

PRINCIPAL REAL ESTATE

Private real estate debt and corporate middle market direct lending: Complementary strategies

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AT-A-GLANCE

- Private real estate debt and middle market direct lending are complementary strategies that can enhance portfolio efficiency when combined, offering different risk drivers and income streams.
- Over the measured time period, Real Estate debt has exhibited favorable risk/return dynamics when compared to other asset classes.
- Both strategies offer floating-rate structures and senior positions in the capital stack but derive income from different sources creating natural diversification.
- Analysis shows combining these strategies can help to reduce portfolio volatility while maintaining attractive yields, as they exhibit low correlation to each other and to traditional fixed income investments.

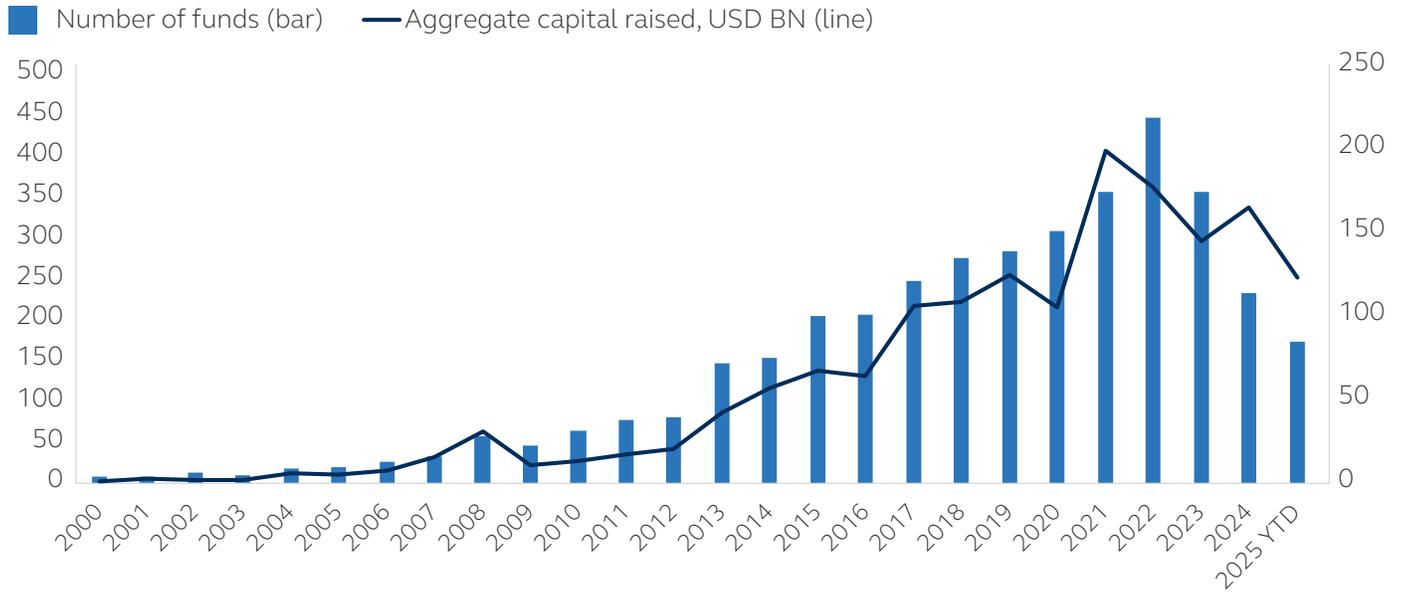
Private credit is now a core building block of institutional portfolios. In its broadest definition, private credit can be defined as any non-bank loan that is not traded on public markets. Both private real estate and private corporate middle market direct lending fit this definition though each has its own distinct risk drivers and income stream.

- Middle market direct lending underwrites corporate cash flows, typically via first-lien, floating-rate loans to sponsor-backed companies.
- Real estate debt is secured by tangible properties and property-level cash flows, often with conservative attachment points and robust collateral packages.

