William Blair

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Investment Banking

One Year In: The Delayed Impact of Higher Rates and the Re-Emergence of PIK

The Delayed Impact of Higher Rates and the Re-Emergence of PIK

Inflation is easing, and the Federal Reserve appears to be near the end of its rate-hiking phase. But many borrowers, particularly those that put credit facilities in place before rates began to rise, still have not experienced the full impact of higher rates.

That's because the Secured Overnight Financing Rate (SOFR), currently hovering just above 5%, only reached 3% in October 2022, and is not projected to fall below 4% until late 2024.[1]

As rates have risen, more of borrowers' cash flow has had to be diverted to cover higher cash interest expenses, resulting in i) reduced liquidity available to fund operations, and ii) reduced cushions for borrowers with a debt service covenant, such as a fixed-charge coverage ratio or interest coverage ratio.

To demonstrate how rates might affect a specific loan, the chart below shows the impact of higher rates on a typical unitranche loan as SOFR has responded to moves by the Fed:

Impact of Rising Rates on a Vintage Q2 2022 Unitranche Loan

	April 2022	LTM June 2023	PF June 2023
Debt	$200 million	$200 million	$200 million
S+550 Yield	6.5%[2]	9.3%[3]	10.7%[4]
Annual Interest Cost	$13 million	$18.6 million	$21.4 million

Options Available for Borrowers

There are options for borrowers that need to modify their credit agreement or otherwise face liquidity challenges due to higher rates. In our conversations with both clients and lenders, as well as in recent credit facilities we have helped arrange, we have seen numerous examples of flexible loan structures that allow borrowers to make a portion of interest payments in-kind (PIK).

Here are what some PIK options look like in practice:

1. **Converting a portion of senior debt interest to PIK.** A loan originally priced at S+5.5% may become S+6.5% with 2.0% being PIK. The overall cost of capital is higher, but the cash interest burden is reduced by 1%.
2. **Junior capital facilities that feature the ability to toggle between cash pay and PIK.** Here, the proceeds of a new junior debt facility are used to pay down a portion of the senior debt facility. The junior capital facility would carry a higher overall interest rate, but the borrower can elect to PIK a portion, thereby reducing their overall cash interest requirements.
3. **HoldCo PIK notes.** Similar to the aforementioned junior capital facility, however here the debt obligation is placed at the borrower's parent entity and no cash interest payments are required during the term of the note.
4. **Preferred equity structures that may include a PIK dividend and equity upside for the investor.** Similar to the HoldCo PIK notes, no ongoing cash payments are required.

These cash-conserving alternatives are typically more expensive than the cash-pay loans they're replacing but the difference can be worth it for companies with pressing liquidity needs, especially with high rates seemingly in place in the near term.

Looking Ahead

Indeed, the SOFR forward curve suggests only modest declines in the next 12 months. If the current SOFR forecast holds, we expect to see an increase in the number of borrowers that seek refinancing options that may include the flexibility of PIK interest payments.

William Blair's Leveraged Finance team is well-equipped to discuss alternatives to traditional senior cash-pay debt structures. To learn more about these alternatives, please don't hesitate to contact us.

1. Pensford Forward Curve and Refinitiv, an LSEG (London Stock Exchange Group) business
2. Assumes 1.0% SOFR floor
3. Based on average monthly SOFR from July 2022 - June 2023
4. Based on June 1, 2023, 30-day SOFR of 5.2%

William Blair's Leveraged Finance Group

Team of dedicated leveraged finance professionals with significant experience across the full suite of middle-market financing structures

Common Transaction Objectives

Refinancings	Access greater flexibility, improve terms, and/or replace existing capital provider that the company has "outgrown"
Acquisitions	Position business for potential future sale
Growth Capital	Finance bolt-on or transformational acquisitions
Shareholder Liquidity	Provide "dry powder" so capital is available to immediately act on acquisition pipeline

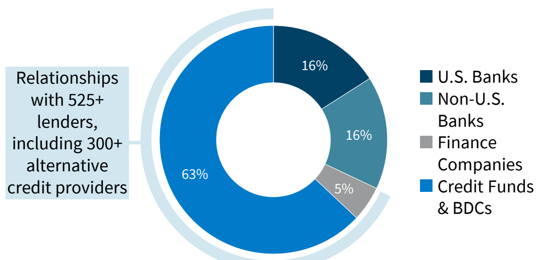
How We Are Different

- Conflict-free advisory focused on delivering best solution available
- Proprietary 360° view of leveraged finance market from William Blair's global M&A and debt advisory practices
- Seamless integration with William Blair's sector coverage teams
- Experts at orchestrating competitive auctions to achieve optimal financing outcomes
- Provides turn-key financing teams able to deliver unparalleled speed, execution, and certainty to close

Full Service Offering

- Senior bank loans
- Leveraged loans
- Unitranche facilities
- Second lien loans
- Subordinated debt
- Late-stage / venture debt
- Structured equity

Market-clearing Distribution



Select Transaction Experience

Certified Power Inc. Unitranche Credit Facility 2023	amino Senior Secured Credit Facility Preferred Equity 2023	Cellipont Bioservices Senior Secured Term Loan 2023	EFC International Senior & Subordinated Debt 2023
TAOGLAS Unitranche Credit Facility 2023	Potbelly Sandwich Works Senior Term Loan 2023	SIXAXIS Senior Secured Credit Facility 2022	CCS Fundraising Senior Secured Credit Facilities Preferred Equity 2022

William Blair Leveraged Finance by the Numbers

190+
completed transactions since 2015[1]

60+
Financial sponsor clients[1]

525+
banks and alternative credit provider relationships[1]

$26B+
arranged financing since 2015[1]

Leveraged Finance Group Investment Banking

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1. Data as of May 31, 2023.

About William Blair Investment Banking

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William Blair's investment banking group enables corporations, financial sponsors, and owner/entrepreneurs around the world to achieve their growth, liquidity, and financing objectives.

Drawing on the collective intellectual capital and deep sector expertise of a global team that reaches across 21 cities on four continents, the investment banking group brings a rigorous and innovative approach to corporate board advisory projects, mergers and acquisitions, and equity and debt financing. From April 2018 to March 2023, the team advised on more than $733 billion in completed transaction volume.