

# PIK income in private debt

Strategic flexibility or hidden fragility?



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## PIK and choose

As the private debt market grows in sophistication and systemic importance, the structures underpinning its transactions are becoming increasingly complex.

One such structure, payment-in-kind (PIK) income, has emerged as a contentious yet increasingly common tool.

While PIK income offers flexibility and higher yields, it can mask underlying credit stress.

We examine the dual nature of PIK income, exploring when it is used as a proactive structuring tool and when it serves as a red flag for deeper issues.

The study draws on current market data and recent deal activity to help investors differentiate between tactical innovation and brewing risk.

## Why PIK

PIK interest allows borrowers to delay cash interest payments by capitalising them, i.e., adding unpaid interest to the principal balance.

For lenders, this boosts nominal yield, while for borrowers, it conserves liquidity.

Unlike cash payments, however, this income remains unrealised until the loan matures or is refinanced.

## The surge

According to Moody's, 7.4% of income reported by private debt funds (based on listed business development companies) came in the form of PIK in the second quarter of 2024 — the highest level since the firm began tracking the metric.

Bank of America estimates it to be even higher at 9% with 17% of loans having optional PIK features.

Leading the pack in PIK income were:



Source: Bank of America

Encouragingly, over 90% of these PIK loans were structured as such from the outset, suggesting a deliberate design rather than emergency relief.

## Use case 1: Strategic PIK in growth-focused deals

In sponsor-led buyouts, PIK is often embedded at origination to support transformation plans or capital-intensive expansion strategies. For instance:

- Beauty Industry Group, backed by L Catterton, negotiated a PIK structure with Blue Owl that allowed ~20% of interest payments to be deferred, freeing up working capital as the company scaled up its distribution footprint
- Avalign Technologies, owned by Linden Capital, amended its agreement with Ares to PIK up to 30% of interest payments, allowing the company to reinvest in R&D and manufacturing enhancements

These deals demonstrate how structured PIK can support long-term value creation, particularly when sponsors and lenders are aligned on the business plan.

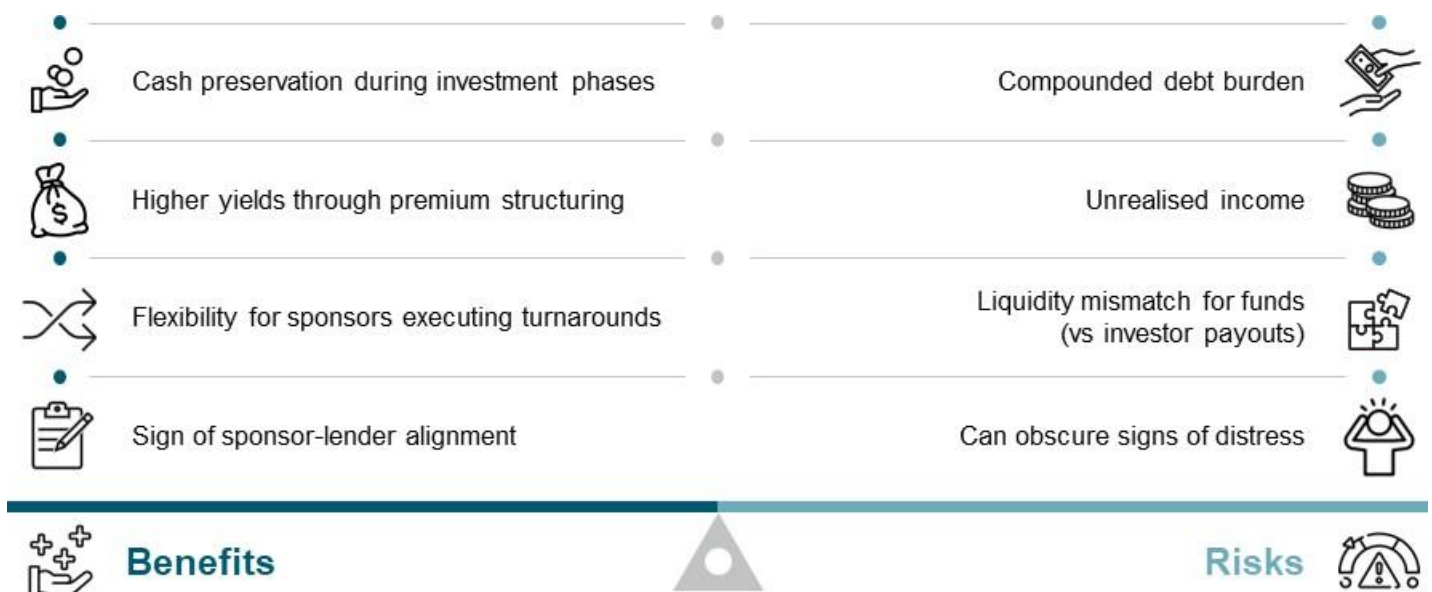
## Use case 2: PIK as a red flag for credit deterioration

