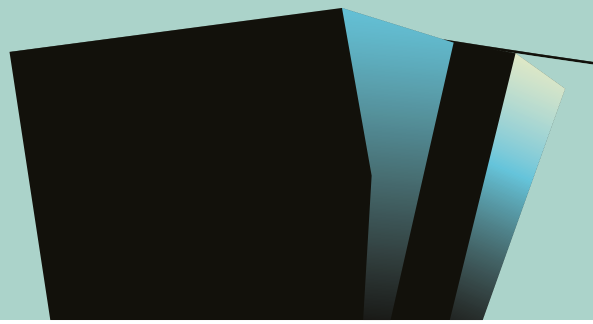
The rise of PIK sparks concerns

Interest rates are staying higher for longer, debt service is piling up and liquidity is falling at some business development companies. What could possibly go wrong, asks Robin Blumenthal



Although defaults have stayed at a relatively tame level for a while, a peek under the surface reveals that interest-coverage pressure is building on business development companies and many portfolio companies that borrowed when rates were near zero now face the prospect of refinancing at much higher rates.

Enter payment in kind interest, or PIK, where some, and sometimes all, cash payments are delayed and amortised into the loan's principal. But the PIK of today bears little resemblance to that of times past.

Indeed, PIK, which once was strictly a feature of junior debt, has found its way into the senior part of the capital structure. And despite the party line that PIKing interest is an option largely offered to well performing companies with good growth prospects, that's not necessarily a guarantee that those payments will get made.

"The introduction of PIK as a core component of a first-lien security is a relatively new concept," says Matt Freund, managing director and president of Barings BDC. "It seems unlikely that a significant increase in PIK income was generated largely at the direction of the lender community.

"Based on the historical utility of PIK, we would expect an increase in PIK overall to be at least partially – if not primarily – a reaction to issuer underperformance and modifications to existing credit facilities. On its face, it certainly grabs our attention."

How much PIK is in market?

Estimates of PIK usage in BDCs vary, but Fitch Ratings reported in late May that pressure on portfolio company performance drove PIK interest to an average of 9 percent in its universe of 24 rated BDCs in the first quarter, significantly higher than the 6.8 percent in 2020, during the covid pandemic, and sharply higher than the 3.6 percent in 2019, when interest rates were at historic lows.

The Fitch report warned that its covered universe of BDCs faces "persistent headwinds in 2024, with rising [PIK] income and continued markdowns of investments during [Q1 2024] signalling additional credit issues and resultant net investment income pressure". That could create problems for BDCs, which fund their dividends with net interest income.

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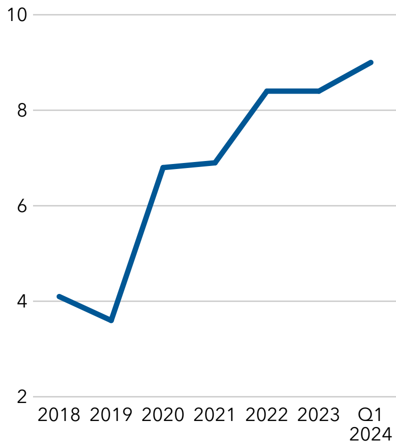
Fitch said that in Q1, 15 BDCs recorded net realised losses ranging from less than 0.1 percent to 1.7 percent of average investments at fair value, while nine recorded modest net realised gains.

In a white paper this year, mid-market lender Man Varagon, part of Man Group, using public BDC filings, estimated that PIK income as of 30 June 2023 accounted for as much as 12 percent of interest income among top-tier, publicly traded BDCs with market capitalisations of more than $500 million. Man Varagon focused on senior loans

PIK income/interest and dividend income, average of Fitch-rated BDCs (%)



Data as of year end, except for Q1 2024
Source: Fitch Ratings

to performing, sponsor-backed companies and underlying portfolios in the mid-market, although the spike in PIK interest might be related to its more frequent use in larger, unitranche loans.

Getting creative

The increase in PIK is largely a function of existing portfolios managing liquidity through amendments, says Zeshan Ashfaque, senior credit officer at Man Varagon. "A common theme is that liquidity may not be as robust as you may want it to be," he states. Moreover, he notes that public BDCs report net losses, so some of the loss rates may be masked by when an equity position was sold.

Managers are also getting more creative in their use of PIK. "You'll often see pure PIK interest and no cash pay in the first year of a loan," says Joseph Price, a member of law firm Mintz. He notes that using PIK facilities is becoming more popular at the holding company level, which is more expensive. The downside is that in such structures, lenders get paid last if there is a problem.

Chelsea Richardson, Fitch senior director, non-bank financial institutions, said she expects the pressure on portfolio performance to continue through the year, with potential for an uptick in amendment activity.

Some BDCs are cutting base management fees from the standard 1.5 percent to 1 percent, she said, perhaps in response to earnings pressure and an increase in non-accruals. The Fitch report cited Oaktree Specialty Lending's recent cut in its base management fee to 1 percent of assets from 1.5 percent, Golub Capital BDC's drop in its base fee to 1 percent last year and a recently announced incentive fee rate reduction.

Cautious attitude

"You have PIK in a loan typically when there's not enough liquidity to pay the full interest rate in cash," says Man Varagon's Ashfaque. "Lenders generally prefer receiving current cash interest income instead of deferring it, although you could argue that if a PIK loan has a sufficient yield premium over a comparable cash pay loan, then you are being compensated for the incremental risk."

Some managers frown on the use of PIK, regardless of the type of facility. Barings' Freund says: "Whether an issuer elects to PIK some interest via existing PIK-toggles or requests it via an amendment, even though one may be more anticipatory than the other, neither is a positive signal."

Not all PIK is created equal. Some lenders structure a partial PIK option into a loan at origination, particularly for companies with good growth prospects, says Chris Cessna, a director in Houlihan Lokey's financial and valuation advisory business. "The best use of a company's cash is sometimes not in paying interest but in reinvesting in growth," he says.

But it's a different story for companies that borrowed when base rates were much lower and are now having trouble covering debt service costs. "Lenders sometimes are amending their terms to forgo some of the cash and use PIK," Cessna says, which typically comes at a premium.

In this event, PIK interest is just one of many solutions negotiated by sponsors and lenders across difficult situations, says Tim Kang, a director in Houlihan Lokey's financial and valuation advisory business. "These aren't just handouts or freebies; they're all very sophisticated, calculated measures of risk. PIK is another form of loan and, at the end of the day, lenders provide loans expecting repayment." ■