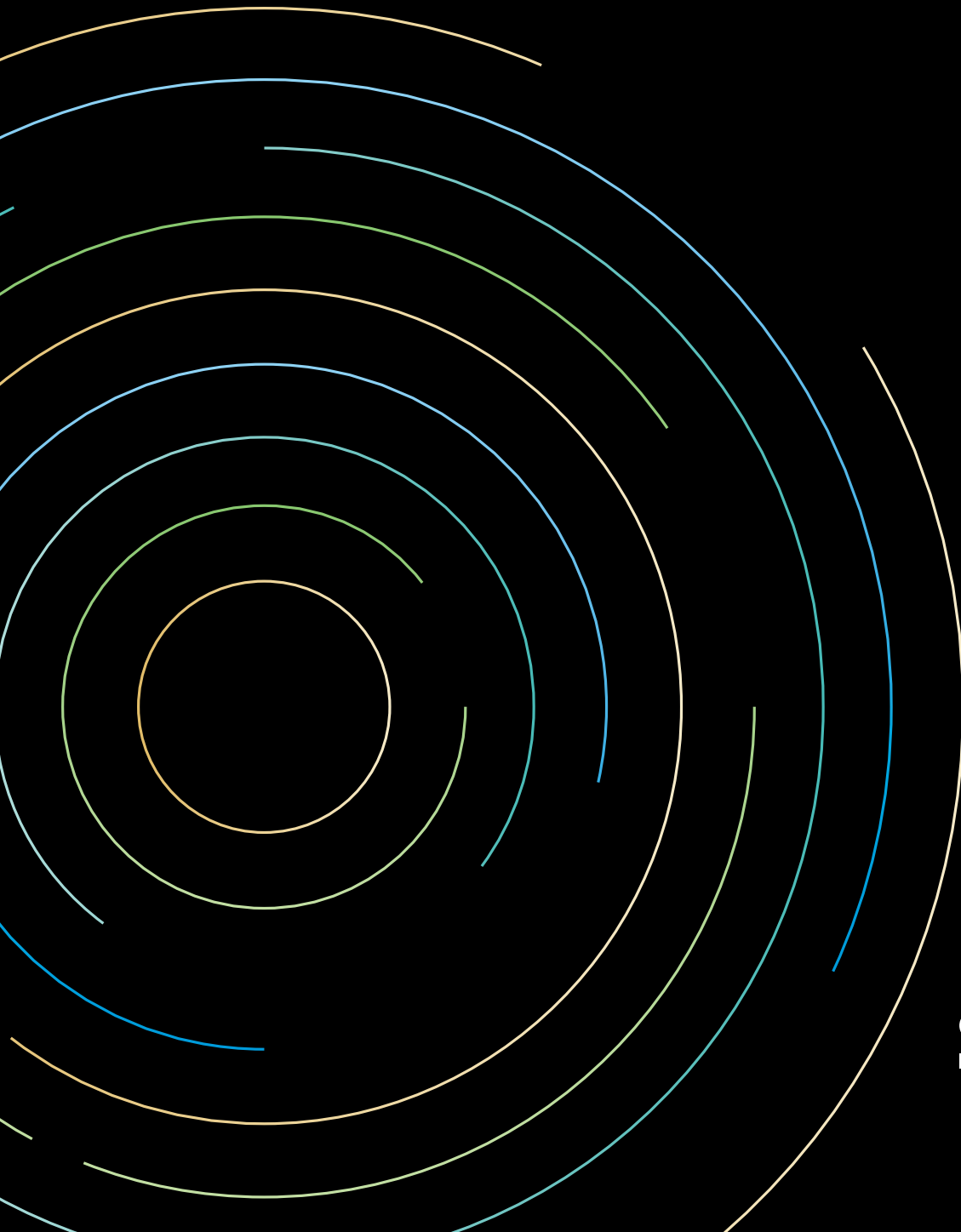


Credit Stress Toolkit

WHITE PAPERS



GOLUB CAPITAL

This three-part series brings together the following white papers:

Whose Default Is It? 4

Default Disparities Across Private and Public Credit

Default rates are a common starting point for evaluating credit performance. But what counts as a “default” can vary widely depending on who you ask. This paper explores the often-overlooked disparities in how defaults are defined and measured across public and private credit—and even among private credit managers themselves. It helps explain why default rates are not always directly comparable and can be misleading without context.

A Matter of Control 9

Covenants, Lender Vigilance and Managing for Outcomes in Direct Lending

The term “cov-lite” often carries a pejorative connotation, and the rise of cov-lite loans in private credit has sparked investor questions about lender protection and risk management. This paper offers a timely perspective on the role of covenants in private credit and how they remain important levers of control when supported by strong documentation and active oversight.

The Bigger PIK-ture 14

Bringing Clarity to Payment-in-Kind Structures in Private Credit

Payment-in-kind (PIK) interest is often viewed as a sign of borrower distress, but the story is more nuanced. In practice, private credit providers frequently offer PIK options to high-quality borrowers as a way to enhance flexibility and support long-term value creation. This paper explores the forms, timing and intent behind PIK—offering views on when it signals strength versus stress.

Credit stress is a recurring theme in investor conversations, often tied to headline topics such as default rates, cov-lite loans and PIK interest. Yet these topics are sometimes misunderstood or oversimplified in broader market commentary.

The Credit Stress Toolkit was developed by the Golub Capital Insights team to help investors better understand these commonly cited signs of credit stress—clarifying what they do (and don't) tell us in the context of private credit.

Whose Default Is It?

Default Disparities Across Private and Public Credit

In private direct lending, references to published default rates can vary widely—whether from traditional rating agencies, valuation firms or legal groups. We consider key differences in the very definition of “default” across different providers and the various methodologies used to measure them. The reality is that default can mean different things in different contexts and across different industry participants. We conclude that investors should always inquire: *Whose default is it?*

Public vs. Private

To start, investors should recognize a clear distinction between the nature of public and private credit and the various methodologies used to measure credit stress and default across these two areas. (See Exhibit 1)

Rating agencies maintain broad coverage of the syndicated public loan universe, with clear and common criteria for assessing these securities, and provide a consistent, industry-wide view. In contrast, coverage of private credit is less comprehensive, with more limited tracking of these illiquid, non-traded loans and different criteria applied to their credit

Exhibit 1

Public vs. Private: Different Markets, Different Metrics

	PUBLIC CREDIT	PRIVATE CREDIT
Rating Agency Coverage	Broad coverage of syndicated loan universe; all rating agencies provide credit “ratings”	Limited tracking of direct lending issuers and credits; some rating agencies provide credit “estimates”
Information Access	Information generally accessible on syndicated loans with transparent data	Private loan information that is both opaque and not readily available
Loan Pool	More clearly defined market-standard pool of loans for broad analyst engagement	No consensus on or equally accessible pool of loans for analyst measurement
Market Pricing	Generally available market pricing on most syndicated loans	No public venue for pricing; select loans marked quarterly by third-party valuation firms

Source: Golub Capital analysis and LSTA publication: “Why is there a disparity in private credit default rates?” May 15, 2024. The major indexes and ratings agencies use different methodologies and definitions to measure default. S&P Capital includes selective defaults, including PIK conversion or deferred payment, amend to extend, and amortization waivers. Conventional default includes only missed interest or principal payment, distressed exchange, and bankruptcy filing. Different ratings agencies also use different time periods for their default calculations: Fitch, S&P and KBRA calculate their default rates on a trailing 12-month basis, updated monthly, so they reflect the size of the universe 12 months prior; Proskauer and Lincoln consider defaults on a point-in-time quarterly basis.

estimates. The very distinction between a credit rating and a credit estimate is worth noting. Much of the difference in analyst coverage across public and private credit is due to the opacity of the private lending landscape, where information is less transparent and accessible. In a word, it's *private*.

