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Briefing

What are Pay-in-Kind Securities?

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Payment-in-Kind

Pay-in-kind securities are financial instruments that pay investors in the form of additional securities rather than cash coupons. Like zero-coupon bonds, they give a company breathing room before having to make cash outlays, offering in return rich yields. PIKs can be bonds, notes, or preferred stocks with interest or dividends paid in securities rather than cash. The securities used to pay the interest or dividends are usually identical to the underlying securities, but occasionally they have different terms.

Pay-in-kind notes have played a key role in the funding structure of leveraged finance, particularly in leveraged buy-outs. Part of leveraged finance is mezzanine or "in between" debt. Mezzanine debt has long been used by mid-cap companies in Europe and the US as a funding alternative to high yield bonds or bank debt. The product ranks between senior bank debt and equity in a company's capital structure, and mezzanine investors take higher risks than bond buyers but are rewarded with higher returns averaging between 10 and 15 per cent. In many cases, particularly in the early years following a leverged buyout, the company cannot afford to pay such a high rate in cash. Hence the choice of paying the high mezzanine interest rate in the form of additional securities instead of cash.

Example of PIK notes in a leveraged buyout

In July 2004, the leveraged buyout firm KKR refinanced its acquisition of Sealy Mattress Company with $75.0 million principal amount of subordinated pay-in-kind (PIK) notes. KKR described the notes as follows:

> The notes accrue interest in-kind at 10% per year, compounded semi-annually. Sealy Corporation is not required to pay accrued interest on the notes in cash for the entire time that the notes are outstanding.
>
> The notes mature on July 15, 2015, following the maturities of substantially all other existing indebtedness of Sealy Mattress Company, including its $685 million senior secured credit facility, $100 million senior unsecured term loan and $390 million senior subordinated notes. At maturity, the outstanding principal amount of the notes, along with any accrued and unpaid interest, will be paid in cash by Sealy Corporation.
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> Sealy Corporation may redeem the notes at its option at any time, in whole or in part, at an initial price of 105% of the principal amount thereof plus all accrued interest not previously paid in cash, which price declines to 102.5% after the first anniversary of issue, 101% after the second anniversary of issue and 100% after the third anniversary of issue. At any time prior to the third anniversary of issue, Sealy Corporation may also use the proceeds of an equity offering to redeem any or all of the notes at its option at a price of 101% of the principal amount thereof plus all accrued interest not previously paid in cash. In addition, upon a change of control of Sealy Corporation and the repayment of Sealy Mattress Company's senior secured credit facility, holders of the notes will be able to require Sealy Corporation to repurchase the notes at a price of 101% of the principal amount thereof plus all accrued interest not previously paid in cash.
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> Source: kkr.com

PIK maturity and early repayment

As may be seen from the above description, the PIK notes typically mature only after all other, more senior, debt has matured. This often means the investors have to wait a long time for their principal, as well as all the accumulated, compounded interest, to to mature. However, as the example illustrates, PIK notes are prepayable (although in some cases only after a few years of "non-call" protection). In the early years, the prepayment incurs a premium, but after 3-4 years most PIKs can be prepaid without penalty. Because these instruments bear a high yield, borrowers are keen to repay them as soon as they are able -- generally when the company reaches the point where it can refinance all its leveraged debt, senior as well as subordinated.

PIK toggle notes

PIK toggles pay interest in cash at one rate or, at the compnay's option, pay interest in additional PIK toggle notes. The interest paid in addtional notes is set at a higher rate than the cash interest rate.

> For example, in 2007 Universal Hospital Services offered a PIK toggle note where interst was payable semi-annually in cash at a rate of 8.50%, or 9.25% if the interest was paid in additional notes.

Holdco PIKs

Some PIKs have the added risk of being issued at the holding company level, meaning they are "structurally" subordinated and rely on the residual stream of cash, if any, from the operating company to pay them down.

Payment in Cattle?

According to Wikipedia, "payment in kind" refers to payment for goods or services with a medium other than money. "Kind" (or kine) in this context is an archaic noun meaning cattle, from the Middle English word kyn. The term originates from a period in history when livestock were a common means of exchange. So far no PIK has offered interest payments in this form, but with the price of beef going up, you never know...

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