Of Principal Interest

Credit Market Insights by Antares

Synthetic PIK – What is it and should investors be concerned?

Cash is fungible and synthetic PIK may be no worse than traditional PIK from a credit perspective, but synthetic PIK is not reported as PIK and therefore could mask brewing credit issues for some lenders.

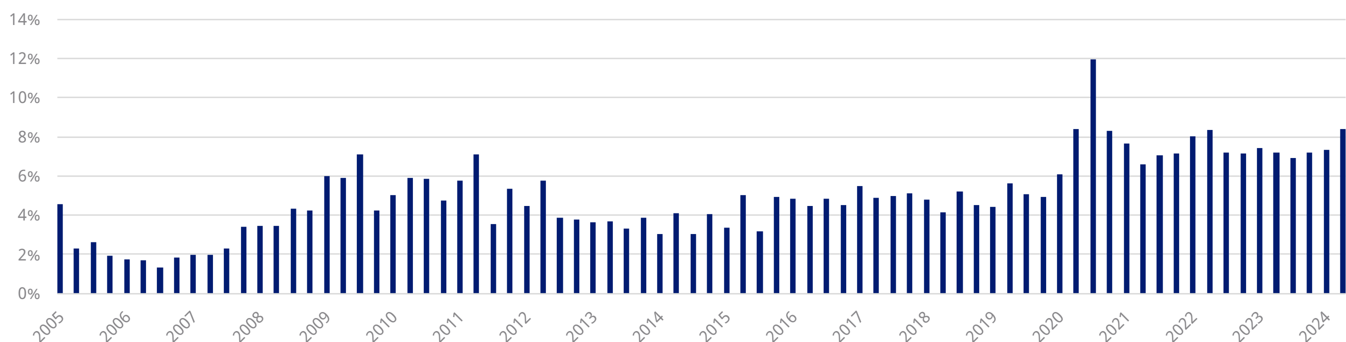
ABCs of PIK

"PIK" stands for "Payment In-Kind" and is an option that can be granted to borrowers that allows them to make part or all of their interest payments over a period of time by adding to their principal due at maturity instead of making cash-based interest payments. Offering a PIK option can be a competitive advantage for direct lenders because PIK is far less common in the broadly syndicated loan (BSL) market.

Sometimes, a PIK option is included upfront at the initial origination of the loan to allow borrowers greater flexibility to pay back debt. Exercising a PIK option comes with a premium, but borrowers may judge the extra cost to be worthwhile in certain circumstances. For example, although a fast-growing tech company may have the ability to cut their marketing and R&D costs to make their interest payments, they may judge that they are better served incurring the extra cost to PIK their debt so as not to detract from investment in their future growth. This might be deemed a "healthy" use of PIK and would not be deemed to be a default by a credit rating agency.

In other cases, a PIK option is included via an amendment in the wake of current or anticipated cash flow stress with the aim of helping the borrower avoid payment default. The ability to constructively negotiate such relief (often with injections of equity and additional fees) is part of private credit's appeal to borrowers vs. public markets. However, PIK in this case reflects credit stress that would typically result in the mark down of a loans valuation.

Chart 1: CDLI PIK % of Total Income has been elevated of late suggesting credit stress has risen.



Source: Cliffwater Direct Lending Index

From a credit perspective, PIK exercised from existing loan document terms tends to be less worrisome than PIK exercised out of necessity to avoid default; however, high levels of PIK in either case could be a cause for concern for loan fund or BDC's creditors and investors insofar as it suggests potentially heightened credit stress and lower cash based net investment income (NII) to repay bank debt and cover investor dividends. In a report dated September 3rd, 2024, from Fitch titled "BDC Cash Income Dividend Coverage Pressured by Payment-in-Kind Income", Fitch notes:

"BDCs are required to distribute 90% of taxable income, including PIK interest, and increasing PIK interest income could result in mismatches between cash interest received and cash dividends paid out."

18 of the BDCs Fitch rates had cash dividend coverage levels below 100%, with some even below 80% coverage. "Sustained cash earnings coverage below 100% is viewed negatively."

"Collections of PIK income underwritten at origination will be higher than PIK income resulting from amendment activity, but this has not yet been proven given the rise in underwritten PIK in recent years and limited exits of these investments to date."

Enter Synthetic PIK…the new turkey bacon?

In contrast to traditional PIK, synthetic PIK allows borrowers to pay interest in cash instead of making a non-cash "in kind" payment. This is achieved by creating a smaller delayed draw term loan - also known as the synthetic interest payment facility (SIPF) – for the explicit purpose of allowing the borrower to draw down funds to pay cash interest on the primary loan. The SIPF is typically "pari passu" with the primary debt tranche, but the exact pricing, fee arrangements, and other terms of synthetic PIK deals can vary significantly. Most appear to be offered in the upper middle market transactions vs. core or lower middle market at present.

Some lenders lament the use of the term "synthetic" as having a pejorative connotation of ill-conceived financial engineering and note that not all "synthetic" things are necessarily less healthy (like turkey bacon vs. pork bacon). At least from a lender perspective benefits of synthetic PIK include:

- Interest payments in cash improves cash NII dividend and interest coverage ratios.
- Avoiding the trigger of a bank's or debt facility provider's cap on PIK that could limit a fund's access to leverage.

PIK your poison

Antares acknowledges that cash is fungible and that the pure credit impact of synthetic vs. traditional PIK on a stand-alone basis is immaterial (all else equal on terms); however, in either case, high levels of PIK remains a cause for concern (e.g. turkey bacon may be no worse than pork bacon, but that's not to say it is health food). There is good reason why most traditional revolving credit and DDTL facilities restrict borrowers from drawing down funds to pay interest. Moreover, synthetic PIK is not reported as PIK and therefore its use may mask underlying credit problems that are not adequately reflected in loan valuations.