As a result, it's easier to establish a consensus pool of loans and apply a consistent set of criteria to assess these loans in the public space. In private credit, however, the pool of loans readily available to any one rating agency will vary based on its own loan book and level of access.

The differences extend also to the absence of market pricing for most private loans—an important indicator of credit stress—since these securities are not publicly traded. Instead, valuations on private debt are provided, loan by loan, by the individual lenders themselves, often assessed or corroborated by third-party valuation firms.

Even when a credit estimate is available on a private loan, it must be understood as distinct, in terms of methodology and data availability, from a public issuer rating. All this renders side-by-side comparison of public and private credit default rates not only complicated but potentially misleading.

Private vs. Private

Even within the private credit space, there is no uniformity in how default is defined or measured.

Across the array of industry participants covering private credit issuers—which includes valuation firms, rating agencies and law firms—each draws from their own unique set of loan documents. As a result, no single source can reliably represent industry-wide credit stress. Further, some coverage analysts (such as Lincoln and Proskauer) include covenant breaches in their definition of default, while others do not. That's an important distinction. (See Exhibit 2)

Breaching a maintenance covenant, while technically a form of default, is not construed as a conventional measure of default. True default is far more grave; it usually involves a failure to pay principal or interest or company insolvency. Including covenant breaches can skew default rates—especially for smaller firms that are more likely to have such covenants. Larger firms, which tend not to have maintenance covenants, may appear less stressed simply due to this methodological bias.

Finally, other inconsistencies exist beyond the inclusion (or not) of covenant breaches. Some firms may include amendments, amortization waivers, payment-in-kind (PIK) conversions or distressed exchanges. While all of these actions may represent early signs of credit stress, they do not indicate the same degree of stress, and their selective inclusion or exclusion only adds to the disparity in measurement. Again, we must ask: Whose default is it?

Exhibit 2

Private vs. Private: Different Views from Different Lenses

AGENCY	UNIVERSE	INCLUDES COVENANT DEFAULTS	TYPES OF “SELECTIVE” DEFAULTS INCLUDED*
Fitch	Provides private ratings on 1,200 middle market loans	No	• PIK conversion/deferred payment
S&P	Provides credit estimates on 2,800 borrowers	No	• PIK conversion/deferred payment • Amend to extend • Amortization waiver
Proskauer	Tracks 980 senior secured and unitranche loans	Yes	• Includes covenant breaches
Lincoln	Tracks 500 middle market direct loans	Yes	• Covenant breaches only
KBRA	Index contains 2,400 companies financed by direct loans	No	• Distressed debt exchanges or restructurings • Excludes others (e.g., PIK, covenant breaches)

*The types of “selective” defaults included do not meet the definition of “conventional” defaults.
Source: Golub Capital analysis and LSTA “Why is there a disparity in private credit default rates?” May 15, 2024.

Selective Metrics May Heighten Perception of Risk

What does this mean for investors seeking to understand the level of true default risk in private credit? As shown in Exhibit 3, the inclusion of selective measures of default can significantly impact their perception of potential risk. Both metrics are provided by the same rating agency, but two things stand out.

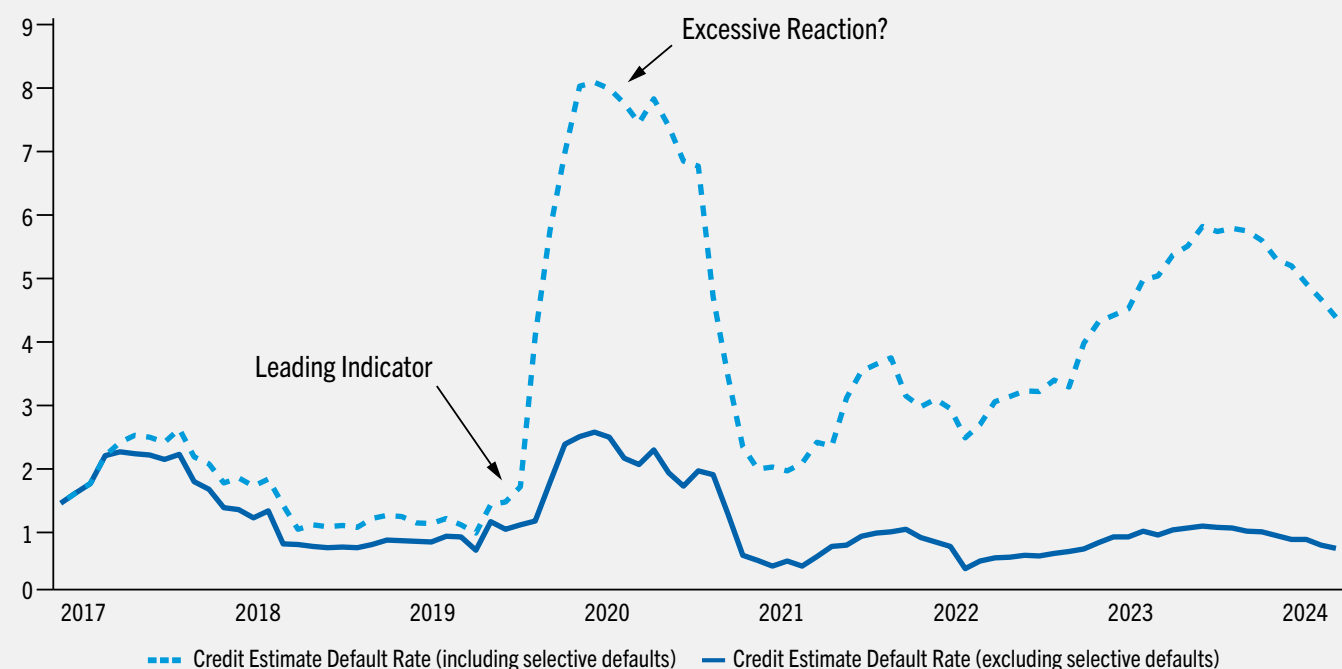
First, selective defaults tend to be significantly higher than the conventional payment default because they include more and earlier indicators of stress. Second, the selective default line is more sensitive, rising earlier and more sharply than conventional measures of default.

This suggests that selective default metrics can be a useful leading indicator of future stress. However, they can also amplify perceived risk. While they offer early detection value, that signal must be interpreted in a broader, more informed context.

Exhibit 3

Leading Indicator or Over-Reaction?

S&P Default Rate: Conventional vs. Selective¹ Default Measures



1. Golub Capital Analysis and S&P Capital; Selective defaults for S&P Capital include PIK conversion or deferred payment, amend to extend, and amortization waivers. Conventional default includes only missed interest or principal payment, distressed exchange and bankruptcy filing.

Whose Default Is It?

Consider three distinct measures of selective default rates from Fitch, S&P and Lincoln International, all measured at the end of Q3 2024.