Our analysis shows that adding real estate debt to a portfolio of middle market direct lending loans helps to potentially reduce portfolio volatility, improve return consistency, and deliver attractive income premia. In short: neither asset class is a substitute for the other — they are a powerful complement.

Secular growth in private credit has accelerated as banks retrenched post-Global Financial Crisis given regulatory constraints and again in recent years. Fundraising and assets have expanded materially, with direct lending becoming the largest private credit strategy by assets under management, while asset-based strategies—including real estate debt—gain share as investors seek collateral-backed income. Preqin's most recent outlook notes private debt's continued investor favor, despite a slower 2024 fundraising year; North America remains dominant, and regulatory shifts continue to open new lending channels for non-bank capital. At the same time, real estate debt fund aggregates and indices such as NCREIF/CREFC and GL-2 now provide more transparency and sector-level performance snapshots, underscoring the maturation of the asset class.

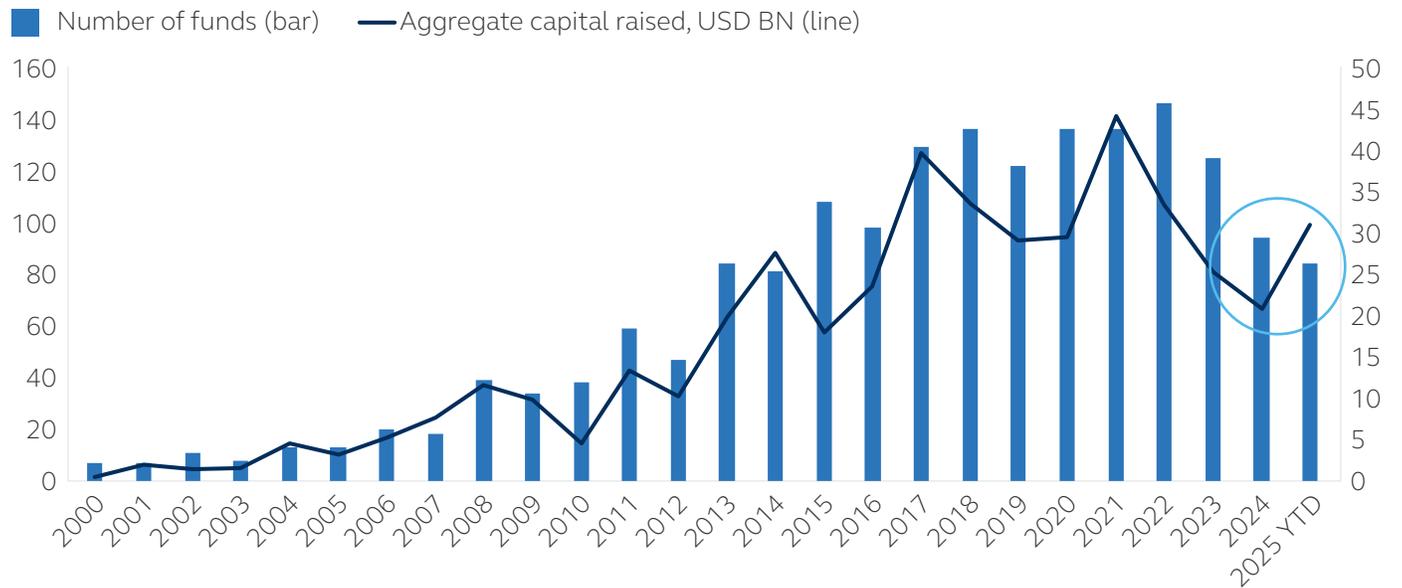
EXHIBIT 1: Private credit capital raised, 2000 – 2025



Source: Preqin, Direct Lending, Real Estate December 2025

Strategies within private real estate debt and corporate direct lending can be broken into capital preservation, mezzanine, distressed credit, opportunistic, specialty or niche financing, among others. While corporate lending comprises the bulk of what’s traditionally thought of as private credit, real estate debt has started to emerge in private credit conversations as a viable alternative for investors within this portfolio allocation bucket and more investors have started to explore this asset class in more depth as evidenced by the sharp rebound in allocations in 2025, which was the fifth highest capital raise (\$31B) for the sector since 2000 (Exhibit 2). So, how do real estate and direct lending complement each other and what benefits may each asset class provide?

