For Financial Professional/Institutional Use Only in the United States. May not be used with the public. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

Principal Asset Management[SM]

PRINCIPAL ALTERNATIVE CREDIT DIRECT LENDING

Finding value in the middle market: smaller size = greater potential

FEBRUARY 2024

Middle market direct lending can mean different things to different lenders and investors. Many, if not most, would agree that companies with over $500 million in revenue or a debt facility over $500 million in size, pushes a company outside of the middle market parameters (in fact, that's a specific definition provided by Refinitiv in its data). However, direct lending continues to expand beyond the middle market and is now taking market share from the more traditional broadly syndicated public market. In fact, transactions well over $1 billion debt facility size are regularly being funded by large direct lending firms. With evolution of the market and segmentation within the middle market, a question that may come to mind is, "How is the value proposition different across the various segments of direct lending?" There are significant differences in terms and pricing based on the size of a borrower or transaction and the associated competition to provide a lending solution. At Principal Alternative Credit we focus on the lower middle market, which we define as companies with EBITDA of $5 million to $15 million, and opportunistically pursue lending solutions with companies generating from $15 million to $50 million EBITDA, which we consider core middle market.

	Lower middle market	Core middle market	Upper middle market	Broadly syndicated
Company size (EBITDA)	$5–$15 million	$15–$50 million	$50–$75 million	Above $75 million
Facility size	Below $100 million	Below $200 million	Above $200 million	Above $300 million
Market participants	Small group of direct lending firms and BDCs, especially in the $5–$10 million EBITDA range	Direct Lending firms, BDCs, Funds	Regional & commercial banks, Direct Lending firms, BDCs, Funds	Commercial banks, Broker dealers, CLOs, Mutual Funds, Other HY market participants
Lender group	1–3 lender club	3–7 members	7+ members	Many
Borrowers' orientation to positive secular trends	High proportion	Moderate to high proportion	Broader mix	Lower proportion with more mature/declining
SOFR spread*	575 to 750 bps	500 to 650 bps	450 to 575 bps	300 to 400 bps
Debt multiple	2.0x-4.5x	2.5x-6.0x	4.0x-6.5x	Up to 7.0x
Loan-to-value	Typically 35-45%	Less than 50%	Less than 60%	Less than 65%
Expected yield (gross)	11.50-13.25%	10.75-12.75%	10.0-11.25%	8.5-10.5%
Expected return (gross)	11.50-14.0%	10.75-12.75%	10.0-11.5%	8.5-10.0%
Expected recovery rate	70%+	70%+	60%+	50%+
Financial covenants	2+	Often 2	1 or less	None

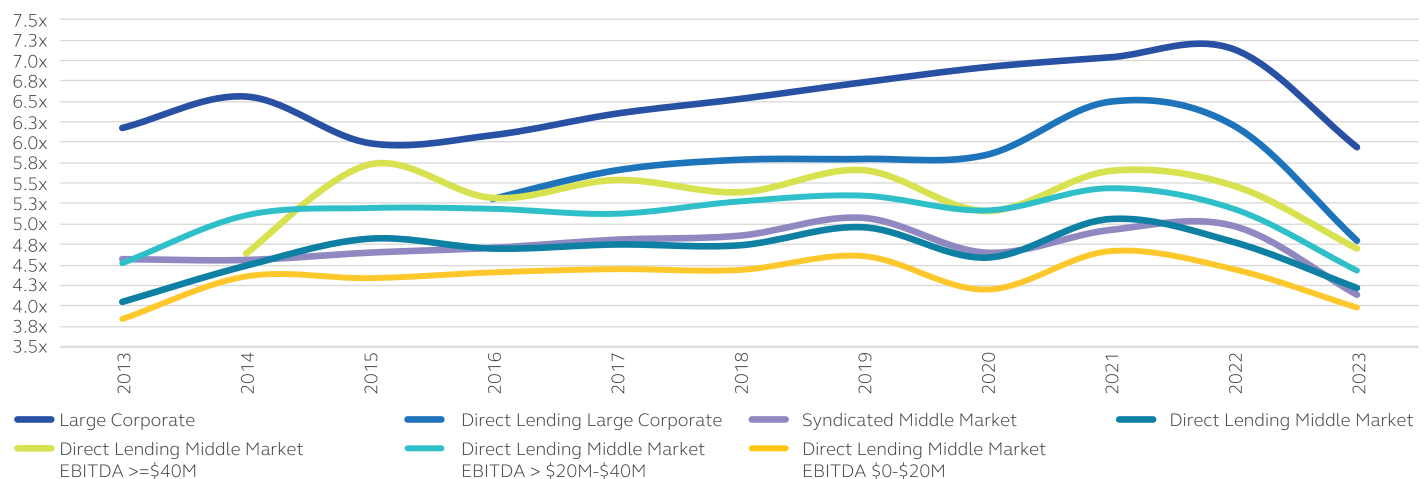
As of December 31, 2023. Source: Principal Asset Management. Expected gross yield and Expected gross return are before management fees, loan costs and other expenses. These estimates are based on business plans, expectations and market conditions that Principal Alternative Credit has observed on the US direct lending market generally. There is no guarantee that an investor will achieve these yields or returns on any similar investments in the future. The ranges shown are for investments of institutional investment quality that Principal Alternative Credit would consider for client portfolios and are not inclusive of all loan origination opportunities from PE sponsors, other lenders, banks, advisors and Principal's proprietary network. Projected performance is not a reliable indicator of future performance and should not be relied upon as a significant basis for an investment decision. *Estimated range based on 1st lien position.

