PennantPark

Payment In Kind Concerns? PIK Your Managers Wisely

August 2025

- **PIK can provide borrowers with temporary flexibility, but when it grows beyond modest levels it becomes a signal of underlying credit stress and heightened repayment risk**
- **With nearly half of BDCs reporting PIK income above 5%, investors must look past headline yields to understand the true quality of earnings**
- **PennantPark's safety-first approach emphasizes resilient companies with strong free cash flow, keeping PIK exposure minimal and focused on delivering sustainable, high-quality yields**

I. Introduction to Payment in Kind (PIK)

PIK is a financing mechanism that allows borrowers to pay interest with additional debt rather than cash. While this tool can temporarily relieve liquidity pressure, it does so by increasing future repayment obligations and repayment risk.

Historically, PIK was primarily associated with distressed credit. Today, however, given elevated corporate leverage and the higher cost of debt in an elevated interest rate environment, many private credit managers are increasingly introducing PIK even into senior loan structures.

As a measure of risk, PIK levels are also a meaningful measurement for investors to review. While it's important to monitor non-accruals in a portfolio, reviewing PIK interest provides a more well-rounded view of overall risk. And since non-accrual definitions can vary across sponsors and managers, PIK levels are uniformly defined and required to be reported.

II. PIK as a Temporary Cushion and a Risk Multiplier

PIK is sometimes used to help companies preserve liquidity and avoid technical defaults. While this may provide short-term relief, it does not resolve the underlying issue. PIK accruals increase leverage, leaving companies more vulnerable to future repayment challenges.

This dynamic can make reported yields appear strong because managers recognize PIK as income. However, no real cash is generated and debt simply grows larger. For investors focused on capital preservation, the key is distinguishing between limited, manageable use of PIK and systemic reliance that masks deeper weakness.

III. Types of PIK Exposure

PIK can take different forms depending on the credit health of the borrower and the lender's objectives.

At the onset of a loan, lenders may allow a borrower to choose between paying interest in cash or in-kind. This "toggle" structure gives flexibility during periods of heavy investment, growth, or volatility.

When a company's credit profile deteriorates, lenders may require interest to be paid in-kind because cash interest is no longer feasible. This mandatory PIK structure is often a red flag of weakening fundamentals.

More recently, some managers have adopted "synthetic PIK," where a small revolver or delayed-draw facility is provided alongside the main loan. Borrowers draw on this facility to pay interest, creating the appearance of cash payments while effectively adding new debt. Because it obscures stress and inflates leverage, synthetic PIK warrants the same caution as traditional PIK.

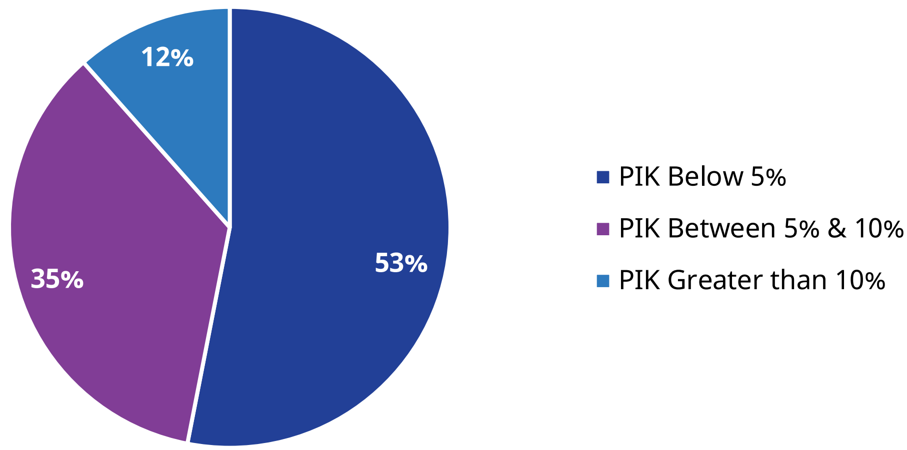
IV. Understanding PIK Levels

The impact of PIK depends less on its presence and more on its scale. A modest allocation can be consistent with healthy credit fundamentals, particularly when tied to temporary borrower needs. In those cases, PIK provides short-term flexibility without materially changing the overall risk profile.

Concerns arise when PIK grows beyond the low single digits of portfolio income. Once it reaches 10%-15% or higher, it signals that borrowers are relying on debt rather than operating cash flow to service obligations. Reported yields may remain steady, but they are supported by non-cash accruals that compound leverage and increase repayment risk.

As of Q2'25, nearly half (47%) of Business Development Companies (BDCs) reported PIK income as a percentage of total interest income above 5% and 12% of BDCs reported PIK levels above 10%[1]. These figures highlight how widespread non-cash income has become and why vigilance around PIK levels is essential for capital preservation.