EXHIBIT 2: Private Real Estate Debt capital raised, 2000 – 2025



Source: Preqin, Direct Lending, Real Estate December 2025

Diversification

Diversification is the first reason to pair these strategies. Direct lending’s returns are primarily a function of income (base rate + spread) minus credit losses, while real estate debt returns blend contractual income with third party note valuations that are tied to the underlying property’s performance. Returns over time have produced low to moderate correlations with traditional fixed income and relative to each other, which supports better portfolio efficiency when combined.

Adding real estate debt to a fixed income portfolio has the potential to substantially improve the risk-adjusted return for a broader investment portfolio. For instance, when combined with real estate equity, real estate debt can act as a downside mitigant and when combined with fixed income, portfolios may provide yield enhancement. This can be achieved with limited correlation to either of the asset classes.

As shown in Exhibit 3, Real Estate Debt also provides similar diversification benefits when compared to Direct Lending. The structural differences between direct

lending and real estate debt make them highly complementary.

- In direct lending, risk and return are anchored in corporate performance and sponsor support, with loans priced off floating benchmarks and documented with financial and technical covenants.
- In real estate debt, underwriting is anchored in the value, cash flow durability, and resiliency of the underlying property—multifamily, industrial, retail, lodging, or specialized assets—and the loan is typically secured by the asset, cash flows, and project-level reserves.

This distinction creates diversification across economic cycles: when corporate earnings dispersion rises, real estate collateral-based lending can dampen mark-to-market volatility; when property values transition or cap rates move, senior, well-structured direct lending may provide cash flows that offset appraisal-based volatility. The result is a smoother, more resilient private credit allocation.

EXHIBIT 3: Correlation between private debt and other asset classes

	Global Stock ^{*1}	Global Investment Grade ^{*2}	Global REITs ^{*3}	Investment Grade CMBS ^{*4}	Private Equity Real Estate ^{*5}	Direct Lending ^{*6}	Core Private Real Estate Debt ^{*7}	Core Plus Private Real Estate Debt ^{*8}
Global Stock	1.00	0.48	0.80	0.41	-0.34	0.67	0.44	-0.04
Global Investment Grade	0.48	1.00	0.61	0.87	-0.38	0.14	0.85	0.22
Global REITs	0.80	0.61	1.00	0.57	-0.13	0.60	0.62	0.32
Investment Grade CMBS	0.41	0.87	0.57	1.00	-0.40	0.16	0.95	0.27
Private Equity Real Estate	-0.34	-0.38	-0.13	-0.40	1.00	-0.15	-0.32	0.52
Direct Lending	0.67	0.14	0.60	0.16	-0.15	1.00	0.21	0.06
Core Private Real Estate Debt	0.44	0.85	0.62	0.95	-0.32	0.21	1.00	0.32
Core Plus Private Real Estate Debt	-0.04	0.22	0.32	0.27	0.52	0.06	0.32	1.00

Source: Bloomberg, Principal Real Estate. Quarterly returns 1Q 2014 to 2Q 2025. No investment strategy, such as asset allocation or diversification, can guarantee a profit or protect against loss in periods of declining values. Past performance does not guarantee future index returns. It is not possible to invest directly in an index.

Long-term returns

Over the course of ten years, middle market direct lending has delivered higher returns (8.97% over ten years) compared to real estate debt (7.07%), but with greater volatility (see Exhibits 4 and 5) over this measured time period.