Because each firm has its own distinct—possibly overlapping, but not identical—pool of loans and applies its own definition of selectivity in determining default, we’re left with highly disparate measures of default in the private credit space.

Fitch calculates its default rate based on a pool of approximately 1,200 loans. It’s an annualized figure, based on nine months of available data, marking it as a relatively new data source. S&P uses a broader base of around 2,800 loans and applies its own selective default methodology, which is similar to but not fully aligned with Fitch’s approach.

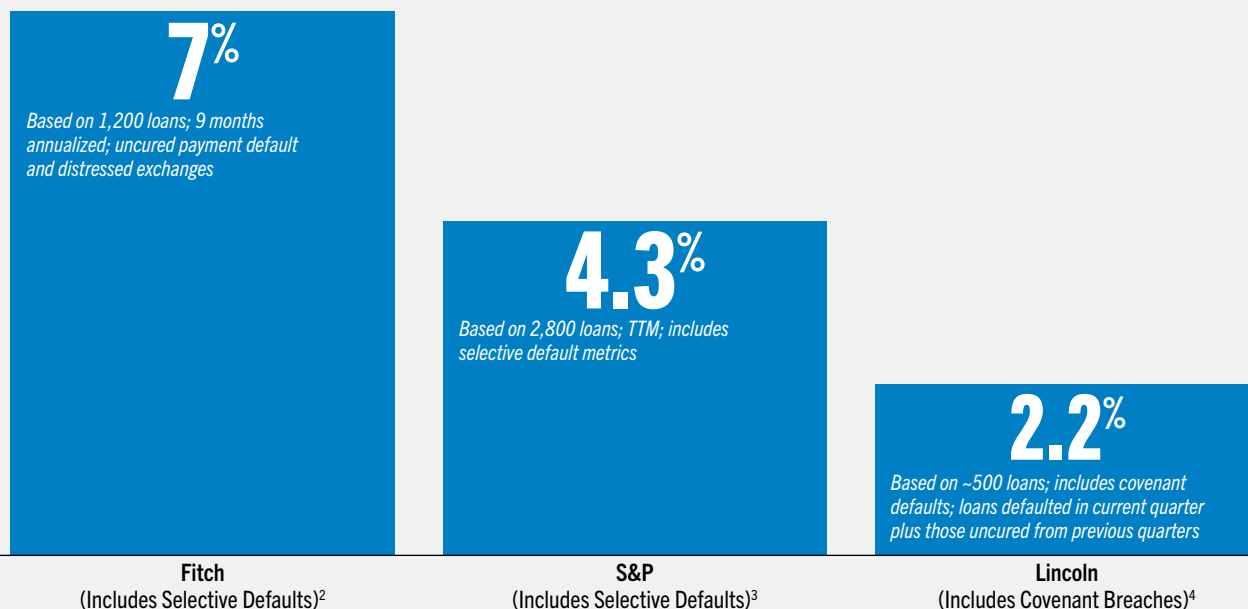
Meanwhile, Lincoln, which reviews about 500 direct loans as part of its valuation work, employs a distinct methodology centered on covenant defaults.

The result is more confusion than clarity, with default rates sometimes varying substantially across different organizations. The only way to navigate through this relativity in the representation of private market credit stress is to understand the distinct methodologies applied in each case.

Exhibit 4

Whose Default (Rate) Is It?

Disparate Default Rates¹ as of September 30, 2024



1. S&P Global Ratings Private Credit And Middle Market CLO Quarterly: “The Times They Are A-Changin’” (Q4 2024), Lincoln International Q3 2024 Lincoln Senior Debt Index and Fitch’s Private Credit Default Rate.
2. Fitch’s default rate includes both “restricted defaults” (where an issuer has experienced an uncured payment default or distressed debt exchange (DDE) but has not entered bankruptcy filings,) as well as “defaults”, which indicate that the issuer has entered into bankruptcy filings, liquidation, other formal winding-up procedures or has ceased business operations. A DDE occurs when the lender has experienced a significant reduction in terms that was executed to prevent bankruptcy, such as introducing a new PIK option or extending the debt’s maturity when the business is under a significant level of stress such that alternative refinancing options might not be available. Fitch’s default rate represents the nine-month (through 9/30) annualized default rate based on issuer count.
3. S&P’s default rate represents the trailing 12-month selective default rate based on issuer count.
4. Lincoln’s default is based upon covenant defaults and not payment defaults. Lincoln uses the size-weighted default rate for loans which have defaulted in the current quarter and defaults from previous quarters that are still in default status (i.e., have not been cured).

Manager vs. Manager: Degrees of Default Measurement

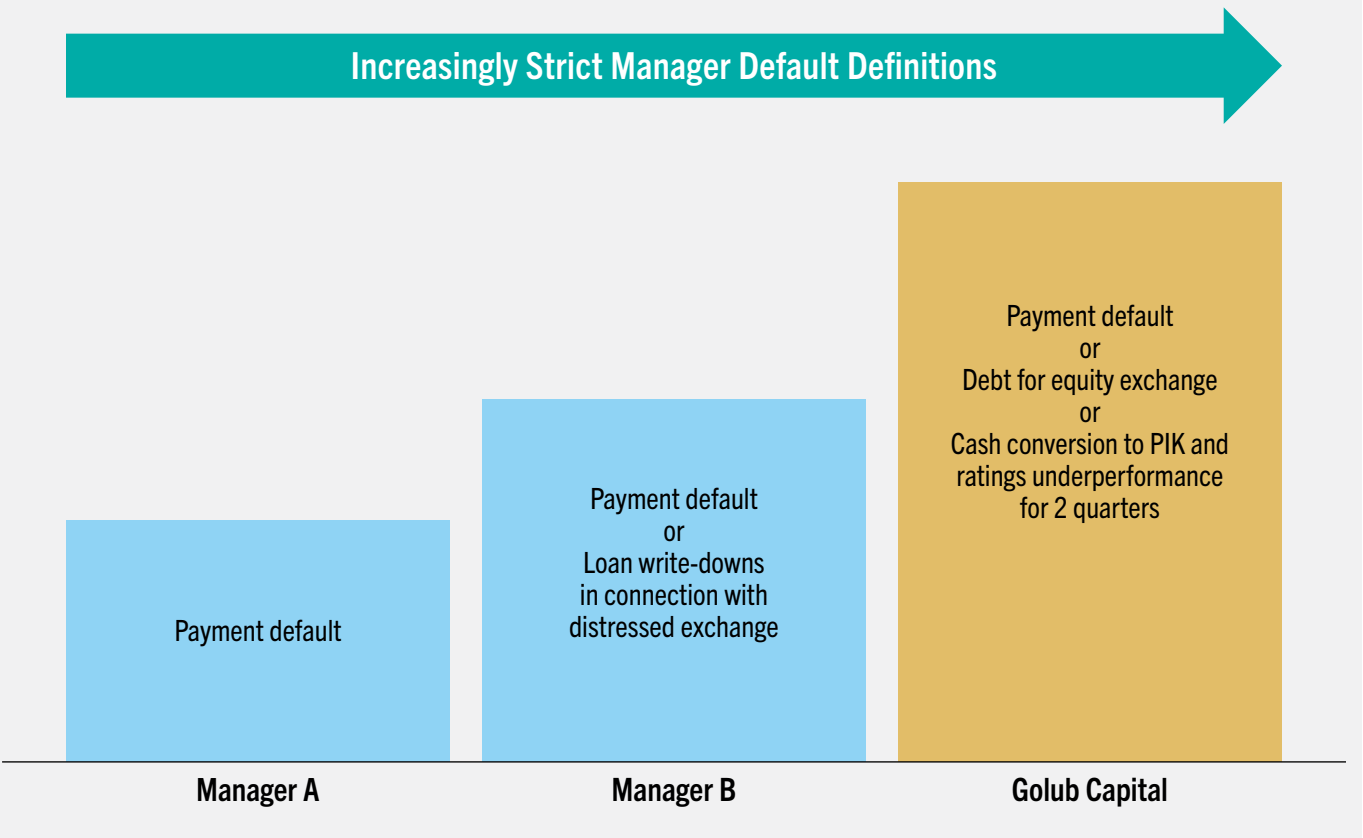
We pursue the disparities of default measurement beyond public vs. private and private vs. private contexts, down to the manager level. Here, too, we find a wide range of selectivity and varying degrees of strictness in the application of different definitions of default.

