by Sergio Grasso

PIKs: give and take

European PIK bond issuance surged to approximately €3 billion by mid-2025, underscoring a robust resurgence in investor appetite for this once-cautious, highly structured debt instrument. Predominantly deployed to finance sponsor-led dividend recapitalizations and liability management exercises, these transactions reflect a distinct pivot toward risk-on sentiment across credit markets.

When included, the allure of the toggle or pay if you can features attached to those securities lies in the flexibility: PIK "toggle" and "pay if you can" instruments, for example, offer issuers the option to service interest in cash or to capitalize it, contingent on liquidity availability- and tests- or activated at the borrower's discretion, thereby preserving cash in times of operational constraint. Those mechanisms, unlike "pure" PIK structures that mandate full capitalized interest (mandatory PIKs) presents a hybrid yield opportunity that resonates strongly with credit investors seeking enhanced spread with or without immediate cash servicing obligations. If the interest is paid in kind, a higher interest rate applies because deferring payments creates more credit risk.

Notably, an estimated 60% of issuance volume in 2025 has been channeled into dividend recapitalizations, with the remainder percentage supporting refinancing and capital structure optimization strategies.

<ins>However, these figures likely understate the true volume, as a significant portion of activity remains non-public, executed discreetly via reverse enquiries, private credit platforms and direct lending funds</ins>. Such deals, tailor-made, often emerge only in the footnotes of quarterly earnings presentations, with sparse disclosure and limited transparency—a hallmark of today's opaque private debt landscape.

PIK toggle notes continue to act as capital solutions providers, accommodating bespoke borrower requests for liquidity, covenant-lite structures, and flexibility in extended cash burn periods. In this context, the "strategic deployment" of PIK bonds—whether toggle, contingent cash pay or mandatory-serves as a tool to bridge cash flow volatility, optimize leverage profiles, or navigate timing mismatches in equity realization. <ins>The issue of a PIK note shouldn't be mistaken for credit weakness; rather, it reflects the financial engineering flexibility afforded to sponsors in today's evolved credit markets</ins>.

Despite recent episodic volatility—most notably in March following renewed geopolitical and trade- related tension from the U.S.—the European high-yield market remained resilient. <ins>To suggest that this surge in PIK issuance constitutes a narrow liquidity window exploited by opportunistic borrowers and shareholders would be reductive</ins>. Similarly, recent market commentary suggesting these transactions are merely substitutes for stalled IPOs or delayed sponsor exits, fails to appreciate the strategic financing intents underpinning most PIK structures.

In my view, as I said, PIKs are not symptomatic of financial distress. Rather, they are part of the institutional capital toolkit, used by operationally sound corporates with the credit profile and investor credibility required to access the structured unsecured debt markets.

<u>Comments like "PEs loading up balance sheets with too much debt" or warnings about "symptomatic signs of an overheated HY market" feel just as empty and outdated today as they did 20 years ago</u> when I started to trade European PIKs (of course not for CLO portfolios).

Assuming that all PIK securities in the balance sheets are indicative of borrowers' financial vulnerabilities, would imply that a significant portion of the private debt market, very active with these bonds, is fundamentally unsound—a conclusion that clearly oversimplifies the reality.

That said, not all executions have been without controversy (20 years ago, likewise, many PIK bond issues were met with scrutiny). A telling example lies in Urbaser, the Spanish waste management conglomerate (enterprise value ~€5.5 billion), which completed two dividend recapitalizations in less than 50 days—the first, 1 billion euro, via senior secured debt, the second, another billion, via a 7- year unsecured PIK toggle bond. The latter, launched with significant yield concessions, drew criticism, also from my side, for its lack of transparency and sponsor aggressiveness, particularly from holders of the senior facilities issued in June, originally rated Ba3/BB-/BB+ but later downgraded following the re-leveraging with the PIKs. The senior investors, although the Opco leverage remained unchanged, did not anticipate a subsequent dividend payment being executed so soon after the previous one (a transaction unlike any I can recall).

<u>The "second" Urbaser PIK deal, an aggressive issue under many considerations, no doubts about it</u>, represented one of the widest new issue concessions (525bps margin spread on senior liabilities) seen in Europe's PIK market over the past five or six years. Only the May 2024 PIK issuance by the Italian Fedrigoni came close in terms of premium (400bps margin spread on top of senior), though it remained structurally different by comparison: Fedrigoni's PIK was shorter in tenor and rated CCC by one rating agency, with a two-year maturity gap vs. the company's senior debt.

By contrast, Urbaser's PIK, assigned B3 rating by three rating agencies, was maturity-aligned with senior liabilities. Fedrigoni PIKs (the company is grappling with soft paper market and decided to defer all interests) is down YTD more than 12 figure in secondary market from the price of 103,85 registered in January25.Not great in a bullish market.

Despite this, Urbaser, when free to trade, performed strongly in the secondary market, trading well above reoffer—a testament to the yield-starved environment and to investors' willingness to appreciate the fundamentals and the wide premium at launch in primary (for curiosity, the Ardagh PIKs, today worthless and in distress, issued in 2019, offered at launch a gap of 350bps over the senior paper and tightened even inside 200 bps spread at a given time when investors did not understand the corporate outlook and followed advice from the sell side instead of doing some work).