EXHIBIT 4: Direct lending returns vs. real estate returns

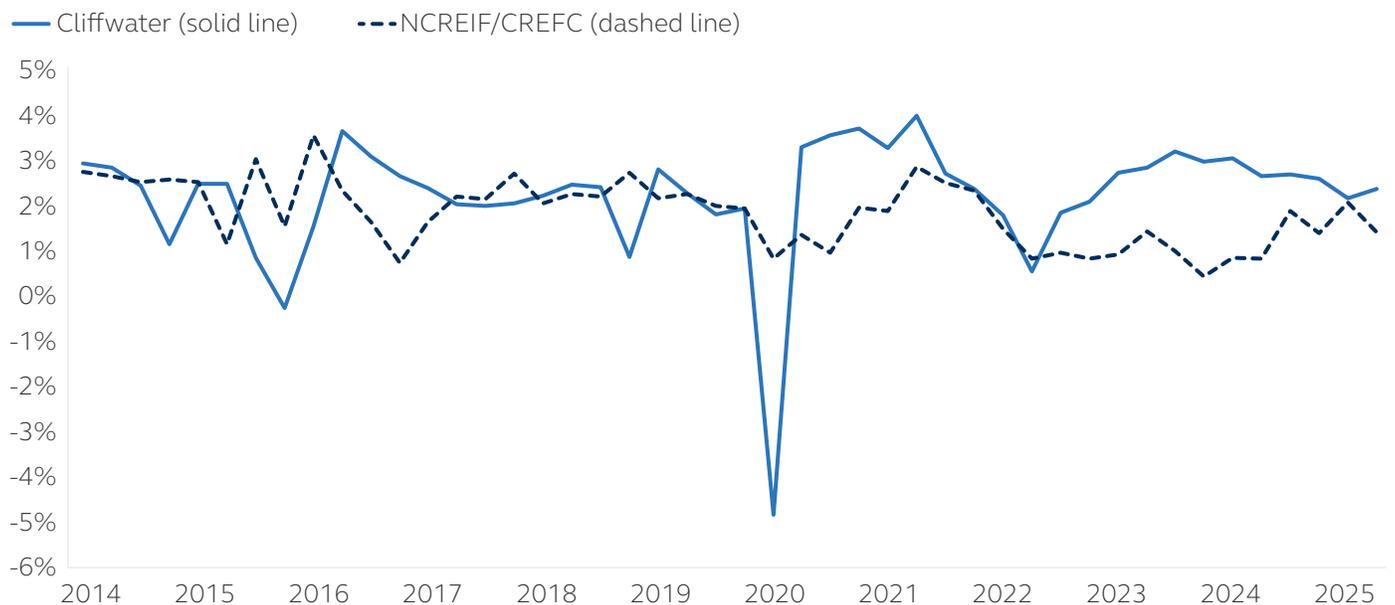
	10-year	Since NCREIF/CREFC Inception (1Q14-2Q25)
Direct lending	8.97%	9.07%
Real estate	7.07%	7.40%

Source: Cliffwater direct lending index and NCREIF Open End Debt Fund Aggregate as of 2Q25

When we examine rolling quarterly returns, a clear pattern emerges: real estate debt has delivered a steadier, more predictable return stream compared to middle market direct lending. Both strategies generally move in the same direction, but the range of returns is far greater in direct lending (i.e., higher highs and lower lows), reflecting its sensitivity to corporate earnings cycles and sponsor dynamics. The majority of direct lending’s outperformance—or “alpha”—over real estate debt has been concentrated in the most recent period, aided by elevated base rates, whereas real estate debt has maintained a smoother trajectory throughout the cycle.

