iCapital

Painting a PIKture: The Benefits and Risks of PIK in Private Credit

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Payment-in-kind (PIK) usage is often talked about as a problem for direct lenders, partly because PIK is viewed as a sign of portfolio stress. But there are reasons why lenders offer PIK, and there are distinctions between "good" and "bad" PIK. In fact, PIK can play a strategic role in direct lending strategies. So, it's important not just to know if PIK is present, but to also to understand the risks and benefits of PIK, and how its usage fits in with a manager's overall direct lending approach.

In recent years, loans making PIK payments have increased within the portfolios of business development companies (BDCs). According to S&P Global, 11.7% of loans held by BDCs made PIK payments in 2Q 2024, up nearly two points from 2Q 2023.[1] Generally speaking, PIK is a loan feature that allows a borrower to defer regular interest payments by adding the interest to the principal balance of the loan (at an accrual rate). PIK is prevalent with both private market funds and BDCs, as both tend to work closely with borrowers and have flexibility to customize lending solutions. BDC's tend to be more scrutinized in their use of PIK due to public reporting that quantifies PIK exposure.

PIK provisions are used for several reasons. Growth-oriented borrowers might want to defer interest payments to concentrate cash flow on growth initiatives, while other borrowers might need to conserve cash to withstand a difficult period. So, an important part of evaluating PIK is understanding why a borrower is using it, and if the underlying business is at risk.

Exhibit 1: Why a Borrower Might Use PIK

Why a borrower might use PIK	Considerations from the lending side
An opportunity to reinvest for growth. Growth-oriented companies may see an opportunity to accelerate reinvestments and could benefit from deferring near-term interest payments. Technology, a growth-industry, is a high user of PIK and now represents the largest industry exposure for direct lenders.	**These types of "good" PIK features are often offered at loan origination.** The lender may want to help portfolio companies reinvest in market opportunities or provide additional flexibility for when a business need arises. PIK interest also provides a benefit to the lender in the form of a higher return premium. In exchange for unpaid current interest payments, the lender will see a higher yield on the loan from higher principal and interest accruals.
An option to add flexibility. Instances of PIK toggles offer the borrower an option to pay regular cash interest payments, defer interest payments to maturity, or switch back and forth; typically, they trigger if certain conditions are met.	
Problematic borrowers. Companies that are having trouble making interest payments due to financial stress may look to utilize PIK. This will likely be a retroactive negotiation and can increase the risk of future interest payments and/or principal loan repayment.	**The lender may offer PIK as a retroactive amendment.** In instances of borrower stress, the lender may provide extended support in exchange for a higher end payout. From the lender's perspective this approach may also avoid the potential added costs of a workout or restructuring.

One fact that shouldn't be lost when evaluating PIK is the growth of the direct lending market. Many direct lenders incorporate PIK as part of their lending platform. Considering the market has increased six-fold over the last ten years, it's no surprise there are some newer, more flexible financing aspects of the market, such as PIK.[2] In fact, the ability to offer PIK is seen as part of the customized financing solution that direct lenders provide and can be a competitive advantage in allowing them to see more deal flow.

Terms are negotiated at origination and go through a risk-reward evaluation to justify the return premium. That said, proactive use of PIK should be viewed as lower risk. However, there are exceptions. And problematic borrowers retroactively turning to PIK can represent a concern and potentially signal future defaults.