Wholistically, the direct lending middle market continues to represent value compared to other alternatives, such as the broadly syndicated loan market and public high yield market, where in our view, yields and risk premiums continue to remain compressed in comparison with the private middle market (Exhibit 1). However, the competitive dynamics within different segments varies considerably and clearly affect the value proposition to investors. Generally, the upper middle market continues to be very competitive as managers seek to deploy ever growing capital bases. Many of the larger deals are effectively in competition with the broadly syndicated loan and high yield bond market. Thus, terms must be competitive with the public market, which tends to be covenant lite and priced aggressively compared to the traditional middle market. In addition, though only lenders with large amounts of capital may lead the upper middle market deals, there are typically many participants competing and ultimately lending on each deal. This competitive dynamic affects pricing and terms, but also brings into question the direct involvement of many lenders in the underwriting, documentation and on-going monitoring process. In this upper middle market segment, we very selectively find value, but it is not a focus of Principal Alternative Credit. As larger managers raise more capital, the desire to deploy capital continues to increase and the natural focus is on larger private credit transactions. These larger deals may generate significant transaction and asset- based fee income for managers, but the return for investors is likely being negatively impacted by the increased competition. In addition, these larger deals tend to have greater leverage (Exhibit 2) and looser terms with weak or no financial covenants when compared to lower and core middle market transactions.

Exhibit 1: 1st Lien term loan yields & MM yield premium (annual)

As of December 31, 2023. Sources: LSEG LPC, Pitchbook. Past performance is not a guarantee of future results.

Exhibit 2: LBO total leverage across markets (annual)



As of December 31, 2023. Sources: LSEG LPC. Institutional Middle Market are large term loans that are mostly rated and syndicated to a wide investor base. Periods not shown due to not enough deals. Past performance is not a guarantee of future results.

In addition to realized yield and internal rate of return (IRR), achieving a positive multiple on invested capital (MOIC) is oftentimes a primary goal for investors and may be adversely affected by several factors. As investors move up-market those factors are oftentimes quite impactful.

- **Pace of capital deployment:** As competition has increased, particularly in the upper-middle market, we have observed some managers do not have sufficient or diverse and unique channels for origination to match their capital raising success, resulting in large quantities of uncommitted capital that provide a drag on their clients' realized MOIC.
- **Lower yields and IRRs associated with competitive upper middle market:** Many managers and especially managers that have realized significant growth are targeting larger deals, which creates greater economics for their business model, but doesn't necessarily create desired value for their investors. As mentioned, these larger deals tend to have lower yields and expected returns, along with weaker terms and covenants. Given the lower return profile, MOIC will naturally be lower than the experience expected in the core and lower middle market space.
- **Refinancing risk:** Larger transactions tend to be more regularly refinanced given the lack of call protection for lenders, compared to core and lower middle market deals, which often have call protection features. In addition, private equity (PE) sponsors and borrowers are generally more likely to refinance given the lower frictional costs compared to smaller deals (upfront transaction fees and expenses are spread over larger loan balance). Also, the larger deals are often owned by PE sponsors with dedicated capital markets teams that will more regularly seek financing efficiency, as compared to smaller sponsors that may not dedicate the same resources to lowering borrowing costs and seeking more borrower friendly terms over the life of an investment.

Middle market direct lending has historically delivered positive returns relative to risk and accumulated value for investors through time. The increased competition and factors that drag on MOIC for upper middle market investors seem to call into question whether all of the middle market segments may deliver risk-adjusted returns that investors have come to expect. We believe the historic performance Exhibit 3 of middle market direct lending is more representative of what may be expected from core and lower middle market, where there is generally less competition, greater risk premiums and potential for better risk-adjusted returns.