Share of BDCs with PIK Income as % of Total Income[1]

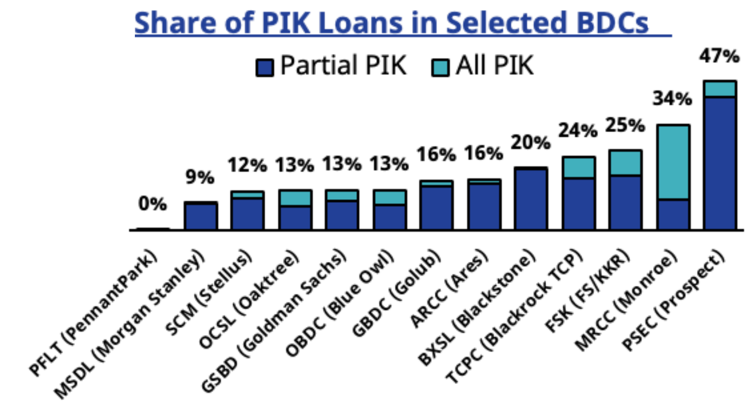


Source: LSEG LPC's Middle Market Connect 2Q25 BDC Analysis.

While PIK exists across all segments of the private credit market, its usage and implications can vary meaningfully. In the upper middle market, where deal sizes are larger and competition among lenders is more intense, underwriting discipline has often given way to "chasing deals." By contrast, the core and lower middle market tend to reflect stronger underwriting standards and closer lender-borrower relationships. Sponsors and lenders in this segment often negotiate more robust covenants and maintain a greater focus on real cash flow generation. These dynamics make it easier to detect early warning signs and limit over-reliance on PIK.

V. PIK Your Managers Wisely

At PennantPark, our investment philosophy is clear: safety comes first. We focus on lending to leading companies in defensive industries such as Government Services, Business Services, and Healthcare. These are businesses with durable models and strong free cash flow generation. By emphasizing resilient borrowers, we minimize the need for non-cash income and reduce exposure to systemic reliance on PIK. In line with our conservative approach, our exposure to PIK loans remain below 3% across our senior debt strategy (PFLT), significantly lower than average (as of 6/30/2025).



Source: Raymond James, 2Q25 PIK Trends: Share of Total and Net Investment Income — Slight Decline Due to Defaults. Published August 28, 2025. Data shows the share of first lien loans with full or partial paid-in-kind coupons across selected funds in Raymond James's BDC coverage universe. Share of PIK exposure for additional BDCs in Raymond James's coverage universe is available upon request.

At PennantPark, we prioritize stable and cash-flowing borrowers and maintain limited exposure to PIK loans. In fact, PennantPark Floating Rate Capital Ltd. (NYSE: PFLT) had virtually no exposure to PIK loans as of 6/30/2025, according to a recent Raymond James research report. In contrast, some lenders now generate more than 25% of their investment income from full or partial PIK loans.

Just as private credit managers must be selective in the loans they originate, investors must be equally selective in choosing their private credit partners. Too often, headline yields are supported by rising levels of PIK rather than true cash generation. This is particularly important today: nearly 95% of private credit managers came to market after the Global Financial Crisis*, an era defined by low interest rates and unusually low default levels. That backdrop no longer applies. We are now in a higher-rate, more volatile credit environment where experience, discipline, and a focus on capital preservation are essential.

Investors should look closely at whether managers are relying on PIK to support reported performance or whether they are building portfolios of companies that consistently generate the cash needed to service debt. Choosing a conservative, battle-tested manager with historically low PIK exposure is the best hedge against elevated PIK and the repayment risks it represents.

We welcome a conversation; please contact invest@pennantpark.com or the professionals listed below.

About PennantPark:

PennantPark is an independent middle market credit platform founded in 2007 by private credit industry veteran Art Penn (Co-Founder and former Managing Partner at Apollo Credit). As of 2025, PennantPark has invested over $26 billion in over 780 private credit transactions since its inception. Our clients include some of the world's largest and most sophisticated institutional investors. We are in the process of expanding our offerings to focus on the private wealth market. The Firm is headquartered in Miami and has additional offices in New York, Chicago, Houston, Los Angeles, Amsterdam, and Zurich. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. PennantPark is an experienced manager of BDCs, LP drawdown vehicles, CLOs, SMAs, and joint ventures.

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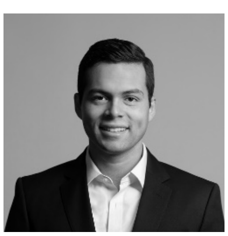

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