PIK exposure has a natural upper limit in BDCs

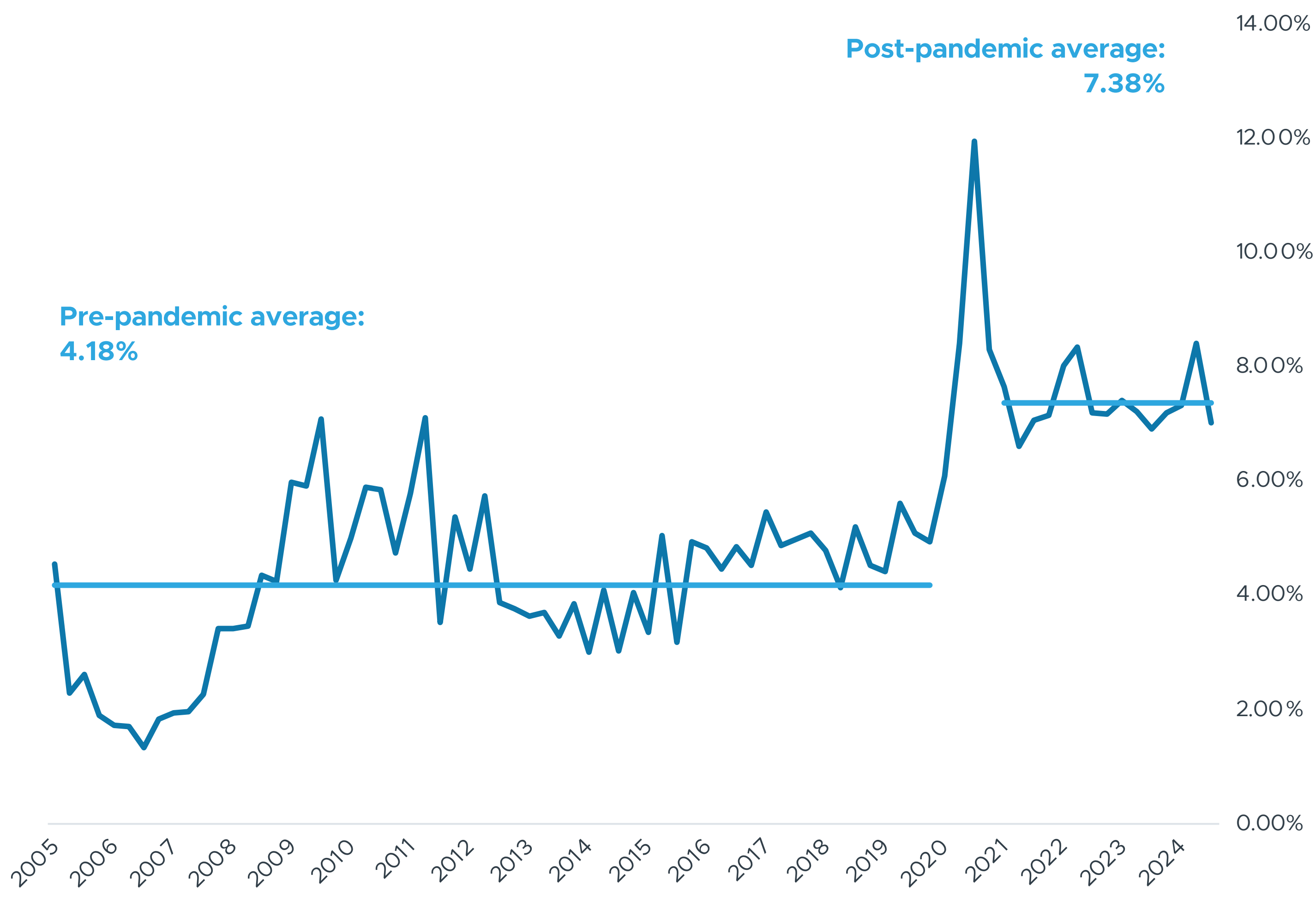
Cliffwater CDLI data shows that PIK income has been a stable part of total income over the last four years. PIK income as a percent of total income is one measure of borrowers converting cash interest to PIK and can signal higher risk in times of sustained increases.

In 3Q 2024, CDLI PIK income was 7.03% of total income – roughly in line with the recent average (Exhibit 2). We expect PIK exposure to have a downward bias in the coming years based on a healthy macro environment and lower base interest rates. As interest rates decline, fewer borrowers may need to rely on the flexibility offered by PIK.