These differences are often buried in the footnotes of credit manager presentations. Some rely on a simple payment default metric, which is a conventional measure but a relatively narrow approach. Others expand their definition to include certain write-downs associated with distressed exchanges. Some adopt even more conservative criteria, including persistent ratings underperformance or PIK conversion. (See Exhibit 5)

These discrepancies can complicate due diligence and make manager-to-manager comparisons difficult. Our advice to investors remains the same. Always ask: Whose default is it?

Exhibit 5

Manager vs. Manager: Default Disparity Across Managers



A Matter of Control

Covenants, Lender Vigilance and Managing for Outcomes in Direct Lending

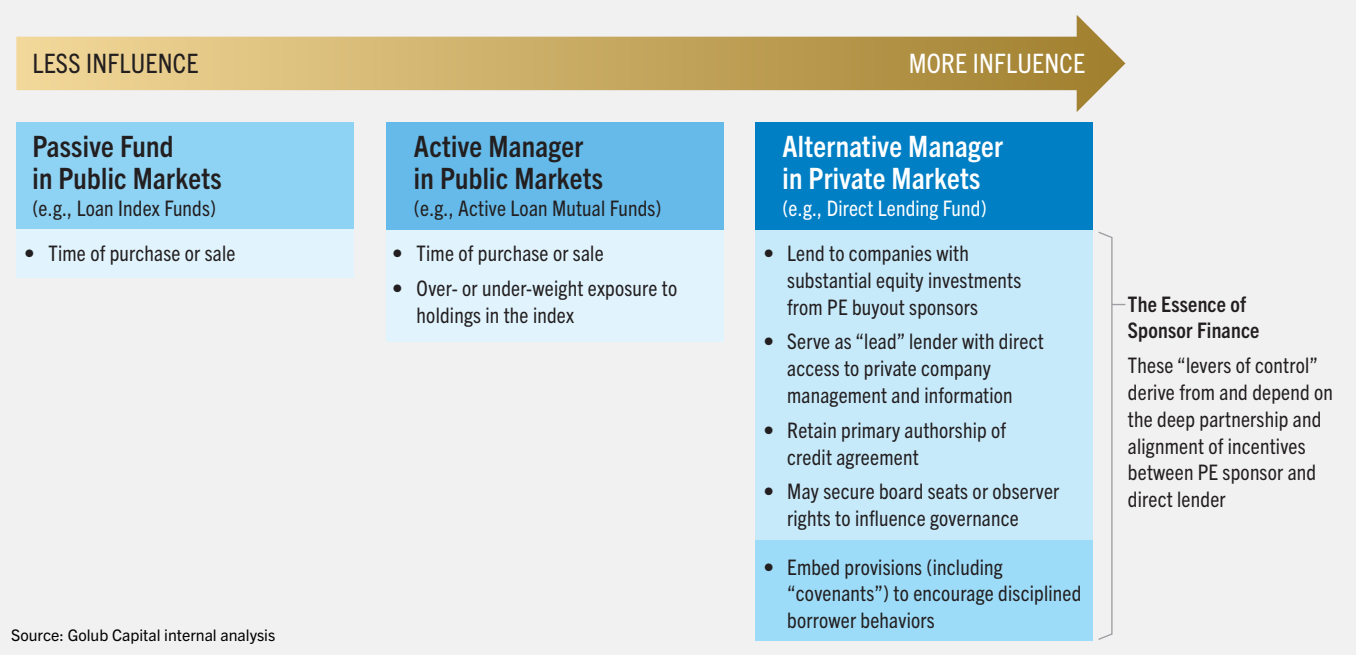
In the world of investing, so much seems out of our control. Yet, there are some areas where investment outcomes are not completely at the mercy of market forces, particularly in alternative strategies such as private credit. The role of covenants and lender vigilance in direct lending highlights several levers at managers' disposal to positively influence investment outcomes.

Investment strategies can be viewed on a continuum of manager control (Exhibit 1). On one end, passive investors relinquish control, seeking simply market exposure. They manage only the timing of purchase and sale. Traditional active management offers some control through selective overweighting and underweighting of index exposures, seeking to enhance returns above the market beta.

In the world of private markets, especially in private credit, managers have more levers to create value and, arguably, a greater ability to control or influence investment outcomes. They create bespoke exposures by analyzing private company information, investing alongside private equity (PE) sponsors as lead or sole lenders—often securing board seats—and by embedding explicit provisions (“covenants”) in their loan documents to monitor and/or restrict certain borrower actions.

Exhibit 1

Degrees of Control



Above all these levers of control stands the essential enabling condition of sponsor finance: the relationship between the PE sponsor and the direct lending manager. Sponsors value long-term partnerships with a small group of trusted lenders, and both sides value the ability to do repeat deals. This bond is the primary mechanism for aligning incentives.

In this essay, we focus on covenants as a tool for reinforcing that alignment and shaping investment outcomes.

To Maintain or to Incur: Similar Goal, Different Mechanism

Among various loan covenant types, two that require definition upfront and are particularly relevant to this discussion are maintenance and incurrence covenants (Exhibit 2).¹ Both aim to encourage borrower discipline and preserve lender value in cases where the borrower underperforms expectations, but they function differently.

Maintenance covenants, mostly confined to private middle market loans, have two key characteristics. First, they require borrowers to report key financial metrics on a regular basis, providing lenders with early warning signals of potential distress. Second, they serve as functional levers to force engagement,

where lenders can prompt corrective action if signs of stress begin to appear. The actual breach of any covenant level constitutes an event of default, giving lenders the power to accelerate the loan and/or enforce various creditor rights. Lenders may then exercise remedies, including potentially taking control of the company through stock pledge rights.

Incurrence covenants are different. They also reference a trigger point that the borrower must meet, but the level is only tested if a borrower performs certain prohibited actions. Incurrence covenants typically cover actions that increase risk to the lender, such as taking on more debt or distributing cash to equity holders without first repaying debt. If the borrower's financial situation deteriorates, incurrence covenants provide lenders with built-in protection against the borrower making matters worse.