PIK also has a darker side, often signalling liquidity stress when applied retroactively through amendments. For example:

- Khoros, a Vista Equity Partners portfolio company, began deferring all interest payments in early 2024 at an interest rate of over 16%, prompting lenders to classify the loan as troubled as business fundamentals declined
- Envision Healthcare, a KKR-backed healthcare group, used PIK amendments as a stopgap measure in the run-up to its 2023 bankruptcy, resulting in unpaid capitalised interest and significant losses for many lenders

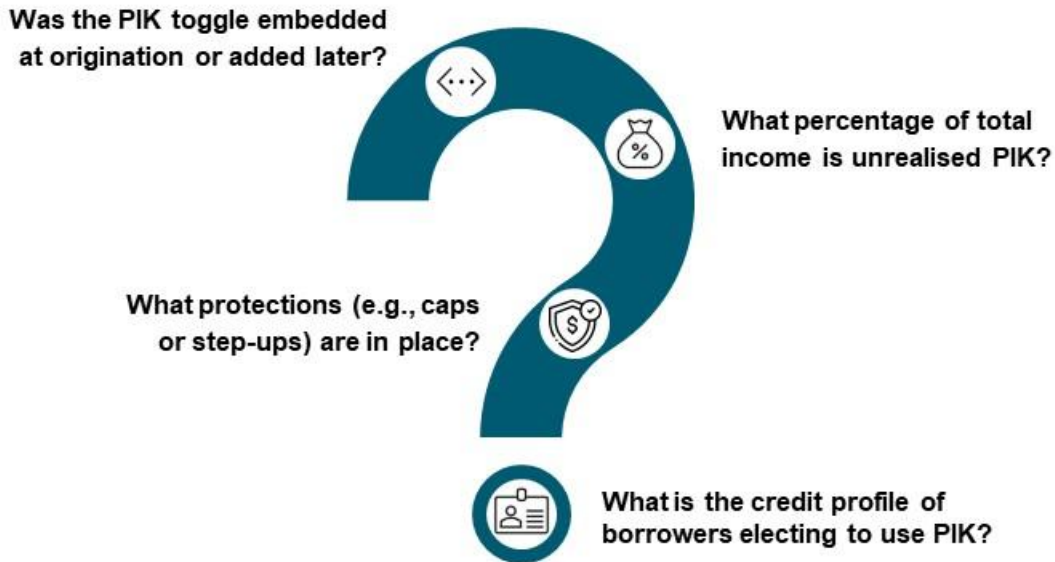
These cases highlight the risks of using PIK to avoid default rather than enable strategic reinvestment –deferred interest accrues and, eventually, must be paid.

## Balancing the PIK-equation



## What investors should watch out for

For allocators and fund investors, the presence of PIK income in private debt should prompt deeper diligence, rather than panic. Key questions to ask include:



Remember, PIK income can inflate short-term internal rates of return (IRRs) without necessarily increasing cash flows or reducing default risk.

## Upper vs lower middle market

Interestingly, upper-middle-market borrowers (with EBITDA >\$100 million) exhibit higher rates of structured PIK usage than their lower-middle-market counterparts.

This contradicts the common assumption that smaller, riskier companies are more reliant on PIK.

Larger companies utilise PIK more frequently as they:



This further reinforces the notion that context is everything.

## **PIK not a crutch, but a tool**

PIK income is a tool, neither inherently good nor bad. When used intentionally, with the right structures and safeguards in place, it can be a smart way to balance short-term flexibility with long-term returns.

That said, when relied upon as a crutch to avoid default or conceal underlying weaknesses, it can create cascading risks.

As the private debt market scales up and regulators and allocators increase their scrutiny, the ability to distinguish between strategic PIK and stress-driven PIK will become crucial for underwriting, performance, and portfolio stability.

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