Bottom line, this divergence underscores the complementary nature of the two strategies. By layering real estate debt into a direct lending allocation, investors can dampen volatility without materially sacrificing yield, creating a more balanced risk-return profile. The COVID-19 shock, which disrupted virtually all asset classes, is evident in historical data, yet even through that stress period, real estate debt’s collateral-backed structure helped preserve stability relative to the sharper swings seen in corporate credit. **Pairing these strategies is not about choosing one over the other, it’s about combining their strengths to support consistency and resilience across market environments.**

EXHIBIT 5: Rolling quarterly returns for direct lending and real estate



Source: Cliffwater direct lending index and NCREIF Open End Debt Fund Aggregate as of 2Q25

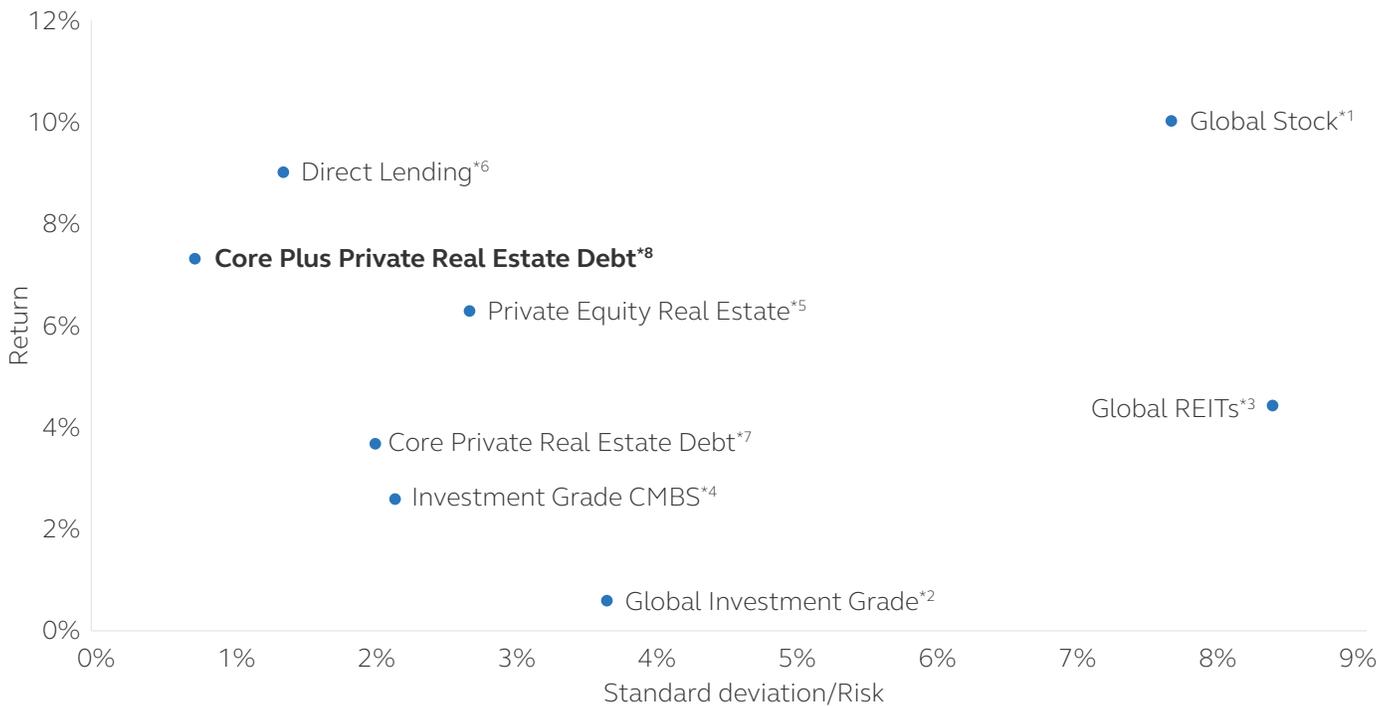
Institutional and wealth allocators can implement simple (policy-contingent) blends to capture these complementary benefits. In a private credit sleeve, a 60/40 or 50/50 mix of direct lending and real estate debt can be used to pursue return objectives while managing volatility than a single-strategy allocation. Allocators with existing middle market direct lending exposure can add 20–40% real estate debt to smooth quarterly marks, diversify collateral, and extend duration modestly while maintaining short- to intermediate-term cash flow visibility.

