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OPINION - Unpacking PIK In Private Credit and Its Usefulness as A Predictive Tool

We've got some thoughts about a controversial subject: the role of Pay-In-Kind Income in Private Credit - with a special focus on BDCs - and whether changes in this metric can predict the future of creditworthiness.

December 2, 2025

Written On The Wall

The popular take on "Private Credit" right now - and for the last few months - is that "cracks" are appearing in the creditworthiness of its \$1.7bn universe of non-investment grade loans and that even more serious problems lie ahead. One of the "signs" often given by the credit seers - who range from famous names like **Jamie Dimon** and **Jeffrey Gundlach** to renowned business publications like **Bloomberg** and the **FT** - is that **pay-in-kind income** (PIK) is piling up on the balance sheet of Business Development Companies (BDCs) and is "increasingly being used to mask borrower distress". Effectively, PIK interest is said to allow lenders - and their borrowers - to kick troubled credit cans down the road. The lenders get to keep booking the income, which allows them to continue garnering management and incentive fees, where they would not be able to otherwise.

Explosive

Wait! There's more: This is said to create - in the dramatic words of Private Credit's critics - a "PIK Time Bomb":

"By deferring interest, the principal balance of the loan grows larger every month. If the company eventually defaults, the debt burden is significantly larger than it was at the start. This reduces the recovery rate for lenders, as the enterprise value of the business may no longer cover the inflated debt load".

Devastating

The most common thesis at the moment is that PIK levels are increasing across the board - a "sure sign" that the credit rot is already happening. Eventually this will be followed by an

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explosion of written off loans and of accumulated PIK balances - the latter making the former even worse.

Deep Breath

Scary stuff, but how much truth is there to the assertion that higher PIK income is a valid “canary in the coal mine” of coming credit losses and will there really be a mountain of PIK income that will have to be written off?

Nothing New

As the headline says we're going to unpack this controversial subject. Worries about PIK have been around for many years but are reaching a fever pitch right now in our corner of the financial world. Unfortunately, many of the critics do not appear to understand the many different varieties of PIK loans, their uses in leveraged lending and historical track record. PIK features have been part of leveraged lending and arranged in all sorts of ways. Let us discuss the main types:

Eons Ago

When the author was a lender many, many years ago PIK was popular in lower middle market “mezzanine” lending with both lenders and borrowers. The former wanted to be rewarded for the perceived risk in lending to a leveraged private company but were wary of receiving equity or warrants, given the uncertainty about how to value the stake and the timing of any exit. (This was before the PE market exploded and companies of all sizes began to trade like baseball cards). The borrowers - especially the PE sponsors - were delighted to not have to “give up” any equity. That was then and this is now and the advent of “unitranche” and “second lien” loans has effectively made “mezzanine” investing obsolete, in many cases, as both lenders and sponsors are often happy to top up loans with small dollops of equity. However, there are still plenty of new loan facilities being made in the world of Private Credit with these non-cash, long term payment features. We'll call this “**Traditional PIK**”.

Case In Point

Gladstone Investment (GAIN) often mentions the substantial amount of income that will be derived at the maturity of their loans but which the BDC does NOT book into income till received. In its latest 10-K, GAIN made this disclosure:

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The majority of the debt securities in our portfolio have a success fee component, which enhances the yield on our debt investments. Unlike PIK income, we generally do not recognize success fees as income until payment has been received. Due to the contingent nature of success fees, there are no guarantees that we will be able to collect any or all of these success fees or know the timing of any such collections. As a result, as of March 31, 2025, we had unrecognized, contractual success fees of \$52.5 million, or \$1.43 per common share. Consistent with GAAP, we generally have not recognized success fee receivables and related income in our accompanying Consolidated Financial Statements until earned.

Cash-Less

A more recent development are loans which from the outset are all, or mostly, paid in PIK form. These did not exist in my day but have come from the broadening financing ambitions of Private Credit. These “**Full PIK**” facilities are typically structured as either loans or preferred and often are advanced to companies on a fast growth path who need to conserve every dollar. For a primer on Full PIK, click [here](#).