In addition to PIK exposure, the credit performance of the underlying loan is a factor. Most PIK interest has been

Exhibit 2: PIK as a Percent of Total Income has Been Stable for the Last Four Years

Cliffwater CDLI PIK as percent of total income



Source: Cliffwater Direct Lending Index (CDLI) with data through 3Q 2024. For illustrative purposes only. Past performance is not indicative of future results.

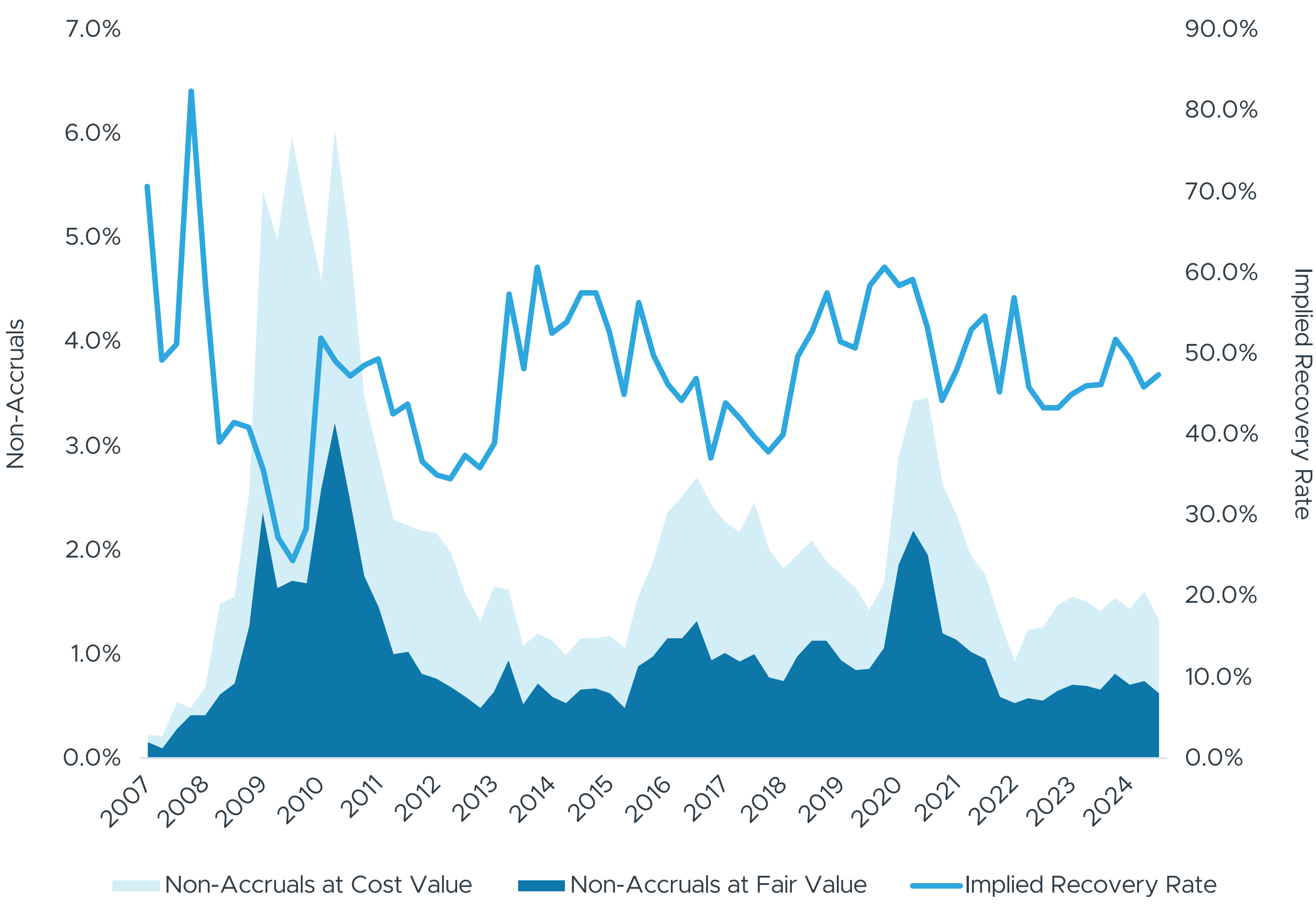
associated with performing loans, a signal that a majority of current PIKs were negotiated at origination. Non-accruals, at less than 1.5%, have not spiked higher, which would have been indicative of more non-performing loans and stress in the portfolio (Exhibit 3).