EXHIBIT 6: Allocation analysis

		Allocation sensitivity analysis										
Open ended CRE Debt		0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
Private Credit		100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%
Return	125.2	159	152	146	140	134	128	122	116	111	105	100
Ann Return	7.5	8.6	8.4	8.2	7.9	7.7	7.4	7.2	6.9	6.7	6.5	6.2
StDev	1.1	1.91	1.73	1.55	1.38	1.22	1.06	0.92	0.80	0.71	0.67	0.69
Ann StDev	2.1	3.8	3.5	3.1	2.8	2.4	2.1	1.8	1.6	1.4	1.3	1.4
Ann Sharpe	2.2	1.54	1.63	1.74	1.87	2.02	2.20	2.41	2.62	2.76	2.75	2.51
MDD	-2.5	(5.6)	(5.0)	(4.4)	(3.8)	(3.1)	(2.5)	(1.9)	(1.3)	(0.7)	(0.0)	0.0

Source: NCREIF/CREFC, Preqin, Principal Real Estate, 1Q 2025. MDD = max drawdown

EXHIBIT 7: Volatility vs. return (since 2014)



Source: Bloomberg, Principal Real Estate. Quarterly returns 1Q 2014 to 2Q 2025. No investment strategy, such as asset allocation or diversification, can guarantee a profit or protect against loss in periods of declining values. Past performance does not guarantee future index returns. It is not possible to invest directly in an index.

Risk

Both private real estate debt and middle market direct lending share a common objective: delivering resilient income while mitigating downside risk. Each strategy achieves this through structural features that support investors across market cycles. A key defense is the prevalence of floating-rate loans priced at a spread over a benchmark index, which helps insulate portfolios from fixed rate interest-rate volatility. High-yield real estate debt typically involves shorter-duration mortgages—typically 2-3 year terms (five years fully extended)—while direct lending loans average three years of life with stated maturities of five to six years. This short-term, floating-rate design reduces mark-to-market sensitivity and provides a natural hedge as base rates fluctuate.

Importantly, these strategies are private in nature and therefore exhibit low correlation to public markets. This independence enhances portfolio resilience by reducing exposure to systemic shocks and concentration risk. Allocators who combine real estate debt and direct lending gain diversification benefits that are difficult to replicate with public credit or equity alone.

Both asset classes also occupy senior positions in the capital stack, offering a cushion against declines in enterprise or asset values. Real estate debt underwriting focuses not only on borrower creditworthiness but also on the intrinsic value of the hard asset securing the

loan. Investors can “look through” to the property—its location, tenancy, and cash flow profile—providing transparency and tangible collateral. In direct lending, loans are typically first-lien senior secured and backed by a blanket lien on the borrower’s assets, including working capital, property, plant, equipment, and intellectual property. Net-net, loss given default risks are mitigated as the structure enhances recovery prospects in stressed scenarios.

Finally, the source of cash flow differs between the two strategies, creating complementary risk drivers.

- Real estate debt relies on contracted property-level income streams—such as rents from multifamily, office, industrial, and retail assets—offering predictability and stability.
- Direct lending, by contrast, depends on operating cash flows from the borrower’s business, which can evolve through growth initiatives, diversification, and operational improvements. While corporate cash flows are dynamic, disciplined underwriting focuses on businesses with durable fundamentals and the capacity to perform through cycles.

Together, these distinct cash flow engines provide investors with a balanced mix of contractual and adaptive income sources, reinforcing the case for pairing real estate debt with direct lending in a private credit allocation.