New-ish

The most well-known segment that is a recipient of these kinds of funds are **Software as a Service** (SaaS) companies. These businesses typically are very well funded with equity - usually before any Private Credit lender gets involved. When the lenders do turn up on the scene, they look to the SaaS companies “high recurring revenue, low churn (90%+ retention), and mission-critical products”. **Hercules Capital** (HTGC) and - later - **Ares Capital** (ARCC) - and several other deep-pocketed groups - have been very successful in this area over the last two decades. For a brief summary, click [here](#). As you might imagine, many years had to pass before lenders embraced these EBITDA negative companies and the heavy PIK commitment required but the segment - and the “Full PIK” - and variations thereon - are now mainstream.

Either Way

Another form is the **PIK-Toggle**. Historians tell us this was first developed in 2005 as part of the LBO of Neiman-Marcus. Given the high leverage involved, the borrowers were given the option to pay a portion of their interest due in kind. Yes, this increased risk, but the option was known - and underwritten - up front. The argument was made that this flexibility gave borrowers a mechanism to navigate through temporary poor patches of performance. The lenders charged

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more for the PIK than for the cash interest - which properly compensated them - and could point to all the equity beneath them as comfort that they would ultimately be paid in full at the maturity of the loan. In reality, as companies often change owners in only a few years, the PIK would be collected at the time of a corporate sale.

Shifting

Of late, PIK-Toggle structures have become more "borrower friendly". However, in recent years PE sponsors are funding more and more of their acquisitions with that huge pool of investor capital sitting in thousands of funds big and small. Generally speaking, the PE groups are putting up 60% of the capital needed and the lenders 40%. That's why the latter are comfortable saying yes even to a generous PIK-Toggle, based on the knowledge that PE sponsors have a lot of "skin in the game" and plenty of "dry powder" available if need be, to keep companies going.

Useful

PIK-Toggles got plenty of use during the early days of Covid as companies - not knowing the government would end up bailing them out - wanted to reduce their cash outgoings. PIK-Toggles have become popular again in recent years when the Fed raised rates all the way up to 5.50% in 2023. At the time, many critics believed borrowers' debt service numbers would crash under the weight of their higher interest rate burden. However, thanks to the support provided by the sponsors AND by the PIK-Toggle interest deferral, there was no tsunami of defaults brought on by the Fed's hawkish stance. In the subsequent years to today, the stress on debt service has only increased as have most debt service metrics for borrowers.

Musing

We wonder sometimes why critics of PIK-Toggle want the feature banned - or see its use as a weakness. If you've owned companies - as we have and still do - having flexibility about debt service is a great boon and - in most cases - a positive for the lenders as well.

Not The Point

Anyway, we suspect Private Credit's critics are not really concerned with the forms of pay-in-kind that we've discussed above, especially those arranged at the beginning of a facility. The main bugbear seems to be the belief that when borrowers are facing unexpected and unprojected financial hardship - as happens a great deal in leveraged lending - the Private

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Lenders are only too willing to allow cash interest due to be paid in kind. This is seen by many as “Bad PIK”.

This refers to PIK amendments introduced through loan modifications after a deal has been closed and are thought to signal deteriorating credit quality and represent attempts to provide ad hoc relief to struggling borrowers. Industry observers have raised concerns that widespread use of bad PIK amendments may be suppressing measured private credit default rates by converting what would otherwise be payment defaults into deferred-interest events. The concern is that PIK amendments function as a “shadow default rate,” masking underlying credit deterioration.

True. But Not Really.

This is the heart of the subject and the “industry observers” are not wrong that “Bad PIK” mostly occurs when a borrower is struggling. However, the motivations of the lenders are not those given in the paragraph above. We would argue in their defense that there is no intention of hiding or avoiding the recognition of credit deterioration. In the Good Old Days - especially when banks were the principal lenders to LBOs, we were all taught that acting quickly when a borrower “got into trouble” was the best course of action - often resulting in forcing a bankruptcy or fire sale to an interested party. After all, there were regulators to contend with, reserves to be booked and the earlier one could get the debt resolved, the higher the likely “recovery”.

Changed

That’s not the way the world works now, and that is a Good Thing - as we’ll explain. When a company stumbles, acting too fast may result in the loss of financial support from whatever PE groups are involved. That’s not good either for a lender’s reputation or the troubled company involved. Time and time again - and on great display during Covid - the PE owners have stepped up to the plate when their companies have stumbled. This is the “second way out” - typical lender terminology - when a company’s financial performance fails.

