Proskauer

Private Credit Deep Dives – PIK Toggles (Europe)

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At the start of June 2022, the prevailing rate for the sterling overnight index average (SONIA) was 0.94%. Just 12 months later, SONIA has risen to 4.43%, and comparable increases in the equivalent reference rates have been seen both in the US and in the Eurozone. This has represented the fastest ramp-up in interest rates since at least the 1980s, and on an absolute basis has pushed rates to their highest level since the Great Financial Crisis. For borrowers of floating rate debt, of which the loan market is the largest constituent part, this has meant a dramatic increase in the cost of debt service. For a borrower of a unitranche loan priced with a 7.00% margin over SONIA, for example, the overall interest burden during the aforementioned period would have increased by 44%. In highly leveraged capital structures (which became increasingly common over the preceding decade, due to the persistently low cost of debt), this has put very considerable pressure on cashflows and, in some instances, raised the prospect of potential liquidity issues. Similarly, in the case of new primary acquisition financings, stubbornly high valuation multiples (notwithstanding the higher cost of capital) are creating structuring headaches for private equity sponsors, who need to bridge the gap between the high prices demanded by vendors and the debt burden that the company in question can reasonably tolerate.

One feature of the private credit market that has historically distinguished it from the liquid credit market is its willingness to contemplate that, in certain instances and subject to certain conditions, some of the interest accruing on loans provided may be “paid in kind” (known as “PIK” interest) by being capitalised and added to the principal amount outstanding, rather than paid in cash. While on specific transactions, the deal may be structured so that some or all of the interest is at all times paid in kind (particularly if it is structurally subordinated paper), the most common formulation seen on senior private credit financings is a “PIK toggle”, which is a borrower option to pay a certain amount of interest in kind as and when the need arises. The PIK toggle exists in both European and US transactions, but it is worth noting that, in the latter, it is most commonly seen either in mezzanine facilities, or in senior secured facilities when the borrower has decreased cash flow and liquidity (i.e., as an amendment to existing economic terms, rather than something the senior lenders have agreed to right off the bat as part of a new financing).

This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer's Private Credit Group in London, will analyse how private credit providers look to regulate and limit use of this flexibility and how sponsors may look to maximise its usage in the current macroeconomic environment.

1. **Structure** – First and foremost, lenders will look to ensure that the borrower in question is an eligible candidate for a PIK toggle from a structural perspective. If it looks like the PIK feature is essentially being used to fund an unjustifiably high purchase price (by facilitating a higher level of leverage than the company can feasibly service) then that will not be likely to be palatable to a lender. However, if it is within a sector that does generally attract high valuation multiples and the sponsor is putting in a meaningful equity cheque (and there is therefore an attractive loan-to-value ratio and a healthy equity cushion sitting behind the senior debt) then that is likely to be received much more favourably. In addition, lenders will generally be more open to the prospect of a PIK toggle where there is an accretive buy-and-build strategy, as this may mean there are temporary periods of elevated leverage and reduced cash cover following debt-funded acquisitions (before synergies are realised and flow through into profitability) and the toggle may be a useful feature in such circumstances.
2. **Premium** – Allowing interest to be paid in kind constitutes an increased credit risk for a lender, as it is essentially allowing a cash revenue stream to be deferred until a later date (by which time the company’s financial position may have deteriorated). As a result, a lender will expect to receive additional compensation for allowing interest to be capitalised. There are two ways in which this is

achieved:

a. The first is inherent to the way in which PIK interest is paid. When it capitalises, it is added to the principal amount of the loan that is ultimately payable at maturity. From the point it capitalises, it therefore accrues interest (as does the rest of the principal balance of the loan) – there is therefore an "interest on interest" effect, which represents an increase in overall return for the lender.

a. The second is a negotiated term, which is any premium that might be applicable to the pricing of the loan when the PIK toggle is exercised. Some large cap sponsors will look to replicate the formulation that is commonly seen in the world of high-yield PIK notes, being that a flat premium (of 50-100 basis points, for example) is payable on top of the rate that would be payable if the interest were paid in cash. However, this remains relatively uncommon within private credit, where the approach is generally that the applicable premium will be calculated by reference to the amount of margin that is requested to be capitalised. For example, lenders may require that for every 100 basis points of margin that is to be capitalised, 25 basis points of premium will be payable (on a pro rata basis). Generally, this premium will itself be capitalised, rather than payable in cash. There are a couple of pitfalls for lenders to be mindful of here: (i) on aggressive deals, language is sometimes proposed that implies that the premium only applies to the portion of margin to which the PIK election applies (i.e., so if a quarter of the total interest payment is to be capitalised, the premium will only be applied to a quarter of the overall accrual in that interest period); and (ii) where grids or term sheets refer in a shorthand way to "12.5bps of premium per 100bps of PIK" (or similar), for example, sponsors may aggressively interpret this to mean that the first 99 basis points of capitalised interest is free of premium, rather than the premium applying on a pro rata basis proportionate to the amount of PIK. Where fully understood prior to execution, neither of these points are commonly accepted by private credit providers.