Conclusion

Private real estate debt is a compelling complement to middle market direct lending. The combination delivers diversified collateral, resilient income, and improved risk-adjusted outcomes through cycles. With bank dislocation and refinancing needs creating durable deal flow, investors can use disciplined, senior-oriented real estate credit alongside direct lending to build portfolios that are both productive and resilient. The takeaway is clear: pair them.

*1 MSCI Int'l (BBG - NDDUWIF)

*2 Bloomberg Global-Aggregate Total Return Index Value Unhedged USD

*3 FTSE EPRA NAREIT DEVELOPED Total Return Index USD

*4 BB/BC Inv Grade CMBS Index(TR Unhedged)

*5 NFI ODCE

*6 Cliffwater Direct Lending Index

*7 Giliberto-Levy Index,G-L1 (CLA; T.R.)

*8 NCREIF/CREFC Debt Agg TOTAL Return

MSCI Int'l (BBG - NDDUWIF): The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries. With 1,321 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg Global-Aggregate Total Return Index Value Unhedged USD: The Bloomberg GlobalAgg Index is a flagship measure of global investment grade debt from a multitude local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

FTSE EPRA NAREIT DEVELOPED Total Return Index USD: The FTSE EPRA Nareit Developed Index is designed to track the performance of listed real estate companies and REITs worldwide. By making the index constituents free-float adjusted, liquidity, size and revenue screened, the series is suitable for use as the basis for investment products, such as derivatives and Exchange Traded Funds (ETFs).

BB/BC Inv Grade CMBS Index(TR Unhedged): The Bloomberg US CMBS Investment Grade Index measures the market of US Agency and US Non-Agency conduit and fusion CMBS deals with a minimum current deal size of \$300mn.

NFI ODCE: The NFI-ODCE is a capitalization-weighted, gross of fee, time-weighted return index with an inception date of December 31, 1977. The NFI-ODCE, like the NCREIF Property Index (NPI) and other stock and bond indices, is a capitalization-weighted index based on each fund's net invested capital, which is defined as beginning market value net assets (BMV), adjusted for weighted cash flows (WCF) during the period.

Cliffwater Direct Lending Index: The Cliffwater Direct Lending Index (CDLI) is an asset-weighted index that measures the performance of private middle market loans, specifically U.S. middle market corporate loans. "Cliffwater," "CliffwaterDirect Lending Index," and "CDLI" are trademarks of CliffwaterLLC. The CliffwaterDirect Lending Indexes (the "Indexes") and all information on the performance or characteristics thereof ("Index Data") are owned exclusively by CliffwaterLLC, and are referenced herein under license. Neither Cliffwater nor any of its affiliates sponsor or endorse, or are affiliated with or otherwise connected to, Principal Life Insurance Company, or any of its products or services. All Index Data is provided for informational purposes only, on an "as available" basis, without any warranty of any kind, whether express or implied. Cliffwater and its affiliates do not accept any liability whatsoever for any errors or omissions in the Indexes or Index Data, or arising from any use of the Indexes or Index Data, and no third party may rely on any Indexes or Index Data referenced in this report. No further distribution of Index Data is permitted without the express written consent of Cliffwater. Any reference to or use of the Index or Index Data is subject to the further notices and disclaimers set forth from time to time on Cliffwater's website at <https://www.cliffwaterdirectlendingindex.com/disclosures>.

Giliberto-Levy Index,G-L1 (CLA; T.R.): The Giliberto-Levy Commercial Mortgage Performance Index (G-L 1) measures the investment performance of select private-market investments in commercial real estate debt. Specifically, the Index tracks fixed-rate, fixed-term senior loans that are made by and held in the investment portfolios ("on balance sheet") of institutional lenders such as life insurance companies and pension funds.

NCREIF/CREFC Debt Agg TOTAL Return: The NCREIF/CREFC Open-end Debt Fund Aggregate is a fund-level aggregate comprising open-end funds that provide credit and financing to borrowers who own commercial real estate.

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