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Measure Twice

Another reason not to act too hastily - even if the sponsor suddenly stops answering the lenders calls - is to maximize recovery. We've been in our day on both sides - owner and lender - and understand that time is needed to identify what ails the company; develop a viable solution; get all the stakeholders to agree and implement an action plan. This usually involves a small army of the lenders personnel, as well as outside turnaround experts, investment bankers and lawyers descending - virtually or physically - on the said troubled company. "These things take time" applies in these situations. While that process is underway - and each one is different - like Tolstoy said - in its own way, "Bad PIK" is put into place; amendments are negotiated and "forbearances" granted.

Not The Way It Is

The argument we find most offensive - even though we're just an observer at this point - is that the Private Debt lenders are motivated to offer up "Bad PIK" to feather their nests or hit some internal bonus target. We're guessing that these barely concealed charges of malfeasance by critics dates back to the GFC when we heard a great deal about flawed incentives causing "Liar Loans" to be booked by the thousands. That may or may not have caused or exacerbated the crisis of 2008-2009 but is simply not a factor in 2025. That's not the way these BDC lenders operate, neither the institutions nor the personnel involved.

If Twice You Don't Succeed

What you are seeing at work when the months go by - and as Bad PIK accumulates - are the lenders working on their third way out. The borrowers cannot earn their way out of trouble nor can the sponsor ride in on a white horse. That's when the lenders have to weigh a series of other options to get repaid. These options include selling assets and/or portions of the business; restructuring the balance sheet but not taking control; restructuring and taking ownership control or stepping away to allow for a Chapter 11 re-organization or a wholesale liquidation. Big decisions have to be made about maintaining or changing management, maintaining or changing strategic direction and whether to plow more capital into the business.

[By the way, this is where the BDC Credit Reporter gets out its binoculars and seeks to assess what is going on, what the way forward might be and the likely outcome for both business and lenders].

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Don't Hurry

We'd hate to see the BDC lenders rush to judgement where these troubled companies are concerned. The BDCs - and their shareholders - are fortunate that they have a wide range of tools available to mitigate losses or even generate a gain. Unlike the banks of yore, the Private Credit lender can become an owner. Interest payments can be deferred, reduced or eliminated. In this regard "Bad PIK" - its name notwithstanding - is a useful and necessary piece of the puzzle. Sometimes the attempted rescue will fail and sometimes not. Sometimes the conclusion will be that "good money" was sent after "bad". Other times - as ARCC reported this quarter - a former trouble spot became the second largest realized gain in its history.

 In conclusion, all the different kinds of PIK have a role to play in Private Lending. Critics are misreading their presence in loan financing and incorrectly imputing all sorts of nefarious behavior to the lenders.

A Twist in Our Tale

A last note: We conceded above that if we suddenly saw a material increase in Bad PIK appearing across the lending landscape that COULD indicate more borrowers were getting into trouble. Here's the rub where that's concerned: there's no evidence that is happening. We've listened to 44 IIIQ 2025 conference calls and no BDC mentioned any serious uptick in amendment requests from their borrower base. Also, there was no across the board jump in the number of new non-accruals in the 10,000 strong universes of BDC financed companies. A few here, a little there and at most no new names at all. In fact, several very large BDCs reported lower overall PIK income in the IIIQ versus the prior quarter. There's no building PIK trend to alert us of anything.

Don't Bother

Anyway, we'd suggest to anyone concerned about future credit conditions in Private Credit and looking for useful ways to divine the future to look elsewhere than changes in PIK balances across the industry. The data is something of a blunt instrument because there are so many

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different forms of PIK. Even an increase in "Bad PIK" might give a false picture and could just reflect a delay in the time lenders are taking to find their "third way out" of troubled companies.

In A Nutshell

The better way - but one that requires much more work - is to constantly track the number of companies and dollars moving from performing as expected to underperforming. This will show up in a series of metrics, but PIK won't be one of them. At this point - and despite all the "evidence" being pointed to since Tricolor and First Brands shook the market's confidence - we see no compelling signs that the credit picture is any worse than it was at any other time in 2025 and is definitely much better than at times of prior downturns in years past.