3. **Maximum PIK** – It is common for private credit lenders to limit the amount of margin that may be capitalised. This is important in order to give comfort that the toggle cannot be used to avoid a payment default in a material liquidity crunch. Requiring that there is still a meaningful cash-pay component ensures that, if the company has really run out of cash, it will still miss its cash interest payment and the lenders will have an actionable default and therefore a seat at the negotiating table. This maximum limit is most commonly expressed on an absolute basis (for example, it might require that no more than 2.00% of margin accrual may be

capitalised) but may on other deals be expressed by reference to the overall margin profile (for example, it might permit up to 40% of the margin accrual to be capitalised).

4. **Minimum cash** – Often used in addition to (but sometimes used instead of) the "maximum PIK" condition set out above, it is common to see lenders include a "minimum cash" condition, expressing the minimum amount that must be paid in cash in any interest period. For example, a lender might require that at least 5.00% of margin accrual be payable in cash. The philosophy behind the condition is the same as set out above for the "maximum PIK" – however, they are sometimes used together so as to ensure that there is still a meaningful cash-pay component even if the borrower is at a lower level on the margin ratchet than the opening level, due to an overall decline in leverage since closing. Where a "minimum cash" test is used in isolation (i.e., without a "maximum PIK" test), it is very important to ensure that it is clear that both the PIK toggle and the "minimum cash" test apply only to the "margin" component of the interest accrual and not the "reference rate" component. Otherwise, it could be interpreted that any cash paid in respect of SONIA (or SOFR/EURIBOR etc.) would count towards that minimum cash test and, in the current climate, such amounts will be significant. It is widely accepted that PIK toggles in general should apply to "margin" only, but it is important to look out for this drafting hole.

5. **Number of periods** – Lenders, particularly in the mid-market, will often look to ensure that PIK toggles are being used to address temporary periods when cashflows are tight, rather than representing a permanent feature of the debt service profile. As a consequence, they may look to limit the aggregate length of the interest periods in respect of which the PIK toggle may be exercised (for example, they may limit its usage to a total of 24 months' worth of interest periods). On more conservative deals, lenders may require that the toggle cannot be exercised in consecutive interest periods, for the same reason.

6. **EoD block** – For similar reasons to those outlined above, lenders will generally look to ensure that the PIK toggle is an "ordinary course" flexibility, rather than an option that can be exercised when there are already signs of material distress within the business. As a result, lenders commonly request that the company's ability to use the PIK toggle is switched off if there is a continuing event of default. On more sponsor-friendly deals, this may be limited to a sub-set of material events of default only (for example, non-payment, insolvency-related and financial covenant breach events of default).

7. **Timing** – In general more of a feature of the lower mid-market, some lenders may restrict usage of the PIK toggle to circumstances in which cash is tight following transformational debt-funded M&A activity. So, for example, such lenders may

require that the PIK toggle may only be used in the first 12 months after closing or within the 12 months following any material bolt-on acquisition funded with the acquisition/delayed draw facility. Sponsors on larger deals will generally be resistant to this restriction.

8. **Leakage** – Some lenders in the mid-market will take the view that, for so long as they are foregoing receiving certain cash interest payments, there should be no distributions of cash out of the banking group by way of permitted payments. As a result, they may require that the PIK toggle may not be exercised if a permitted payment has been made during that interest period (or alternatively that no permitted payment may be made in the following interest period). Sponsors may take the view that, whilst this philosophy makes sense with regards to cash distributions to the sponsor itself (by way of monitoring fees, sponsor transaction advice etc.), it should not prohibit distributions made to fund ordinary course holdco administration costs – they may therefore seek to limit the block on permitted payments to certain specific permissions only.

9. **Call Protection** – For additional detail, please refer to our previous Deep Dive on this topic. However, two areas where aggressive sponsors have sought to make reference to PIK optionality are as follows:
    a. Such sponsors argue that when calculating a make-whole, you should calculate it on the basis that all interest would be 100% paid in cash (on the basis that the make-whole is received today, so there is no such additional risk that warrants additional premium). However, certain lenders will take the view that projected interest accruals should assume the same level of PIK toggle usage that is currently in effect at that time. Where there is an actual permanent PIK component to a facility (as opposed to a temporary PIK toggle usage) this debate becomes even more contentious, as the assumed PIK capitalisations may form a core part of the lender's projected return on its investment.

    b. Such sponsors argue that prepayments of principal that constitutes previously capitalised PIK interest (as opposed to principal that was originally advanced as a loan) be exempt from call protection. In general, this is resisted by private credit providers.

For structural reasons, CLOs are generally unwilling to accept PIK toggles within loan documents and, as such, PIK toggles have not become a feature of the syndicated loan market. As a consequence, PIK optionality has become yet another area in which private credit has a competitive advantage in offering sponsors and businesses more tailored operational flexibility when managing their cashflows. This topic's relevance in this market is twofold, as lenders will be interested from a defensive standpoint (to ensure that any such features cannot be abused in a rising rate environment), while also acknowledging that such technology will continue to be of genuine and justifiable value to sponsors that are pursuing ambitious M&A strategies and managing complex processes of corporate integration. The incremental return lenders can generate when interest is capitalised is also clearly of value, when such toggles are structured, priced and documented correctly. For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

About Proskauer

Proskauer's Private Credit Group consists of over 90 dedicated professionals, located in London, New York, Boston, Chicago and Los Angeles, and the team consistently executes some of the largest number of private credit financings in the market (closing 250 direct lending deals globally in 2022, representing nearly $85 billion of new capital).

Related Professionals

- **Daniel Hendon**
  Partner
- **Bharat K. Moudgil**
  Partner