While Antares believes offering flexibility to borrowers is a hallmark of private credits value proposition, this consideration must be balanced against the requirements of sound credit management and stakeholder transparency.

Disclosures

The materials presented herein are provided to you solely for informational purposes and unless otherwise indicated herein, has been prepared using, and is based on, information obtained by Antares Capital ("Antares") from publicly available sources. It does not constitute an agreement, or an offer, commitment to offer, or agreement to sell any loans, securities or other assets including interests in any fund or vehicle. The materials contained herein are not intended, nor should they be construed or implied, to be a recommendation or advice of any kind. The information set forth herein has been compiled as of the date(s) noted, is preliminary and subject to change. There is no obligation on the part of Antares to update the information provided herein after the date hereof. Neither Antares nor any affiliate thereof represents or warrants the accuracy, completeness or reliability of any of the materials contained herein, either expressly or impliedly, for any particular purpose, and shall have no duty to update or correct any such information. Without in any way limiting the generality of the foregoing, you understand that certain of the information provided herein is based on information provided by third parties, and neither Antares nor any affiliate thereof makes any representation or warranty regarding the accuracy, completeness or reliability of any such information. In no event will Antares be liable for any losses or damages arising from or as a result of the use of the information or the materials contained herein.

Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Antares believes that such information is accurate and that the sources from which it has been obtained are reliable; however, none of Antares nor any of its affiliates or agents can guarantee the accuracy of such information and they have not independently verified and are not responsible for any inaccuracies, omissions and outdated information contained in such third-party information or the assumptions on which such information is based. Certain other information regarding market analysis and conclusions could be based on opinions or assumptions (including those of Antares) that Antares considers reasonable. Unless otherwise indicated, such market analysis and conclusions represent the subjective views or beliefs of Antares.

The materials presented herein may include certain projections, forecasts and estimates that are forward-looking statements. Any such forward looking statements are based on certain assumptions about future events and are subject to various risks and uncertainties. Forward-looking statements are necessarily speculative in nature and it should be expected that some or all of the assumptions underlying them will not materialize or will vary significantly from actual results. Accordingly, actual results will vary from the projections, and such variations may be material. Some important factors that could cause actual results to differ materially from those in any forward-looking statements contained in these materials include, without limitation, changes in interest rates, default and recovery rates, market, financial or legal uncertainties, the timing of acquisitions of loans, the types of loans acquired, differences in the actual allocation of loans from those assumed mismatches between the time of accrual and receipt of interest proceeds from the loans and whether or not and how loan investments may be leveraged.

Any statements involving matters of opinion or estimates, whether or not so expressly stated, are set forth as such and not as representations of fact, and no representation is made that such opinions or estimates will be realized. The statements and expressions of opinion contained in this presentation are subject to change without notice and involve known and unknown risks, uncertainties and other factors, and undue reliance should not be placed thereon nor should they form the basis of an investment decision.

For Benefit Plan Investors

Not in limitation of the foregoing, if you are (or are acting on behalf of) a person that is a "benefit plan investor", as defined in Section 3(42) of ERISA and DOL regulations ("Benefit Plan Investor") you are not authorized to, and should not, rely on any information Antares is providing to you as a basis for, or otherwise in connection with, making a decision whether or not to invest with Antares. Antares has not provided and will not provide any investment advice of any kind whatsoever (whether impartial or otherwise) and Antares is not acting as a fiduciary, within the meaning of Section 3(21) of ERISA, and regulations thereunder, to the Benefit Plan Investor or to any fiduciary or other person making investment decisions on behalf of the Benefit Plan Investor, in connection with these materials or any related presentation.

Additional Matters and Important Information for All Non-U.S. Investors

An interest in products or services referenced in this presentation may not be licensed in all jurisdictions, and unless otherwise indicated, no regulator or government authority has reviewed this document or the merits of the products and services referenced herein. If you receive a copy of this presentation, you may not treat this as constituting a public or other offering and you should note that there may be restrictions or limitations to whom these materials may be made available. This presentation is directed at and intended for institutional investors (as such term is defined in the various jurisdictions). This presentation is provided on a confidential basis for informational purposes only and may not be reproduced in any form. Before acting on any information in this presentation, recipients should inform themselves of and observe all applicable laws and regulations of any relevant jurisdictions. Recipients should inform themselves as to the legal requirements and tax consequences within the countries of their citizenship, residence, domicile and place of business with respect to the ongoing provision of services, and any foreign exchange restrictions that may be relevant thereto. Antares does not accept any responsibility, nor can be held liable for any person's use of or reliance on the information and opinions contained herein. Any entity responsible for forwarding this material to other parties takes responsibility for ensuring compliance with applicable securities laws.

Notice to persons in the European economic area and the United Kingdom

This presentation is being made available: (1) to persons in the European economic area only if they are professional investors as defined in the Alternative Investment Fund Managers Directive (2001/61/EU); and (2) to persons in the United Kingdom only if they are professional investors, as defined in the Alternative Fund Managers Regulations 2013 and fall within the following categories of exempt persons under the Financial Services and Market Act (Financial Promotion) Order 2005 (the "FPO") and the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "CISPO"): (i) persons who are investment professionals, as defined in article 19(5) of the FPO and article 12(5)of the CISPO; (ii) persons who are high net worth companies, unincorporated associations etc., as defined in article 49(2)(a) to (d) of the FPO and article 22(2)(a) to (d) of the CISPO; or (iii) persons to whom it may otherwise lawfully be communicated. This presentation is provided for informational purposes only and does not constitute as offer to purchase, acquire, or subscribe for any type of investment.