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Investment Perspectives

Private Credit: Addressing Key Questions in Direct Lending

A timely explanation of today's developments in private credit.

Key Takeaways

This report covers four important topics in direct lending, as well as what to look out for, and how to assess a manager's approach to these elements of the private credit investment landscape.

1. Payment-in-kind (PIK) interest in deals
2. Liability management exercises (LME) among deal participants
3. Convergence of the public and private credit markets
4. Deal flow

1. PIKS

Payment-in-kind (PIK) interest is essentially when a borrower either cannot or chooses not to pay the cash interest due on its loans. Instead, they capitalize the interest, increasing the principal amount of the loan. There are two ways PIK may become a reality in loans: 1. Some amount of PIK is permitted in the original documents, or 2. It is amended into the documents post-close. PIK in a credit agreement is usually limited to the first two years of the loan and 50% of the spread. For instance, if the loan is S+500, which is a 500-basis point (bp) spread above the Secured Overnight Financing Rate (SOFR), then 250 bps can be PIKed for the first two years of the loan. To do this, borrowers pay a penalty to discourage its use, unless there is a real need.

While PIK can be viewed as unfavorable because it can indicate financial stress, there are cases where it fits the credit at the time of origination. This type of PIK is typically used for companies with a strong brand or product and high growth potential, even if they are pre-profitability or in the early stages of profitability. In such cases, the company may be tight on liquidity in the short term, but from a credit perspective, it is still a strong investment. A well-resourced private credit manager with selective origination capabilities should be able to identify these credits that could potentially benefit from this type of loan provision.

Conversely, some types of PIKs are requested by borrowers simply because market conditions permit it. The prevalence of PIK is indicative of a broader market trend where private loan documents need to be more flexible to compete with broadly syndicated loan (BSL) documents. The most concerning scenario, which can be a significant red flag, is when a loan was originally structured without PIK but gets amended to include it halfway through its term due to emerging liquidity problems.

This debate around PIK is particularly relevant now because the amount of PIK in direct lending portfolios has increased significantly. Historically, PIK might have applied to about 5% of a portfolio or less. According to S&P Global, nearly 12% of loans held by Business Development Companies (BDCs) made PIK payments in the second quarter of 2024.[1] This increase is largely due to base rates having risen by 400 to 500 bps, causing some issuers to struggle with managing higher interest expenses. In many of these situations, the flexibility provided by PIK is being used as a crutch rather than a strategic tool. When evaluating private credit strategies, allocators should ensure they understand the extent of PIK exposure in the strategy, and how the manager addresses this risk.

2. LMEs

Liability management exercises (LMEs) are a very important topic that has evolved dramatically post-COVID-19 and continues to do so. Also known as "lender-on-lender violence", LME involves a restructuring that disadvantages one part of the capital structure relative to others, and in some cases, even pits the holders of the same instrument against one another, with significant consequences for the debt holders on the losing end of the process. This has also resulted in unfavorable outcomes for lenders.

Specifically, when discussing LMEs, it is important to be specific about the adverse scenarios that can occur. These include the stripping of collateral, the addition of new debt that supersedes what was initially considered senior debt, and the release of credit support from subsidiaries, among other scenarios. Each of these factors can significantly undermine loan recoveries, highlighting the risks that LMEs present to lenders.

Similar to PIK, there is a vintage element to LME, reflecting the history of direct lending. Historically, direct lending documents did not permit LMEs that would result in different treatment for lenders in the same tranche of a loan. However, this has evolved as the direct lending markets have changed. Pre-COVID-19, direct lending was primarily for companies that did not have access to the capital markets, typically middle market companies. Post-COVID-19, the capital markets dislocated, coinciding with significant capital raising around direct lending due to historic performance and investors' search for yield. This led to direct lending being used by larger companies that traditionally had access to the capital markets.

As direct lending has moved up market, documents for these loans have become less conservative in order to compete with broadly syndicated loans. This has brought LME into the spotlight in recent years.

