as well as the benefits of ample deal flow and efficient processes. However, many investors in direct lending funds and strategies may be unaware of the benefits of also including non-sponsored opportunities in a direct lending portfolio.

### Potential benefits of non-sponsored opportunities for fund investors

- **Less competitive market:** Fewer direct lending firms are focused on the non-sponsored market. This market requires considerable resources and specific capabilities compared to the sponsored market. Further, owner-operators are typically less current on market conditions and the latest credit agreement terms. This results in a potentially significantly higher loan interest rate per unit of leverage than would be expected in a sponsor-backed transaction. In addition, the non-sponsored market is often dominated by banks who have steadily been retreating from lending and typically are unwilling to provide enough flexibility to entrepreneurs to pursue their growth strategies. That trend increased in 2023 with various bank failures, and 2024 has continued the trend of bank tightening. For those direct lending firms who do cover the non-sponsored market, many are only interested in the highest yield investment profiles and ignore lower levered, safer opportunities where banks are their primary competitors, but have the potential to generate significant alpha.
- **Better alignment:** While sponsors often have more financial resources to provide support in a downside scenario, owner-operators typically have almost all their net worth in the equity of their businesses. While a private equity fund may still achieve attractive fund returns if one of their portfolio companies fail, owner-operators generally do not share that luxury. This tends to result in owner-operators taking on less leverage and being eager to provide whatever capital support and sweat equity they can during downside scenarios to help protect their key asset.
- **Stickier assets:** Given the frictional costs (call protection, legal fees, management time, etc.), owner-operators are slower to refinance, and thus non-sponsored deals have the potential for a higher multiple of invested capital (MOIC). In part, this stickier asset base compensates for the additional and harder work to execute and fund non-sponsored transactions as compared to sponsored transactions.

## How is it done?

- Principal Alternative Credit Direct Lending’s dedicated non-sponsored origination professionals have longstanding relationships developed through deep histories in private capital and investment banking. Thoughtful feedback, credible execution, and an understanding of motivations are all essential for success in developing a consistent flow of the most desirable, actionable, and attractive opportunities.
- Our dedicated non-sponsored origination team diligently maintains a presence in the transaction marketplace through speaking opportunities and attendance at over 25 conferences each year. These activities allow us to maintain consistent touchpoints with our numerous referral channels and to generate proprietary investment opportunities directly with borrowers.
- In the last twelve months, the non-sponsored origination team has evaluated over 200 opportunities from a wide variety of sources.

Below we briefly touch upon how non-sponsored transactions are sourced through various channels, each with different characteristics and motivations.

## Select referral channels

☑ Scale of 1-3 checkmarks, with three checkmarks indicating most favorable quality to the lender

### Investment banks

- Typically, the most developed channel with well-diligenced opportunities, including bulge bracket, regional, boutique and niche/industry, and product-focused advisors
- Principal Alternative Credit Direct Lending’s dedicated non-sponsored investment professionals have developed relationships with over 600 investment banks, helping to provide consistent access to relevant deal flow

Deal flow quality: ☑☑☑  
Actionability of ideas: ☑☑☑  
Quality of opportunity: ☑☑  
Competitive process: ☑

### Other capital providers

**Commercial banks, asset backed lending (ABL) providers, alternative lenders, mezzanine providers, equity providers, etc.**

- Referrals for opportunities that do not fit the respective mandates (another lender’s exclusive focus on sponsored deals as an example) and opportunities to collaborate with other direct lenders in club investments
- Principal Alternative Credit Direct Lending team reciprocates by providing opportunities to such capital providers
- Maintaining relationships with other direct lenders that share our philosophy and investment thesis builds continuity and a “friendly competitor” environment

Deal flow quality: ☑☑  
Actionability of ideas: ☑☑☑  
Quality of opportunity: ☑☑  
Competitive process: ☑

## Service providers

### Law firms, accounting firms, consulting firms, out-sourced CFOs, etc.

- Typically, a longer conversion cycle for opportunity creation, but possibility of proprietary introductions to clients and attractive terms given lack of competition
- Originators must focus on continually educating counterparties on capital characteristics and benefits; relationship building is key and supported by our team's long history in the private capital marketplace
- Understanding the various service providers' motivations and objectives allows us to be thoughtful and creative in rewarding referrals and building long-term relationships

Deal flow quality: ☑☑

Actionability of ideas: ☑

Quality of opportunity: ☑☑

Competitive process: ☑☑☑

## Principal Financial Group clients and relationships

- The breadth of Principal Financial Group's service offerings to small and medium sized businesses provides proprietary access for direct lending investment opportunities
- Overlap with various internal groups such as our Retirement Services Group, Advanced Solutions group, and ESOP services group
- Principal's business owner ecosystem group, Elevate by Principal, provides opportunities for Principal Alternative Credit Direct Lending to access potential borrowers directly and offer solutions to support their growth, ownership changes, etc.