If PIK income is a natural part of the direct lending business and here to stay, it's natural to question where it starts to become a burden. BDCs are required to distribute 90% of income, regardless of whether that income is earned in cash or PIK. For this reason, there is a natural limiting pressure to manage PIK – if PIK income exceeds 10% of total income, the portfolio could face liquidity stress. In other words, when PIK income exceeds 10% of total income, there will be a mismatch in cash interest received and the income paid out.

For this reason we believe there's a natural limit to how much PIK income a BDC can and should generate. It also explains why PIK income of 10% or greater should signal higher risk. Beyond the CDLI Index in Exhibit 2, which includes a mix of public, private, and non-traded BDCs, we looked at the 10 largest private/non-traded BDCs, which collectively hold over $85 billion in assets. For this group, average PIK as a percentage of total income amounts to 4.2%, or 5.2% cumulatively, suggesting there are elevated levels of PIK in publicly traded BDCs, given that the broader credit index sees 7.4% of income from PIK (Exhibit 2). The private group is likely to have a higher percentage of their portfolio made up of loans originated in the low-interest rate environment prior to the Fed's 2022 rate-hiking cycle. In fact, of the 10 largest private BDCs, the highest PIK

Exhibit 3: Non-Accruals Remain Low, Signaling Healthy Credit Quality

Cliffwater implied recovery rates and non-accruals (as a percent of value)



Source: Cliffwater Direct Lending Index (CDLI) with data through 3Q 2024. For illustrative purposes only. Past performance is not indicative of future results.

exposure for an individual fund is 8.2%. This comes from a technology-focused fund that has 24% exposure to the software industry, an industry that is a high user of PIK.