Recent court cases, such as the 5th Circuit overturning the bankruptcy restructuring of Serta on New Year's Eve of 2024, have been minority-lender friendly.[2] Now, the market is more aware of what is at stake, the terms, and the language to look for to prevent these transactions. This has led to more transparent discussions when issuing new loans, focusing on what is allowed in terms of subjugation of collateral, removal of collateral, or differentiation of lenders.

There may still be a large number of loans in historic funds and portfolios (especially the 2020–2021 timeframe) with documents that permit LME to some degree. For these older deals, LME likely will continue to be seen. However, for newer deals, there generally has been more discipline, and the LME-type provisions have been tighter, especially in the middle market where the documents have not been intended to compete with the broadly syndicated loan market.

The existence of LMEs may be considered a negative for the overall marketplace, but the good news is that the market is beginning to recognize this, and many more restrictions have been implemented.

3. Convergence of the Public and Private Credit Markets

A newer but consistent trend in the lending market is this idea of flexibility. Borrowers are beginning to recognize that even if they have access to public markets, there are times when the broadly syndicated loan market can shut down, and so the need to have relationships in the private markets may be critical. As this trend evolves, so has the level of sophistication and awareness by not only the borrowers, but also the sponsor universe. As a leader of a corporation, such as a CEO or CFO, it is important to understand that liquid markets and private markets do not always move in tandem. Therefore, having a presence in both markets may be essential.

Additionally, there are other compelling reasons to use private lending, even for a large company with access to the capital markets. Confidentiality can be critical in certain situations, and a company might prefer to engage with one to five private lenders to keep the information tight. Customization is another factor. A very complicated capital structure might be difficult for rating agencies or the broader liquid market to understand. In such cases, you can work with one or two private lenders who can provide a tailored solution.

These trends and use cases have always existed and will likely continue to increase. The market has been discussing the strong trend toward private finance. One related indicator is the reduction in the number of publicly listed companies. While this is not a direct indicator, as both publicly listed and non-publicly listed companies can use private credit, it does highlight the value of private capital. Private capital can be customized, remain confidential, and have a longer-term focus, which is highly valued by companies.

It is also important to recognize that there are two very distinct ecosystems within direct lending. One is the historic use of direct lending that involves financing companies that do not have access to the capital markets. This remains unchanged and is characterized by tens of thousands of companies and hundreds to thousands of sponsors in a space that no one can dominate. In this ecosystem, you are not competing with the capital markets or many of your competitors on any one deal.

In contrast, there is the more recent development of the upper middle market. This involves direct lending used broadly for companies that are not middle market companies but have access to the capital markets. In this ecosystem, elements like PIK and LME, and different uses of M&A financing are more prevalent. This development highlights the imperative need for managers to have deep resources, not only in direct lending, but also deep expertise in the public markets. Having relevance across the public and private credit spectrum, combined with patient capital, is the key to success in middle market direct lending today.

4. Deal Flow

It is important to frame the currently muted deal flow environment within the context of higher rates. When rates increased in 2022, deal activity declined across the capital markets. The reason for this is that an increase in rates also raises the discount rate on the value of a company. For instance, if you're a private equity firm showcasing something in your portfolio, you might think it's worth 12 times earnings before interest, taxes, depreciation, and amortization (EBITDA) when base rates are 25 bps. However, when base rates rise to 525 bps, that valuation might drop to 8 times EBITDA. Consequently, there has been an inclination for owners of enterprises to wait for rates to come down.

By late 2024, there was a growing consensus, perhaps even capitulation, that rates were going to remain higher for longer. This led to a reduction in the disparity of views between buyers and sellers. The anticipation was that with the new administration, capital markets would be more active. However, the administration has behaved differently than the market expected. Before January, we were already predicting a thaw in deal activity, likely toward the end of the year, in the third or fourth quarter. Given recent developments, we now believe that this thaw is another two quarters away.

