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PIK Interest in Private Credit - What Lenders, Borrowers and Equity Investors Should Know

In today's private credit market, an increasing number of loans are being structured or amended to include Paid-In-Kind (PIK) interest features. While traditional commercial and ABL loans generally require cash interest payments, PIK interest features allow borrowers to add interest to the loan principal instead of making cash payments. This trend has become particularly prominent in venture debt transactions over the past eighteen months, as borrowers seek to preserve cash and extend runways, and lenders look for alternatives when immediate liquidity prospects are limited. While PIK interest can be beneficial, it also introduces complexities and risks that lenders, borrowers and equity investors should consider.

Understanding PIK Interest - The Basics

PIK interest is a financing mechanism whereby the borrower does not pay cash interest on a loan, but instead adds the interest at an accrual rate to the principal balance of the loan. This is in contrast to traditional interest payments, where borrowers pay interest in cash at regular intervals, typically monthly or quarterly. PIK interest can be structured in several ways, including (1) full PIK, where PIK interest represents the entirety of the interest payable, (2) split PIK, where PIK interest represents a portion of the interest payable, and the remainder is cash interest, and (3) toggle PIK, where the borrower has the option to switch between cash and PIK interest if certain conditions are satisfied. PIK may also be paid in the form of securities or other property, but predominantly PIK will be accrued and added to the principal balance of the loan in regular intervals (monthly, quarterly or annually).

The result of accruing and compounding PIK interest is that the principal balance of the loan continues to grow, as do the required cash interest or PIK payments over the life of the loan. For example, if a borrower has a \$100 million loan with an 8% cash interest rate, in a typical year, the borrower would make quarterly payments totalling \$8 million in cash interest. However, if a borrower has a \$100 million loan with 8% full PIK interest, the borrower would not make any cash interest payments and would instead add \$8 million of interest to the loan's principal, so that the new principal amount for the following year would be \$108 million. Interest would subsequently be calculated on the increased principal, compounding over time, and potentially rapidly growing the outstanding principal balance. As a result of the growing loan balance, the challenge to pay off the loans or refinance the loans with replacement debt is greater, since the loans are increasing in amount (and in most cases, not amortizing). This also raises issues for equity investors, discussed below, as the principal loan increase is dilutive to their interests.

Triggers, Toggles, Premiums and Availability Periods

When structuring PIK interest provisions, lenders may incorporate triggers that automatically require borrowers to discontinue PIK interest and resume making cash interest payments, sometimes called mandatory return to cash pay triggers. These triggers allow a lender to benefit from improved borrower performance, and may include (i) a liquidity event, such as where an equity financing round exceeds a specified dollar threshold, (ii) achievement of revenue milestones for one or more periods, or (iii) maintenance of a minimum cash balance for one or more periods.

PIK toggle features can also be tied to performance metrics to allow borrowers to switch between PIK interest and cash pay interest based on predefined performance metrics. For example, for pre-profit venture companies, toggles can tie to projected cash runway; perhaps if the company's runway falls below six months, the company can elect PIK; but when runway exceeds nine months, cash pay may resume. This can help venture companies navigate a crisis and ensure that lenders participate in improved liquidity positions. Importantly, lenders typically receive a premium, or PIK toggle spread, when the borrower elects to make interest payments in kind rather than in cash. This premium, which can be as low as 50 basis points above the cash pay interest rate, both compensates the lender for increased risk and discourages borrowers from unnecessarily choosing to make interest payments in

kind. The amount of the premium varies depending on various conditions, including the borrower's financial condition, the length of the PIK availability period, and market conditions.

Interest payments can toggle to part PIK and part cash (a partial toggle). For example, interest for one period can toggle to 60% cash and 40% PIK. With a partial toggle, the premium may only apply to the portion of the interest payment paid in kind, which can create more nuanced alignment between the borrowers and lenders.

Lenders and borrowers also carefully negotiate the duration of PIK availability periods to prevent excessive principal growth and to maintain pressure on borrowers to improve performance. PIK availability period limitations may be relative, absolute or both. The PIK availability period might have a fixed duration cap, perhaps between six and twenty-four months, depending on the borrower's circumstances and industry. PIK availability periods also (or alternatively) might be tied to a specific milestone, such as a few months after the approval of a key drug or the launch of a new product or the creation of material customer contracts. This approach aligns the PIK availability period with the borrower's business plan and anticipated value creation events.

Why Borrowers May Need PIK Options

PIK interest structures can benefit borrowers in various situations, including where borrowers have significant growth potential but temporary cash constraints, need to conserve cash in periods of underperformance, or face a lack of equity funding or uncertain liquidity options.

Private credit markets serve a unique segment of borrowers who fall outside traditional commercial or ABL lending channels and have distinctive characteristics that set them apart from conventional commercial loan candidates. Specifically, they may require large acquisition or growth capital and frequently need to raise significant equity to achieve profitability. Moreover, their management teams might lack experienced financial operators, and they may be in emerging industries with unproven technologies or products. These factors significantly limit their financing alternatives, especially when experiencing cash flow constraints while carrying debt.

The current economic landscape presents substantial challenges for these borrowers. Many are struggling to raise equity capital at valuations that the embedded equity investors will approve - if such equity is available at all. The persistent high-interest rate environment further complicates their financial situation by inhibiting refinancings. Loans originated in the venture debt markets over the past 18-24 months are particularly vulnerable, as venture borrowers attempt to preserve cash while simultaneously facing declining equity valuations. These companies sometimes miss critical performance, equity, or liquidity milestones in their loan documents, which compounds their financial stress. They are simultaneously battling amortization payments and an inability to find suitable exit transactions or raise additional capital. Such challenges are at odds with their debt service burdens, including looming maturity dates.