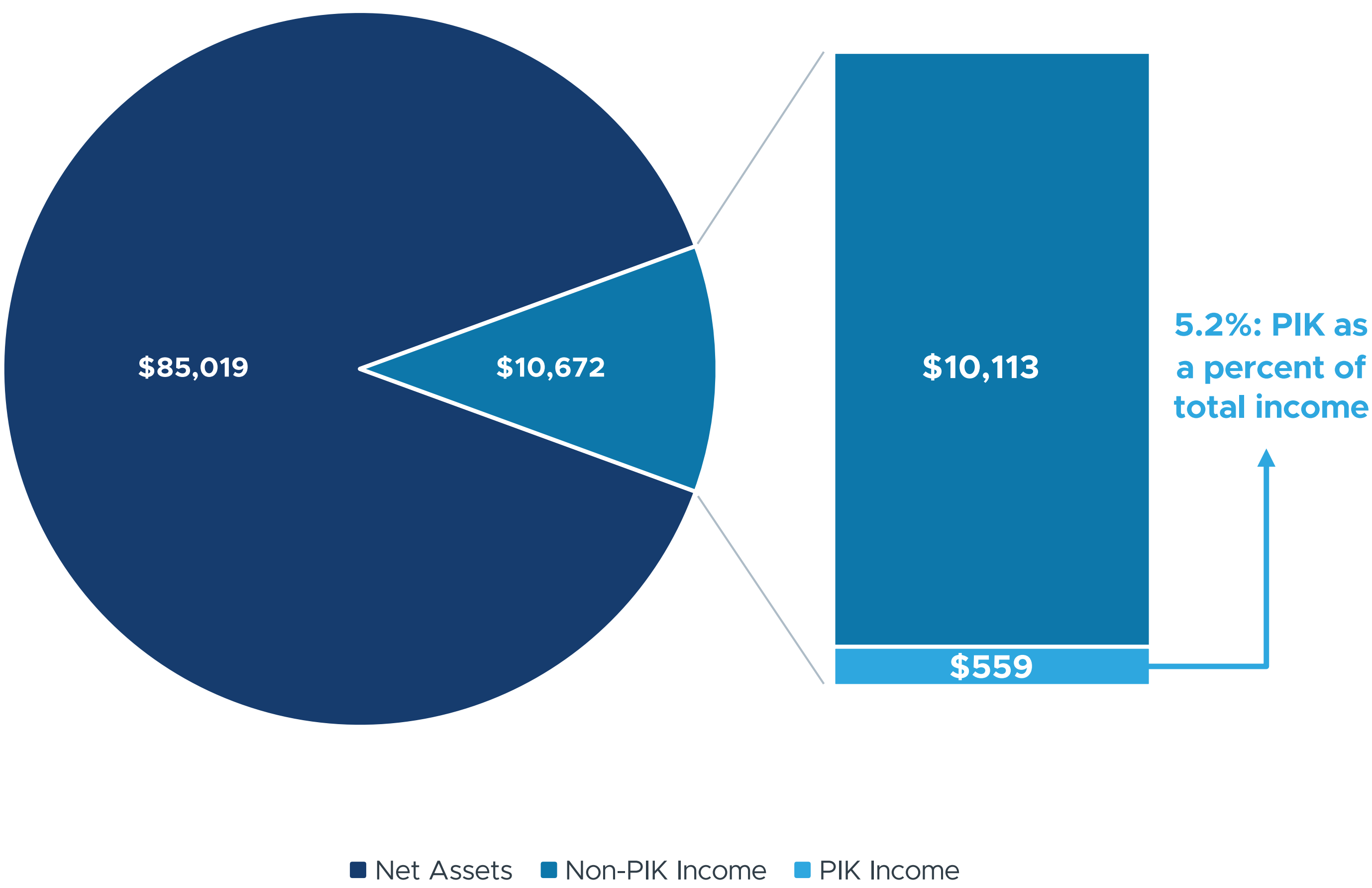
Keeping an eye on exposure while the market evolves

Non-banks, including direct lenders, now hold $23.2 trillion in loans compared to $12.4 trillion held by banks.[3] And in 2024, several major private market firms increased their direct lending forecasts due, in part, to this public-to-private structural shift. In other words, direct lending has grown in size and stature and is now a true alternative to traditional bank lending.

At the same time, many direct lending platforms use PIK as part of their offering and borrowers will often negotiate to include PIK in the loan structure to add it post-origination. Investors should expect to see more PIK as direct lending continues to occupy a larger part of the lending markets by taking share from bank lending. We think investors should be comfortable with some PIK exposure, especially when included in loan origination, and can use a 10% threshold as a measure of higher portfolio risk. As with any asset class, there will be outliers that may suffer losses. But investors can gain comfort in experienced managers that manage PIK issuance and exposure with the same risk-return framework as any other credit decision.

Exhibit 4: Larger Private BDCs Show Less PIK Risk

Aggregate assets and income for the 10 largest private/non-traded BDCs ($ in millions)



Source: Company filings, iCapital as of September 2024. PIK Income represents the previous nine-months ending Sept. 30, 2024, with the exception of one individual fund, which represents the previous 12-months. For illustrative purposes only. Past performance is not indicative of future results.

Endnotes

1. S&P Global, "BDC Assets Show The Prevalence Of Payments-In-Kind Within Private Credit", December 12, 2024.
2. Preqin, iCapital Alternatives Decoded.
3. JP Morgan; Assets and Liabilities of Commercial Banks in the United States H.8 data; Financial Accounts of the United States Z.1 data; Loans held by nonbank entities per the FRB Z.1 Financial Accounts of the United States.

Index Definitions

Cliffwater Direct Lending Index (CDLI): An asset-weighted index of over 11,000 directly originated middle market loans totaling $264B. It seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

Important Information

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