UNDERSTANDING PAYMENT-IN-KIND (PIK)

Hello, I'm Dianna Carr-Coletta, Managing Director and Dedicated Partner in PGIM's Direct Lending group. Today, I'll discuss an important topic in Private Credit: Payment-in-Kind Interest, commonly known as PIK. While PIK is not a new concept, this interest payment deferral strategy has drawn recent attention as higher base rates have persisted. In this environment, it is important for investors to carefully assess how loans are structured and how companies approach servicing debt.

PIK interest is a feature that allows borrowers to defer cash interest payments until maturity. In other words, instead of paying interest in cash, the interest gets accrued and added to the loan's principal balance. This can potentially increase repayment risk. For example, a company takes a $1,000,000 loan with a 10% interest rate, paid annually. If PIK interest is allowed, the borrower can add the interest payment to the loan principal instead of paying in cash. This means the principal grows to $1,100,000, and the 10% rate now applies to the higher balance. Essentially, the nominal yield increases.

There are several types of PIK. A PIK note allows borrowers to pay interest by adding it to the principal instead of paying in cash. A PIK toggle offers flexibility, letting borrowers choose between cash payments or payments in-kind, without notifying the lender or triggering a covenant breach. And finally, part PIK interest combines both, with a portion of interest paid in cash and the rest accrued to the principal.

Since 2022, higher interest rates have weighed on heavily leveraged companies, with many now facing interest payments that exceed cash flow. PIK loans have become a popular option for addressing short-term liquidity issues emerging in this environment. Intense competition in private credit markets, particularly in larger segments where lenders offer the feature to win deals from the broadly syndicated loan market where PIK is less common, is fueling the rise in PIK loans.

Why is it important for investors to consider the use of PIK?

- **First, Reduced Transparency:** PIK adds unpaid interest to the loan principal, quietly increasing debt without triggering a default. This can obscure a borrower's true financial health, delaying signs of distress that would otherwise prompt action.
- **Second, Increased Default Risk:** PIK inflates total debt and often comes with higher interest rates. In an economic downturn, declining revenues and compounding debt can overwhelm borrowers, significantly raising default risk.

- **And lastly, PIK can lead to Mismatched Cash Flows:** BDCs are required to distribute 90% of income whether the income is earned in cash or PIK. If PIK exceeds 10% of a fund's total income, liquidity issues can force asset sales or capital raises, potentially eroding portfolio value.

Industry participants distinguish between "good" and "bad" PIK. So-called good PIK loans are structured at the loan's outset and often go to high-growth companies, typically in the tech or healthcare industries, that plan to reinvest cash or otherwise reserve resources to improve cash flow. The lender typically offers PIK at origination to accommodate the company's intention to commit cash to growth. Bad PIK loans arise from a company's inability to meet existing cash interest obligations. This might occur after a covenant default or during an amendment process to convert to PIK. These situations often signal early financial stress within the company.

At PGIM, we approach PIK differently. We don't consider loans that are structured with PIK at the outset as senior secured debt. To qualify as senior secured in our underwriting, a company must cover all cash interest. None of our senior deals include PIK at origination. If a loan requires PIK interest or a PIK toggle in its covenants up front, we don't classify it as senior secured risk. This strategy reserves PIK to be utilized when there are covenant violations to increase an investor's return for taking on increased risk following our original underwriting and has contributed to our lower credit losses relative to the industry.

When it comes to private credit, avoiding losses is critical, particularly in today's volatile market environment. While PIK offers the allure of increased yields for investors, concealed risks can outweigh potential rewards. Every PIK loan requires careful scrutiny. Success hinges on a lender's experience in limiting PIK usage and selectively identifying situations where it can improve outcomes.

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