It is important to note that when a loan is said to be “cov-lite,” that typically means it contains only incurrence and no maintenance covenants. The term “cov-lite” often carries a pejorative connotation, which we should be alert to. Both maintenance and incurrence covenants influence borrower behavior. In a loan agreement that includes both types of covenants, the incurrence provision is typically set at a more restrictive level than the maintenance covenant.²

Exhibit 2

Maintenance vs. Incurrence: Understanding Covenant Types

KEY TYPES OF FINANCIAL COVENANTS

Maintenance

- Industry analysts and rating agencies typically consider only maintenance covenants in their tallies.
- **Maintenance** covenants **require the borrower to demonstrate** compliance with specified financial provisions (e.g., leverage ratio) that are tested at regular monthly or quarterly intervals.
- Breach of maintenance covenant involves potential **transfer of control rights to lenders** (i.e., default).

Incurrence (AKA “Cov-Lite”)

- Industry analysts and rating agencies consider loans without maintenance covenants to be “**cov-lite**”—even if they have incurrence covenants.
- **Incurrence** covenants **restrict pre-specified actions of the borrower** if covenant threshold is crossed.¹
- **Incurrence covenants have a substantial binding force of their own and have significant effects on firm behavior.**

LEVERAGE RATIO EXAMPLE: ONE METRIC, TWO COVENANT TYPES*

Maintenance (Debt/EBITDA of 4.4x)

Covenant ratio breach is an “event of default”; allows lenders to “exercise remedies”

Incurrence (Debt/EBITDA of 3.6x)

Covenant ratio breach triggers contractual restrictions on prespecified actions (e.g., distributions to equity holders, capex or acquisitions)

1. This could include the issuance of additional financing, the sale of assets or a merger.

Source: High-Yield Debt Covenants and Their Real Effects, Brauning, Ivashina and Ozdagli, August 2023.

1. We should mention, in addition, a hybrid provision known as a springing covenant, which is distinct from traditional maintenance and incurrence covenants in that it applies only to the revolver, not the term loan. When a springing covenant level is triggered (or is “sprung” by reaching a certain utilization rate on the revolver, typically at ~35% drawdown level), it then requires quarterly testing, similar to a maintenance covenant. These become more common in loans to firms with higher earnings before interest, taxes, depreciation and amortization (EBITDA).

2. Generally speaking, the most common covenant metric today is a leverage ratio (i.e., debt divided by an agreed-upon definition of EBITDA). The leverage ratio is commonly used because it serves as a shorthand for the amount of debt relative to the annual cash earnings power of the business (EBITDA). Direct lenders lend against the cash earnings power of the business, and the enterprise value of the business is based on that same cash earnings power. See High-Yield Debt Covenants and Their Real Effects, Brauning, Ivashina and Ozdagli, August 2023.

A Study in Vigilance: The Zone of Control for Managing a Struggling Credit

To illustrate the framework of engagement and the rough sequence of interactions associated with maintenance covenants, we depict in Exhibit 3 what we call the “zone of control.”

This schematic encompasses the ongoing monitoring and reporting that companies provide to their lenders, alongside specific covenant terms, typically based on a common leverage ratio. Lenders (and sponsors) will note any changes in the recurring reports on the company’s financial condition, including potential deterioration in the borrower’s cash or leverage levels. In some cases, the buyout sponsor may agree to infuse cash into the business to reduce borrower stress in exchange for more room on covenant tests, known as an “equity cure.”

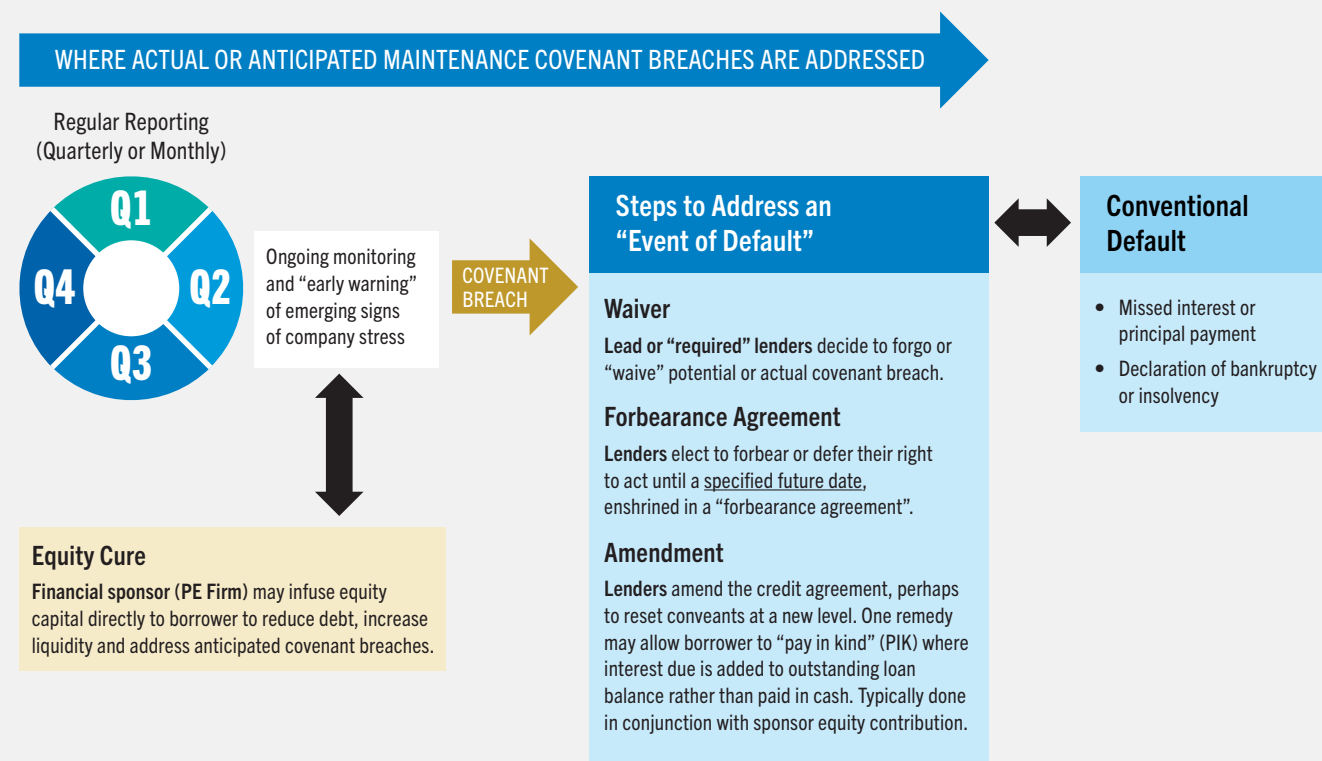
Lender meetings can happen regularly and well in advance of any triggering action associated with a maintenance covenant based on standard loan documentation and oversight. However, once there is a breach, the firm undergoes an event of default (distinct from a conventional payment default) that sets in motion a dedicated lender–borrower meeting.

At this point, several paths may be considered. If the breach is modest and both parties expect a return to normal levels, the lender can simply waive the breach and take further action, such as enhanced reporting or board visibility. If there is concern that the stress may persist but both groups see a return to better conditions in the near future, a forbearance agreement may be reached, specifying a timeframe during which the lender agrees not to exercise remedies. If both parties agree that the covenant level is too restrictive, they can amend the agreement to reflect a different level. All of these actions—waivers, forbearance agreements and amendments—typically involve fees paid by the borrower to the lender.