<u>While caution is a fundamental principle in credit investing (the names mentioned above underscore the point), consistently passing on opportunities can be a costly error. Overlooking potential ways for "making money" means leaving value on the table. This is my important message for investors who remain overly hesitant.</u>

PIK toggle or contingent cash pay instruments remain rare in Europe (although PIKs enjoyed a degree of popularity in the early 2000s until the Great Financial Crisis), highly bespoke, and inherently volatile. <u>But characterizing them as controversial or unpopular is an oversimplification</u>. These instruments occupy a specific, legitimate place within the European leveraged finance ecosystem, offering value to both issuers and investors when deployed judiciously. Overemphasizing the causes and the effects of dividend recaps—and their nominal amounts—on a company's balance sheet can be shortsighted. If investors strictly adhered to rigid financial heuristics, in current circumstances they would miss out on a large portion of market opportunities.

<u>While corporate leverage metrics are undeniably important, they often receive disproportionate attention, especially when applied without context</u>.

<u>In my opinion, the key lies in appreciating the PIK structural nuance and evaluating the risk-adjusted return profile in context</u>. While some deals may push the limits of market tolerance—Urbaser being a clear example—the broader picture suggests that PIKs continue to serve a functional role for corporates with robust fundamentals and sophisticated capital needs. Struggling businesses will remain bad investments regardless of debt seniority and margin involved.

Investors would be well-served to look beyond the usual suspects (Schaeffler, Telecoms) and engage more deeply with other issuers in other sectors, many of whom are increasingly turning to PIK instruments as part of multi-layered capital solutions.

<u>While headline spreads and all-in yield metrics often dominate market discourse, they are far from the primary considerations in assessing PIKs and PIK toggle bonds</u>. The investors' response to Urbaser transaction suggests some corners of financial market have a sophisticated understanding of the multidimensional risk framework that underpins valuation.

<u>Generally speaking, the key credit characteristics include:</u>

1. Structural subordination and intercreditor dynamics between the PIK notes and the operating company (OpCo) debt. This point is a clear distinction from the structures that existed before the Financial Crisis, when PIKs were often issued by the same entity that also incurred senior debt. Let's also remember here how the exemplified Schaeffler Holdco structure is an anomaly in the PIK segment and should be regarded as something unique.

2. Management discretion over payment modality, specifically the issuer's right to toggle interest into PIK rather than cash—introducing a degree of uncertainty that must be stress- tested across downside scenarios. How is the premium determined? What is the governing law of the credit agreement? (Italy is distinctive). Only two questions selected out of dozens available.

3. The covenant framework, including incurrence-based restrictions, J.Crew protection, portability, leakage provisions, and EBITDA definitions, which can materially shift the risk- return equation depending on how permissive or protective the documentation is (the document changes in Urbaser were expected after the first draft received by investors).

4. The anticipated take-out strategy or lack thereof (the exit option, highlighted in cases like Cirsa, where the sponsor strategy has always been clear over the years, explains the recent Cirsa PIK NC1, a rare feature in those bonds today. More common, the short call, 20 years ago and easy to quantify for the option value). When we treat PIKs solely in terms of suboptimal liquidity tools, we risk oversimplifying complex dynamics and decisions, and falling into common, trend-driven generalizations.

5. Recovery prospects at the Holdco level, which are not inherently binary and highly sensitive to sponsor behavior, total leverage, LTV, and post-default waterfall mechanics(or LMEs if you prefer another definition).

In essence, PIKs (toggle or not toggle) instruments are high-beta, sporadically path-dependent securities, often trading more on structural complexity and sponsor credibility than on macro and micro fundamentals and credit spreads alone.

The performance during periods of market stress—such as the COVID-19 crisis—highlights the sensitivity to volatility. While PIK yields and spreads against seniors can widen dramatically (often into mid-high double digits), pricings and YTMs become increasingly driven by idiosyncratic factors, such as capital structure nuances, sponsor credibility and strategy, and expected recovery paths. The 2020 market dislocation demonstrated how relative value across issuers became difficult to quantify using traditional credit metrics, demanding a more qualitative assessment. In such environments, deep credit work pays off: the Douglas SUN PIK 2026 was one of the best performing European HY bonds in the 2023 (taken out by the IPO in 2024), while the memorable Blackstone's trade on Cirsa's PIKs (done at more than 25% YTM) during the COVID downturn, remains a clear example of tactical secondary market entry, exploiting structural mispricing to generate outsized returns.

I try a conclusion: from a structural subordination perspective, these instruments may appear mispriced—and likely are—particularly when PIK investors are exposed to equity-like downside risk (loss with zero recovery) without commensurate upside potential. However, when the credit story is well understood (for example in presence of a corporate "buy-and-build strategy" that, while accretive over time, can lead to transient periods of compressed cash flows), and the entry point is carefully selected with the right structural insights and timing, such opportunities can still offer attractive risk- adjusted returns and a high degree of satisfaction. Adopting a credit-focused perspective and a credit-oriented angle that reflects today's corporate strategies, enables a clearer evaluation of both yield curve and spread pricing and the corresponding payoff structure with all its limitations.