Reading Between the Lines: Manager Approaches to PIK

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"Payment in Kind" (or "PIK") is a concept dating back to ancient times when commerce involved bartering, often with livestock. Given these roots, the "K" in PIK is believed by some to have evolved from the Old English word "kine", which means "cattle" (i.e. payment in cattle). If we fast forward to today, lenders are still using PIK as a form of compensation — in lieu of receiving regularly scheduled cash interest payments, the accrued interest is added to the principal debt balance for payment at a later date.

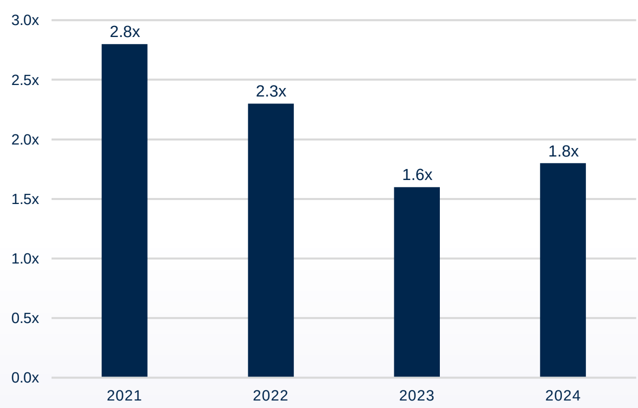
So how did we go from bartering livestock to deferring cash interest payments? The utilization of PIK gained traction in the 1980s in connection with subordinated debt, although senior lenders also started adopting the use of PIK in the years leading up to the Global Financial Crisis ("GFC"). More specifically, in exchange for paying a slight premium, borrowers could elect to convert a portion of their cash interest payments to PIK — commonly referred to as "PIK Toggle". Not surprisingly, most of these borrowers chose to use the "toggle" as the economy was collapsing — S&P found that by mid-2010 nearly 75% of PIK toggles had been exercised for at least one interest payment, as cited in the Wall Street Journal.

The use of PIK can be valuable to borrowers given that it provides flexibility to reduce cash expense during uncertain or troubled times; however, it also results in additional debt accumulating on borrowers that might be over-leveraged and struggling to service their existing debt. To that end, a study conducted by Moody's in late-2010 found that companies with a PIK toggle feature had a ~30% default rate in 2009 compared to a ~17% default rate for comparable companies without PIK.

After the GFC, the use of PIK was used more sparingly by senior lenders, largely driven by lack of necessity in the ultra low-interest rate environment. However, as the Fed started to rapidly increase interest rates in recent years, borrowers' cash flows became strained amidst heavy debt loads which is evidenced by the sharp decline in interest coverage ratios outlined in Figure 1.

FIGURE 1:

Interest Coverage Trends



Source: Fitch Ratings | Privately Monitored Ratings

In light of these trends, the use of PIK has been on the rise again in recent years. According to Lincoln International's proprietary market database, the percentage of investments using PIK has steadily increased from 6.8% in Dec-22 to 11.4% in Jun-25. Moreover, a recent private credit survey conducted by Configure Partners suggests that this trend in PIK usage will continue given that 22% of new loans issued by survey participants in Q1-25 included a PIK option, which is up from 14% in Q4-24.

The use of PIK tends to be more prevalent in larger market deals where structures can be more aggressive and legal documentation is typically looser compared to deals in the lower end of the market. This dynamic can be seen in Cliffwater's Direct Lending Index ("CDLI"), which is based on a robust dataset across both the Upper Middle Market ("UMM") and the Lower Middle Market ("LMM").[1] More specifically, when assessing "PIK Income as a % of Total Investment Income" amongst lenders in the CDLI database, it reveals that lenders in the UMM are utilizing PIK to a much greater degree than lenders in the LMM (see Figure 2 below). Since 2019, UMM lenders have an average of ~8.4% of their investment income generated from PIK, compared to only ~4.8% for LMM lenders over the same period.[2] Several managers have reported PIK as a share of total interest income in excess of 10%, with some even exceeding 15%. For reference, NXT Capital's PIK income is less than 2% of its overall interest income.

Given this backdrop, it is important to understand how various lenders approach the utilization of PIK for both new deals and restructuring existing portfolio accounts.

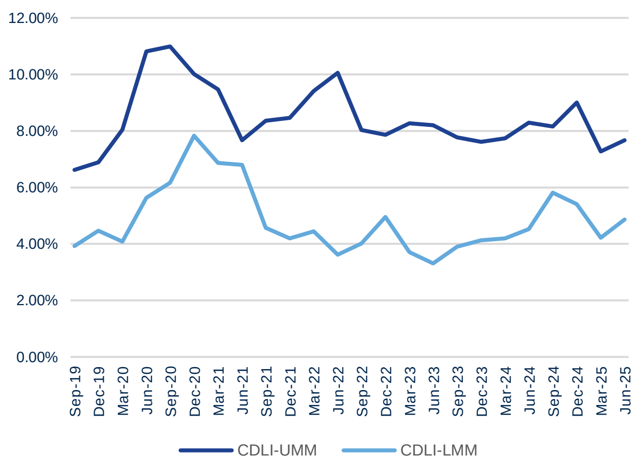
- New Issuances: NXT Capital has always avoided the inclusion of PIK on newly issued loans. PIK at close can lead to overly aggressive loan structures, potentially delay lenders' ability to get back to the table in a distressed scenario, and accretion of PIK leads to a structural increase in funded debt over time.

- Restructurings: As it relates to managing off-track accounts, NXT Capital will *selectively* utilize PIK as a strategic tool in connection with a more comprehensive restructuring. When doing so, NXT Capital focuses on the sponsor contributing incremental capital to support the business. NXT Capital will typically: (1) only PIK a portion of the interest expense (i.e. keep a majority of interest cash pay); (2) include a sunset on when the PIK will revert back to cash interest (i.e. varies by situation, but PIK is viewed more as a temporary fix as opposed to a long-term solution); and (3) increase the all-in pricing (i.e. PIK tends to be additive to the all-in yield).

FIGURE 2:

PIK Income as a % of Investment Income

(Upper Middle Market vs. Lower Middle Market)



Source: Cliffwater Direct Lending Index

Using history as a guide, the reemergence of PIK in recent years should warrant heightened attention and lead to further assessment of lenders' underlying strategies to ensure bigger problems are not being masked. Since inception in 2010, NXT Capital has maintained a consistent and prudent approach with PIK, which has served its investors, sponsors, and borrowers well over the years. More specifically, NXT Capital uses PIK as part of a more comprehensive restructuring solution in which all stakeholders are making contributions — including incremental capital from the sponsor. The success of this approach is further supported by NXT Capital's position in the Lower Middle Market, which is a segment that generally provides better protections through a combination of: (1) inclusion of financial maintenance covenants; (2) more frequent delivery of financial information; (3) direct access to management; (4) tighter terms in legal documents; and (5) the opportunity to hold a meaningful portion of the credit facility, designed to provide adequate representation on all matters.

[1] "Lower Middle Market" is defined as <$40 million of EBITDA | "Upper Middle Market" is defined as >$100 million of EBITDA.

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