Finally, if after these measures are taken, the borrower continues to struggle to meet its interest or principal requirements, the lender may seek to exercise remedies. This could include a host of actions short of taking control. However, the most extreme step in the process is installing a new board at the company—essentially taking the keys. This last step may, in some cases, prompt equity owners to consider bankruptcy for the borrower.

Exhibit 3

The Zone of Control



Source: Golub Capital internal analysis. Waivers, agreements and amendments may and typically are associated with lender fees.

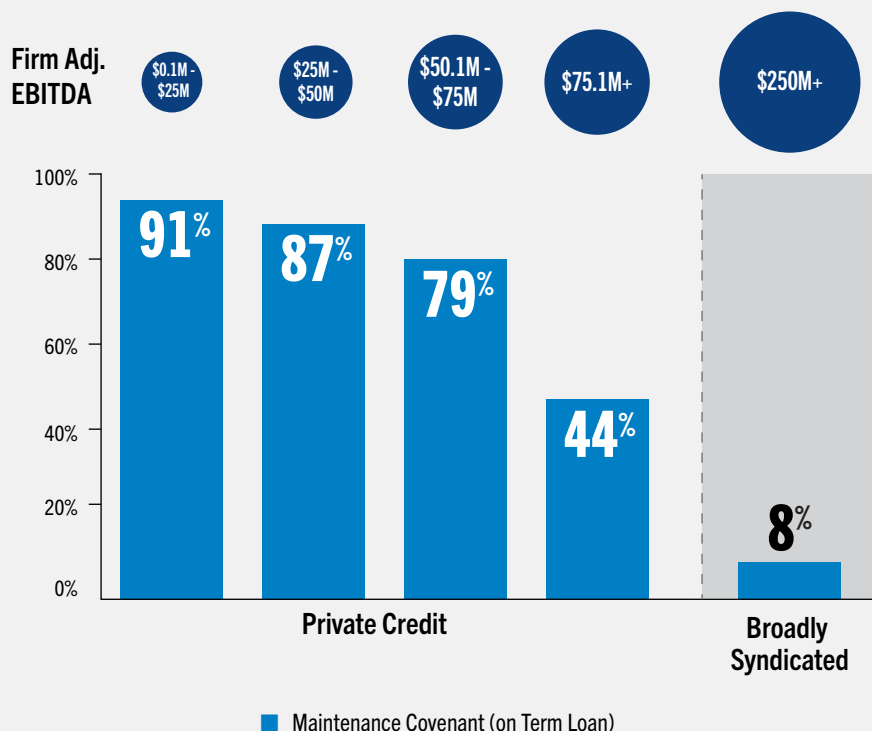
From Maintenance to Incurrence and Beyond

The role that maintenance covenants play in middle market direct lending is important to acknowledge. As shown in Exhibit 4, most private middle market loans include them—up to a point.

Maintenance covenants are more prevalent in smaller deals involving less mature companies, where arguably more oversight is warranted: Generally speaking, borrowers with EBITDA of less than \$50 million are typically subject to a maintenance requirement. As companies grow in size and become more seasoned and resilient, the prevalence of borrowers with maintenance covenants declines. In the public broadly syndicated loan market, maintenance covenants are used only sparingly.¹ While there is a reasonable argument for the diminution of maintenance covenants as company EBITDA grows, other control mechanisms remain, such as negative covenants and incurrence covenants.

Exhibit 4

Sliding in Scale: Maintenance Covenants and Company Size²



“Cov-Lite” Carries the Stigma of “Borrower Friendly,” but...

- Incurrence covenants are typically set at a lower (tighter) threshold than maintenance covenants.²
- The restricted actions triggered by incurrence covenants are intended to re-align incentives of borrowers with their creditors as financial performance deteriorates. They tend to include:
 - Restrictions on payments to shareholders (71%)
 - Restrictions on indebtedness (62%)
 - Restrictions on investment and asset sales

1. As company EBITDA grows and the percentage of loans with maintenance covenants declines, we tend to see a corresponding rise in the number of springing covenants on the revolvers in larger deals, almost as a kind of counterbalance to the decline in term loan maintenance covenants in these deals.

2. Credit Insights Covenant Review, based on the last 12 months as of December 2024.

3. “High-Yield Debt Covenants and their Real Effects.” Brauning, Ivashina and Ozdagil, August 2023.

Lite, Tight and Loose

While maintenance covenants provide value, their presence alone is no panacea. A robust credit agreement should include an array of protective documentation, extending well beyond the inclusion of maintenance covenants (Exhibit 5).

For example, if a maintenance covenant is set at a lenient level that allows substantial underperformance before it is reached, it can be as ineffective as having no covenant at all. Similarly, if the measurement of EBITDA is not clearly defined, the effectiveness of a covenant based on it can be undermined. To ensure sound credit lending practices, various add-backs that might distort EBITDA must be carefully assessed and, in some cases, restricted. The same scrutiny must be applied to borrower collateral—lenders must seek to limit leakage or the ability of the borrower to move key company assets outside the control of the creditor group.

These, and a host of other negative covenants, need to be employed to guard against borrower misbehavior. Such covenants would limit borrowers from taking on additional debt, paying equity shareholders or engaging in acquisitions or capital expenditures that might misalign their incentives with those of their creditors.

The loan document and its covenant-type provisions provide lenders with a means to guide borrower behaviors and encourage the constructive resolution of issues when they arise. They are functional levers of control, allowing private credit managers to influence investment outcomes—a rare commodity in today's investing environment.

Exhibit 5

Cov-Lite Does Not Mean Cov-Less

Don't Be Too Loose

Maintenance covenants may be “loose,” with substantial cushion, or set at a level where substantial underperformance would have to occur before the covenant is breached. The industry sometimes calls this “covenant-loose.”

Define EBITDA

Embedding a clear definition and precise measurement of EBITDA is critical, as it drives most of the monitoring and triggering structures in an indenture agreement, including compliance with various provisions.

Assess Add-Backs

EBITDA can be manipulated by “add-backs” that distort earnings via actions such as immediately taking projected or pro-forma cost savings that have not yet been actioned. They are often related to acquisitions or other proposals.

Control Collateral

Besides EBITDA, lenders seek extensive documentation to mitigate collateral leakage, provisions may limit the borrower's ability to move key company assets (including material IP) to unrestricted subsidiaries outside of the creditor group.

Align Incentives

A host of “negative” covenants could be employed to prevent borrowers from issuing additional debt, using cash to pay shareholder dividends, engaging in acquisitions or capex and taking any other actions that re-align incentives away from creditors.

Source: Golub Capital internal analysis

The Bigger PIK-ture

Bringing Clarity to Payment-in-Kind Structures in Private Credit

Some commentators have described payment-in-kind (PIK) interest as being everywhere and always a sign of borrower distress. In reality, private credit providers often offer PIK to the very best borrowers. For good borrowers, PIK options (whether utilized or not) can enhance borrower flexibility and increase both equity and lender returns. When structured thoughtfully, PIK options can support growth, preserve liquidity, provide an alternative to more expensive equity financing and align with long-term value creation. This paper explores the forms, timing and intent behind PIK, helping investors distinguish between cases where PIK is a sign of strength and where it is a sign of weakness. The key is not to fear PIK but to understand it.

