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Principal Alternative Credit

Principal Asset Management℠

MIDDLE MARKET DIRECT LENDING

Direct Lending: Prepared for a cycle

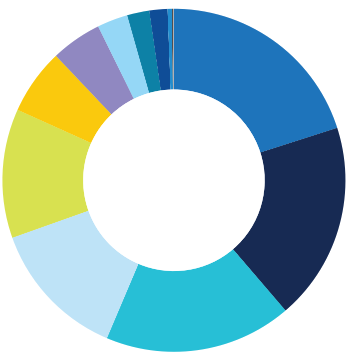
Many clients have asked us how we think direct lending portfolios are positioned relative to prior periods of stress like the Global Financial Crisis (GFC) or COVID-19. Although there are always some differences across economic cycles, we think it is informative to understand how the asset class is positioned from an industry, borrower cash flow, and leverage / loan-to-value (LTV) perspective relative to how the asset class was positioned going into prior periods of stress. Principal Alternative Credit believes managers are best positioned to weather an upcoming recession who have:

- keenly focused on borrower cash flows and ability to service debt;
- lent to companies in less cyclical industries with more stable revenue profiles; and
- avoided the highest levered deals of the last several years.

INDUSTRY PROFILE

Due to the scars of the GFC, many investors in the private equity community and direct lenders have migrated away from the more cyclical industries like capital goods, manufacturing, and consumer cyclicals. Data from Bloomberg on announced private equity buyout transactions demonstrates this trend with 2005-2006 mergers and acquisitions (M&A) volume being 20% consumer cyclical compared to 7% consumer cyclical for the same data from 2021-2023.

2005-2006 private equity M&A activity by industry



2021-2023 private equity M&A activity by industry

As of 31 December 2023. Source Bloomberg.

More stable revenue and cash flow generative industries like technology have represented much of the M&A volume, as private equity firms and lenders focus on companies with a more recurring business mix – a key learning from COVID-19 and the GFC. Technology represents 18% of 2021-2023 M&A volume compared to 6% in the 2005-2006 data, and 12% in 2018 and 2019 heading into COVID-19.

This pivot to less cyclical industries with more recurring cash flow should help provide relative stability in middle market direct lending.

2018-2019 private equity M&A activity by industry

As of 31 December 2023. Source Bloomberg.

LEVERAGE

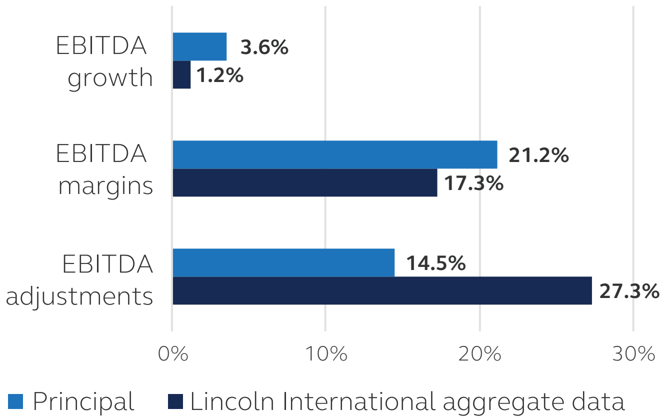
Equity contributions to deals have increased significantly since the GFC when transactions were routinely financed with 30% - 35% of equity in the capital structure, compared to 50% - 60%+ over the past several years. Average leverage ratios peaked at over 6x prior to the financial crisis according to Leverage Commentary and Data (LCD) but hover around 4.7x today. That trend has occurred over a time period where private equity shifted away from lower enterprise value multiple businesses as noted above, to higher multiple software, healthcare, and consumer and business services platforms with more recurring cash flow.

However, covenant protections have dwindled since the financial crisis according to LCD. Most borrowers pre financial crisis were required to have a senior leverage, total leverage, fixed charge coverage ratio (FCCR), and sometimes capital expenditures covenant. That data is artificially impacted by the fact that having both a senior leverage and total leverage covenant are less applicable today, as the market was historically a senior / mezzanine financed market compared to a primarily first lien only market today. However, even adjusting for that difference, covenant protections have diminished. Principal Alternative Credit focuses on the lower middle market where FCCR and leverage covenants have and remain key staples of credit agreements, allowing for early detection of any credit issues and an opportunity to get to the negotiating table prior to payment defaults.

CASH FLOWS

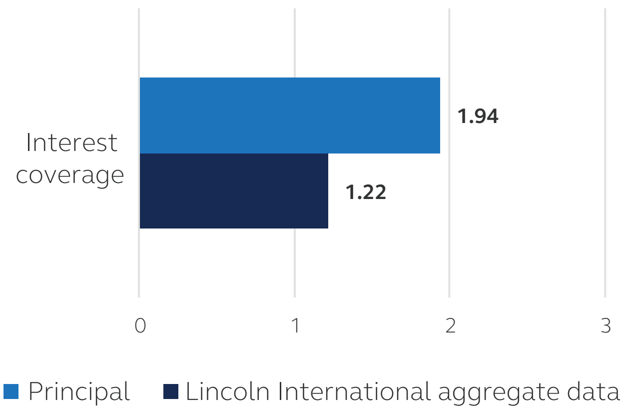
Discerning a borrower's ability to consistently service debt is fundamental to avoiding defaults and losses. Those lenders who focus on the lower middle market, where leverage levels and relative debt burdens tend to be lower than the broad middle market, will benefit from having exposure to borrowers more able to service debt in today's rate environment. The secured overnight financing rate (SOFR) will likely decline in a recession, and borrower cash flows will benefit if that turns out to be the case. However, we believe the lead-in to a recession is critical. In our experience, it's the borrowers that "limp into" recessions who have the most difficulty powering through them, as having substantial free cash flows to reinvest in and maintain operations is critical to maintain or grow enterprise value in advance of and during a recession. Further, since first lien lending has increasingly taken out the portion of the market that used to be financed with mezzanine debt, there won't be as much mezzanine interest to "turn off" during a crisis. This means those lenders who did the highest levered deals over the past several years are more likely to PIK (payment-in-kind) their own interest in recessionary times. Lincoln Financial recently released data suggesting that if the SOFR remains above 5%, the average interest coverage will decline to around 1.2x on average for middle market direct lending portfolios. Principal's portfolio averages over 1.9x interest coverage in this higher rate environment due to its focus on underwriting a borrower's ability to generate consistent cash flow through a cycle and its emphasis on the lower middle market where debt burdens are more manageable.

High free cash flow borrowers



As of 31 December 2023. Source: Lincoln international 2023 year over year growth rate. Lincoln International provides a valuation of the direct lending market.

Interest coverage at higher rates



As of 31 December 2023. Source: Lincoln International data. Lincoln International provides a valuation of the direct lending market.

CONCLUSION

Recessions always bring challenging times for risk assets. According to data from Cliffwater, non-accruals reached an all-time high of approximately 6% for the direct lending market during the financial crisis. Since that time, direct lenders and private equity have increasingly focused on recession-resilient, more-recurring-revenue businesses. Investors should be mindful of managers' approach to covenants and leverage levels, but the private middle market lending industry does appear well positioned from an LTV / leverage perspective compared to prior crisis periods. We believe non-accruals will likely peak at 3% - 4%, considerably less than the higher levels reached during the GFC. This more moderate default rate coupled with current double-digit coupons and anticipated relatively strong recovery levels, should bode well for direct lending returns through the cycle.

Risk Considerations

Past performance is no guarantee of future results. Investing involves risk, include possible loss of principal invested. 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.

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