Exhibit 3: The direct lending market has historically delivered risk-adjusted returns with lower volatility Historical index risk/return since 2004*

Correlation Direct lending vs	
Corp. IG	0.22
Muni	0.12
U.S. Agg	-0.18
10-year Treasury	-0.52

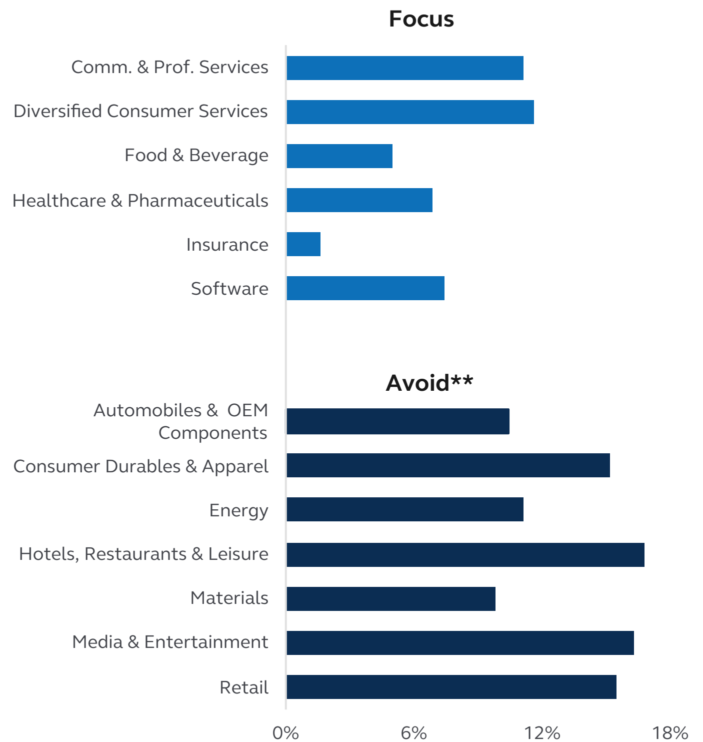
As of September 30, 2023. *Since inception of Cliffwater Direct Lending index on September 30, 2004. Sources: Bloomberg, Cliffwater Direct Lending Index, S&P 500 S&P/LSTA Leverage Loan Index, Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Municipal Index, Bloomberg U.S. Corporate Bond Index, Bloomberg 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. Past performance is not a guarantee of future results.

For Financial Professional/Institutional Use Only in the United States. May not be used with the public. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

As investors consider the potential for enhanced risk-adjusted returns and diversification benefits of lower middle market opportunities, a natural question is: Are lower middle market companies more susceptible to a cyclical downturn, and if there is a default should an investor expect lower recovery for this segment of the middle market?

The lower middle market companies being pursued by PE sponsors and financed by direct lenders tend to be concentrated in industries that are benefitting from secular trends in the economy and market. In particular, Principal Alternative Credit focuses its intentional portfolio construction on stable, recession resilient businesses in the staple food items business & consumer services, technology & software, healthcare, and financial services industries (Exhibit 4). PE sponsors are generally drawn to these companies given the expected organic growth and/or ability to consolidate like-kind companies. These growth and consolidation trends are evaluated while also considering potential cyclical downturns or systemic market events. Targeted industries tend to be less cyclical than companies and industries that are more prevalent in the upper middle market and broadly syndicated public market, such as commodities, manufacturing and industrial applications. In addition, PE sponsors and direct lenders to lower middle market companies also generally expect these companies to have significant total addressable markets and higher expected growth, positioning them to be more resilient when facing a cyclical downturn or exogenous shock.

Exhibit 4: Historic market 5-year cumulative default rate*



*As of December 31, 2022. For illustrative/example purposes only. Target industry portfolio shows the 5-year cumulative default rate of industry as defined by Moody's. Target portfolio represents an estimate given our current business plans, expectations, and market conditions. Portfolio ratings based on Principal Asset Management's proprietary credit rating system. The rating designations BB through B are not those of any independent rating service but are meant to describe Principal Asset Management's assessment of the portfolio. The proprietary ratings go from AAA-CCC. More detailed information about the rating methodology is available upon request. Expectations regarding the default level and potential return enhancements may not be achieved. **The charts for industries we focus on and industries we avoid represent the concentration in these sectors in the overall economy.

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. Further, many of these ARR financed software companies face headwinds of lower switching costs due to the increasing ease for customer switching through apps, etc. This results in many of these ARR financed companies being less stable than the slower growing, but more mission critical software businesses financed historically by direct lenders. While smaller businesses may be perceived as more vulnerable, we believe a $5mm - $10mm EBITDA business of cash flowing collision repair centers, or an outsourced tax services firm, or a bakery business are likely less risky business profiles than a large, software business operating with little to no cash flow.