The Growth of PIK in Private Credit

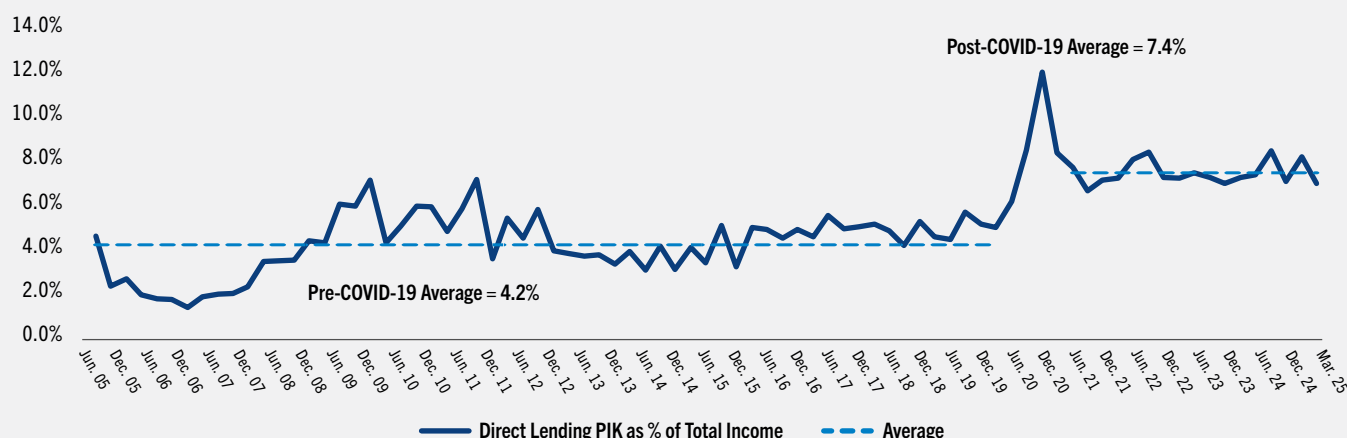
Over the past decade, and particularly since the COVID-19 pandemic, PIK interest has evolved from a niche structuring tool into a mainstream feature of private credit (see Exhibit 1). This expansion has also sparked concern—and, at times,

confusion—among investors. A frequently asked question is, “What percentage of the portfolio is PIK?” Often, this single number is used (incorrectly) as a proxy for assessing portfolio stress, rooted in the historical association of PIK with distressed borrowers or subordinated debt—typically used when companies lack the liquidity to service cash interest.

However, this view is increasingly being seen as outdated.

Exhibit 1

PIKing Up the Pace in Private Credit



In today's direct lending environment, PIK has also become a flexible, strategic feature—not just a signal of distress. Private credit lenders are now incorporating PIK into select new senior secured loans as part of a customized financing solution designed to accelerate growth. In these cases, PIK is not a red flag. It is a feature, not a flaw: It gives borrowers the flexibility to reinvest cash into expansion while enhancing lender economics through higher yields.

In other scenarios, of course, PIK may be introduced to support a borrower facing financial pressure. In those cases, too, it is typically accompanied by improved terms for the lender and/or additional support from the private equity sponsor, such as a cash equity infusion. These structures can preserve value and create a bridge to recovery rather than signal inevitable impairment.

Understanding these nuances is essential to accurately assessing the risk and opportunity that PIK presents in a modern credit portfolio.

Unpacking PIK

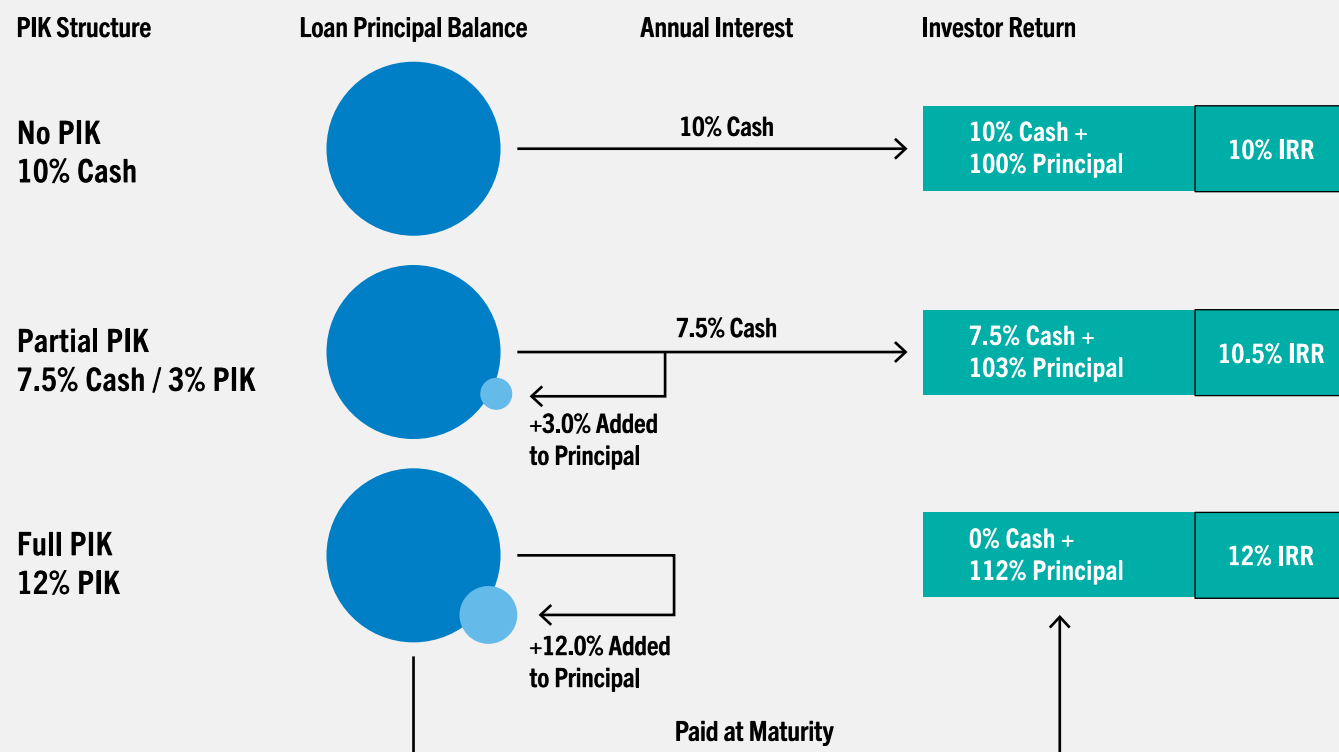
At its core, PIK interest is a mechanism that allows borrowers to defer cash interest payments by capitalizing them—essentially adding the accrued interest to the principal balance of the loan. This structure enhances borrower liquidity (allowing them to use cash for other purposes, not the payment of quarterly loan interest), while lenders are compensated through a growing loan balance and, typically, a higher overall yield.

The PIK payment structure can take several forms, each with distinct implications for both borrower and lender.

- 1. Partial PIK:** This is a hybrid structure where a portion of the interest is paid in cash, and the remainder is capitalized. This approach balances liquidity management with lender cash flow (with modestly lower cash flows but higher principal and total return).
- 2. Full PIK:** In this case, all interest is paid in kind, with no cash interest component. This structure maximizes cash preservation for the borrower while generating higher returns for the lender via a higher non-cash interest rate and compounding returns (based on higher principal amounts).

Exhibit 2

PIK Now, Pay (More) Later



Source: Golub Capital internal analysis. For illustrative purposes only.