What is encouraging is that the environment for lenders has remained relatively healthy. Although deal activity will naturally fluctuate, we believe it is essential to choose a manager with broad origination capabilities and the resources to cover lower middle market, core middle market, and upper middle market segments. A manager with the right amount of capital can deploy effectively regardless of market conditions to capitalize on opportunities even in fluctuating environments.

[1] Gunter, Evan & Yang, Ruth. "PIK-Paying Loans Decline as a Share of BDC Assets." S&P Global, April 8, 2025.

[2] Peramatukor, Tara, of Squire Patton Boggs (US) LLP. "(US) Fifth Circuit Puts Serta Simmons Uptier Transaction to Bed." The National Law Review, January 16, 2025.

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Glossary

A **broadly syndicated loan (BSL)** is a type of leveraged bank loan that is provided by a group of lenders and is commonly used to finance mergers, acquisitions, and recapitalizations. These loans are syndicated by originating banks to a wide range of institutional investors, such as collateralized loan obligations (CLOs), mutual funds, and insurance companies.

Business development company (BDC) is a type of investment company in the U.S. that provides capital to small and mid-sized businesses, as well as distressed companies. BDCs are designed to help these firms grow during their early stages or regain financial stability.

A **basis point** is equal to one one-hundredth of a percentage point.

Base rate: Variable interest rates fluctuate in line with a base rate which, typically, shifts in reaction to market factors.

The **capital stack**, or **capital structure**, refers to the layers of debt and equity capital used by companies to finance operations. Within the capital structure, segments called tranches represent different risk classes that are available to investors.

A **direct loan** refers to a privately negotiated loan provided by non-bank lenders directly to a borrower, typically a middle-market company.

Discount rate is the rate of return used to discount future cash flows. This rate is used to evaluate the attractiveness of the investment by comparing the present value of expected cash flows to the initial investment outlay.

Earnings before interest, taxes, depreciation and amortization (EBITDA) is net income with interest, taxes, depreciation, and amortization added back. It can be used to track and compare the underlying profitability of companies regardless of their depreciation assumptions or financing choices.

GFC refers to the global financial crisis of 2008–09.

Loan origination is the process lenders use to assess and approve borrower applications for various forms of debt. These include loans and mortgages.

Middle market lending: The middle market segment is typically considered to be credit for firms larger than small businesses but too small for large-scale commercial lending or syndicated credit.

Private equity refers to capital investments made in companies that are not publicly traded.

Private markets refer to investments made in assets that are not traded on public exchanges or stock markets (public markets). This includes private equity, where investments are made in private companies, and private debt, where investors lend directly to borrowers without a market to trade that debt. These markets are less liquid or illiquid.

Public markets are where securities are listed and traded on public exchanges. This includes stocks, bonds, and other financial instruments that are available to the general public and are considered liquid investments options.

Risk-adjusted return measures how much risk is associated with producing a certain investment return.

The **Secured Overnight Financing Rate (SOFR)** is the primary benchmark for short-term interest rates. It represents the cost of borrowing cash overnight, collateralized by U.S. Treasury securities.

Securitized products broadly refer to pools of financial assets that are brought together to create a new security, which is then divided and sold to investors. The value and cash flows of the new asset are based on its underlying securities.

Senior debt holds the highest priority in the repayment of a company's borrowed money. Senior debt holders are paid first before other creditors in the event of bankruptcy or liquidation.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Subordinated debt is below senior debt in the repayment of a company's borrowed money. Subordinated debt holders are repaid after all senior debt holders have been repaid in the event of bankruptcy or liquidation. Subordinated debt typically offers higher interest rates to compensate for higher risk.

Underwriting is the process by which the lender decides whether an applicant is creditworthy and should receive a loan.

Vintage refers to the specific time period during which a set of loans or investments were originated or issued.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. The gross yield of an investment is its profit before taxes and expenses are deducted.

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