In response, to support these borrowers, lenders may provide a PIK interest feature combined with extended amortization and maturity timelines. This strategy effectively accomplishes two key objectives: it provides immediate relief from debt service requirements while offering borrowers a longer-term opportunity to improve performance or find a viable exit strategy. By essentially "providing cash" to borrowers, lenders create a supportive path to potential repayment, albeit with the understanding that risks are not entirely eliminated. This approach represents a collaborative method of addressing financial constraints, allowing both lenders and borrowers to navigate challenging economic conditions. It also, as discussed below, shifts additional risk to the equity holders.

Considerations for Lenders when Providing PIK Amendments

When dealing with underperforming borrowers, lenders must carefully evaluate their strategic options. PIK amendments provide lenders with a mechanism to provide extended support while not deploying additional capital, and without lenders taking on risks and costs associated with foreclosure or other remedies. Some lenders may combine the PIK amendment with additional bridge financing if full exits or other liquidity transactions are in sight but there is a lack of operating capital available in the short term. These financings usually come with enhanced economics and are fully secured with the original loans.

Traditional Remedies Versus Flexible Extended Support

While traditional remedies like seizing collateral or cash might seem appealing, these actions need to be weighed against the potential benefits of extending a borrower's runway until an equity capital event or exit can be consummated. Although lenders possess various enforcement tools in distressed situations, preserving enterprise value through continued operations often proves more beneficial than exercising rights and remedies that could diminish collateral value, damage the business or be frustrated by a bankruptcy filing.

Venture lenders operate under a distinctly different and more flexible model than traditional commercial lenders. Rather than focusing exclusively on balance sheet assets like accounts receivable and inventory, venture lenders focus on the enterprise value of their borrowers. Venture lenders also often engage with borrowers in a more flexible manner than traditional commercial lenders. Venture lenders and borrowers can maintain cooperative relationships in crafting an appropriate PIK structure with tolerable risk and compensation for the lender, which can ultimately lead to higher returns to the lender than traditional secured creditors remedies.

While PIK features do address many issues for lenders, creating PIK does add to the overall repayment obligation on an otherwise underperforming loan. As such, private lenders also need to consider the risks of continuing to carry underperforming loans that are increasing in principal value in their portfolio, including pressures on NAV or an inability to borrow against PIK accrual loans under the fund's warehouse and leverage facilities. All of those

matters have to be balanced in considering short and long -term solutions for recovery when borrowers need cash but cannot raise equity or refinance their loans.

Implications of PIK for Equity Holders

PIK interest provides immediate cash flow relief for borrowers, but it can create challenges for equity holders. The increased debt level leads the borrowers' equity holders to face dilution. In an exit, more proceeds will be allocated to the senior debt payoff (including any returns on bridge financings). This dynamic reduces the return on equity, particularly in low value exits. Furthermore, the compounded PIK can also result in a lower equity valuation in a priced financing round, as new equity investors must consent to the use of their proceeds to pay off senior loans or restructure them - returning to cash interest and amortization payments (or refinancing them altogether). In some ways, PIK can be thought of as "synthetic equity," creating several economic challenges for investors: dilution without the benefit of dilution protections, negative valuation implications and disagreements inside the board as to how to evaluate potential exits.

One obvious solution for equity holders is to fund the cash needs themselves, but often syndicates are fatigued and, as mentioned above, borrowers in the private credit space may not have financial expertise or professional investors at the board level who would fund the shortfalls or be able to find new investors. Conversely, borrowers that are backed by very large venture capital or private equity funds may find that their investors prefer to walk away, rather than spend bandwidth or capital on companies that will not provide significant exits for their funds. As such, lenders are often asked to provide the "equity" by converting to PIK, although this can diminish the return on equity sitting lower in the capital stack.

Naturally, this sets up a difficult dynamic between the lender and the equity investors who both must ultimately approve a borrower's exit transaction. Lenders are not required to take a discount on their debt and are understandably reluctant to do so if they have been patient and assumed higher risks by extending PIK terms. On the other side, investors are reluctant to deviate from their negotiated waterfalls or to provide management carveouts or exit success bonuses if their full capital or anticipated returns are unlikely to be realized.

When the borrower's board of directors must approve an exit transaction, if the board is populated with investor representatives and founders, there would be a natural hesitation to vote against their economic interest despite their statutory duties. Also, most investor-backed companies have some sort of voting requirements to approve exit transactions which can place disproportionate voting power with specific investor groups (or even a single investor group). This means that lenders can and should maintain working relationships with all major equity stakeholders, especially if they are considering extending the cash runway by providing a PIK feature. Lenders should also understand the nuances in the investor documentation with respect to voting rights, board representation rights and sale mechanics including drag-along rights.

Using PIK With Troubled Borrowers - the Upshot

PIK structures carry inherent risks and benefits for all parties involved. Lenders, borrowers and equity investors should keep in mind these key considerations:

- While making interest payments in kind rather than in cash provides a temporary extension to a borrower's cash runway, it also causes rapid elevation of loan amounts - creating greater hurdles for exits and refinancings
- PIK can be dilutive to equity holders, especially when coupled with interim bridge financing leading to an exit
- Using PIK can provide time to work towards a suitable exit - but the potential lack of significant returns to equity holders who are further down in the capital stack may cause delays in approving exit transactions while the lender's loans remain at risk
- PIK has to be balanced against the likelihood of achieving sufficient returns through the use of lender's rights and remedies against collateral, as well as the effect that PIK accrual loans may have on the lender's portfolio including compliance or borrowing under warehouse and leverage lines

When borrowers, especially in the venture space, partner with a flexible and patient lender, the founders and investors may achieve positive outcomes using PIK structures in challenging environments.

authorsTest

jennifer

Jennifer A. Post

steve

Steve R. Schwartz