Deal flow quality: ☑☑

Actionability of ideas: ☑☑☑

Quality of opportunity: ☑☑

Competitive process: ☑☑☑

## Business brokers

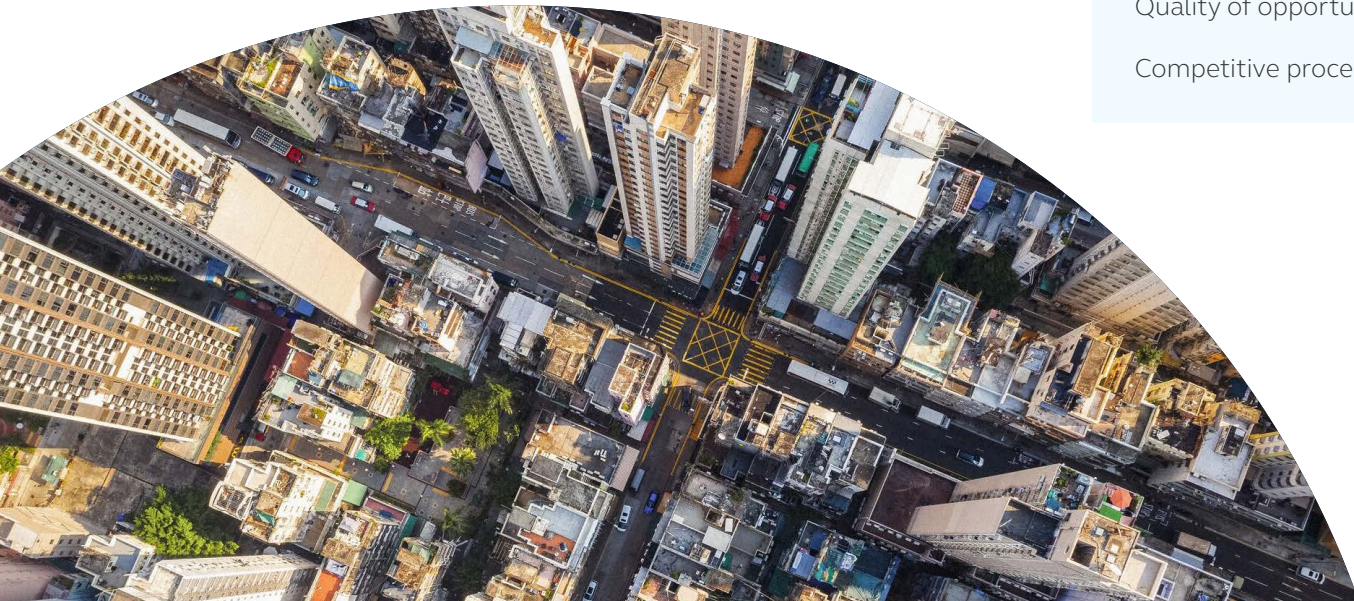
- Typically, a sale or exit process versus capital markets transaction; may need to educate the broker on other non-full sale liquidity alternatives

Deal flow quality: ☑

Actionability of ideas: ☑☑☑




Quality of opportunity: ☑

Competitive process: ☑☑☑






### Family offices (FO) and RIAs

- Many FO and RIA clients have successfully sold businesses or generated returns from investments; many still own companies or have relationships with or investments in entities that benefit from direct lending

Deal flow quality:   


Actionability of ideas: 

Quality of opportunity:  

Competitive process:   




### Networking groups and industry associations































































- Blanket approach to efficiently making introductions to members of each of the mentioned categories

Deal flow quality: 

Actionability of ideas:   

Quality of opportunity:  

Competitive process:   

Referral channel	Deal flow quality	Actionability of ideas	Quality of opportunity	Competitive process
Investment banks	  	  	  	
Other capital providers	 	  	 	
Service providers	 		 	  
Principal Financial Group clients and relationships	 	  	 	  
Business brokers		  		  
Family offices (FO) and RIAs	  		 	  
Networking groups and industry associations		  	 	  

### Conclusion

Maintaining a robust and diverse set of deal sourcing relationships targeting non-sponsored borrowers allows us to further widen our deal flow funnel beyond sponsored opportunities. This broadened and comprehensive deal flow supports our intentional portfolio construction and selection of what we believe to be the most appropriate investments for our clients.

### **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. Private credit involves an investment in non-publicly traded securities which are subject to illiquidity risk. Portfolios that invest in private credit may be leveraged and may engage in speculative investment practices that increase the risk of investment loss.

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MM13571-02 | 06/2025 | 4576591-122026