Lower middle market companies also tend to have numerous exit opportunities for the PE sponsor/owner to realize a return on its investment. The companies tend to be in a life cycle stage that realizes growth and operating scale, which may be appealing to both strategic buyers and other investors such as family offices, as well as larger PE sponsors. As a lower middle market company grows and realizes more scale and business risk diversification, the list of potential suitors expands further, as does the expected acquisition multiple. Given these companies are of a size that many investors will consider as a platform or add-on acquisition opportunities, and oftentimes are less cyclical and specifically benefitting from secular trends, we believe the value of these firms will tend to hold up reasonably well even in a down cycle. In the event of a default and restructuring, the resiliency of enterprise value is the key determinant of recovery.

The lower middle market space is generally less competitive, as relatively few lenders dedicate the required origination, underwriting and total resources to be successful. In addition, many lenders have chosen to move up market to larger middle market transactions in order to deploy "chunkier" capital and seek a different risk-return profile. The lower leverage and higher equity in the lower middle market company's capital structure provides additional downside risk mitigation for idiosyncratic and cyclical events. In addition, the meaningful covenants and more lender friendly documents (i.e. less EBITDA add-backs, smaller baskets for restricted payments, etc.) are meant to limit downside as well.

A condition precedent for lending to any lower middle market company must be thorough due diligence. Stressing the business model and financial profile are key to considering if the proposed capital structure can withstand the borrower's potential cash flow volatility. As a lender, there is no reason to take concentrated or binary risks, thus evaluating any supplier or customer concentration, as well as competitor, regulatory and other key risks is a key determinant during the origination and initial underwriting process. Further, Principal Alternative Credit focuses on businesses with a clear path to $10mm of EBITDA when investing in companies with less than $10mm of EBITDA. The objective is to seek an attractive return for the initial deal risks, while remaining invested in a company and structure that will de-risk over a relatively short time, as the sponsor executes on its investment thesis (path to $10mm+ of EBITDA).

Key requirements to help ensure this de-risking are structure and covenants. Any lower middle market transaction should have true, meaningful financial covenants. Oftentimes, these covenants will be structured with a significant leverage step-down, which requires an improved financial profile for the company to remain in covenant compliance. These covenants also allow the lender to "get to the negotiating table" early if a company is experiencing underperformance. This early engagement with management and the PE sponsor will provide for many more constructive paths (often an equity injection) and an ability to reprice the loan when compared to a transaction with very loose covenants or essentially no financial covenants at all. Thus, through rigorous underwriting and proper structure, lower middle market transactions may provide better resiliency and potential recovery compared to larger transactions.

In addition to intentionally seeking appropriate industry allocation and well-positioned companies for lower middle market exposure, it is also essential to work with a PE sponsor or owner-operator. The path to growth we seek in our lower middle market deals requires a very capable PE sponsor or owner-operator to establish a clear strategy and execute on that strategy. Our seasoned team has the multidecade experience required to evaluate PE sponsors for their expertise in particular sectors, and their ability to execute around strategy, whether it be to realize organic growth with operational improvements, through an acquisition strategy, or both. In addition, we evaluate the likelihood a PE sponsor will support its deal during more challenging times. We favor sponsors our team has years of experience working with in good investments and challenged ones, so that we can truly evaluate their abilities and willingness to support troubled deals. This support is in part through managerial and operational resources, but also notably in the form of additional equity capital contribution. If a PE sponsor doesn't have an exceptional record of supporting its transactions, they aren't the partner for us in the lower middle market.

When working on non-sponsored transactions, we evaluate each owner-operator's wherewithal to support the business in downside scenarios as well. Typically, an owner-operator will have a high proportion of her/his net worth tied up in the company, making them very likely to support the company during any downturn.

There is value across all segments of the middle market with incremental yield and diversification benefits compared to public market alternatives. However, as investors consider their allocation to direct lending, whether it be incremental or an initial allocation, we believe there is clear rationale for exposure to the lower and core middle market segments. The historical performance realized by the asset class has been exceptional, but a lot has changed over the last decade that has most likely altered the expected return profile of larger, more competitive transactions.

For Financial Professional/Institutional Use Only in the United States. May not be used with the public. 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.

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 (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") 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 PGII, PGIE or PGII may delegate management authority to affiliates that are not authorised 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. 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).

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 Investment & Retirement Services Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission.

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 License No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001.

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/ Jurisdictions. 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.

© 2024 Principal Financial Services, Inc. Principal®, Principal Financial Group®, and Principal and the logomark design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and services marks of Principal Financial Services, Inc., in various countries around the world. Principal Alternative Credit is an investment team within Principal Global Investors. Principal Asset ManagementSM is a trade name of Principal Global Investors, LLC

MM12852-01 | 022024 | 3391849-022025