Evaluating PIK: Context, Timing and Borrower Health

PIK interest is often misunderstood as a blanket indicator of borrower distress. A common investor question—“What percentage of the portfolio is paying PIK?”—oversimplifies a nuanced credit feature. The reality is that PIK must be evaluated through the lens of its context, timing and underlying borrower fundamentals.

PIK at Origination: A Strategic Tool

When PIK is structured at the time of origination—particularly for healthy, resilient businesses—it is typically part of a deliberate, risk-calibrated strategy. In these cases, PIK is negotiated to support growth, manage liquidity or align with a borrower’s capital deployment plan. Far from being a red flag, this form of PIK can enhance flexibility and enable value creation without compromising credit quality.

PIK “Toggle”: For Borrower Optionality

PIK toggle structures, which allow borrowers to switch between cash and in-kind interest at will, introduce more complexity. PIK toggles are typically temporary in nature, often lasting two years, and are designed to provide short-term flexibility. The rationale behind the toggle is critical. A borrower opting for PIK to reinvest in high-return growth opportunities presents a vastly different credit profile than one toggling due to liquidity constraints or deteriorating fundamentals. In this case, investor judgment and borrower transparency are key.

“Mid-Life” PIK Amendments (Restructured PIK): A Signal, Not a Sentence

When PIK is introduced mid-loan via amendment, it typically reflects emerging stress. This may indicate a weakening financial position or a need to preserve cash. However, it can still be a value-preserving move—particularly when paired with meaningful concessions from the borrower, such as a sponsor equity infusion or an operational turnaround plan. In these cases, lenders may view temporary PIK relief as a bridge to recovery, not a path to impairment.

The bottom line: context is everything. PIK should not be viewed as inherently good or bad. Instead, it should be assessed based on:

- The timing of its implementation
- The rationale behind its use
- The underlying health and trajectory of the borrower

When tied to a fundamentally sound business, PIK can be a smart, risk-adjusted feature that supports long-term value creation. When linked to a distressed borrower, it may signal elevated risk. Even then, however, it can be part of a thoughtful restructuring strategy. For investors, the key is not to fear PIK but to understand it. A nuanced view enables better risk assessment, more informed portfolio monitoring and, ultimately, stronger credit outcomes.

Exhibit 3

A Quick Peek: A Framework for Understanding PIK

Less Risky

PIK at Origination

- Borrower and lender agree to let loan PIK at the loan’s reception
- Lender has insight into how cash savings will be used

PIK Toggle

- Borrower can choose between a cash or PIK coupon
- Lender has less certainty if they will receive a cash coupon

More Risky

Restructured PIK

- PIK introduced to a loan that previously had no PIK optionality
- This is not ideal as it potentially shows growing distress in a borrower

Ultimately, PIK should be evaluated through the lens of the borrower’s current financial health, liquidity position and strategic intent. Its implementation can signal either prudent capital management or emerging stress—context is key to determining whether its use is constructive or concerning.

Note: Synthetic PIK is excluded from this chart. Synthetic PIK refers to situations where a borrower uses another form of debt, such as drawing on a revolving credit facility or delayed draw term loan, to fund cash interest payments. While not as contractually structured as PIK, it has a similar economic effect by increasing leverage and preserving cash, effectively adding debt to the borrower’s balance sheet.

Source: Golub Capital internal analysis. For illustrative purposes only.

A Deeper Dive: What's Driving the Growth in PIK?

The recent rise in PIK interest across direct lending markets has prompted an important question from investors: “Is this a sign of growing borrower stress or a reflection of private credit’s evolving sophistication?” As with most credit dynamics, the answer is nuanced. There are two fundamental drivers behind the rise in PIK.

PIK as a Competitive Structuring Tool

One key driver of the growth of PIK is its increased use as a proactive structuring feature that lenders can deploy for prospective borrowers. Direct lenders are including PIK—particularly toggle features—at origination to offer more flexible, bespoke financing solutions that appeal to sponsors and borrowers. PIK gives borrowers more tools in their toolkit to navigate changing environments, allowing them to manage interest obligations across a range of base rate scenarios or other potential liquidity headwinds. Private direct lenders may view their provision of PIK as a powerful inducement when

dealing with larger borrowers who might otherwise seek funding in public markets (where PIK loans are much rarer).

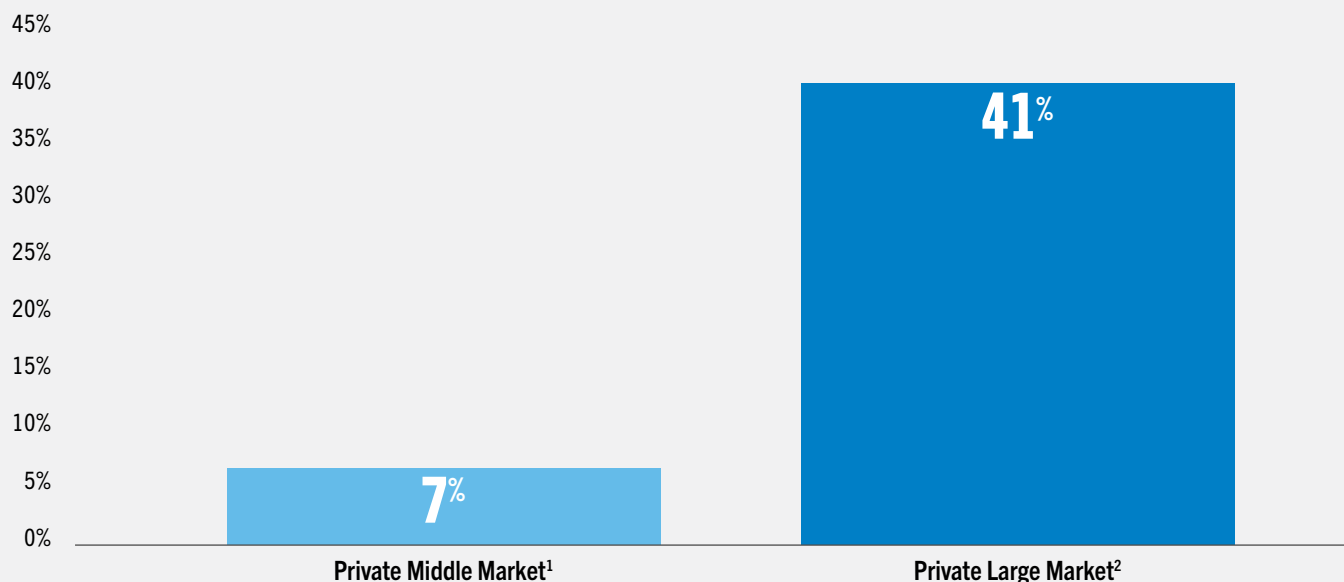
According to S&P Global, a 2024 review of over 300 private credit agreements found that 41% of large market deals (loan sizes of >\$750M) included a PIK toggle feature, compared to just 7% in the middle market (loan sizes of <\$750M) (see Exhibit 4). This underscores how the availability of PIK has become a differentiator for private direct lenders in competitive deal environments, particularly at the upper end of the market, which competes with the broadly syndicated loan market.

PIK as a Reactive Liquidity Tool

At the same time, some borrowers are turning to PIK out of necessity. During periods of higher interest rates, companies facing margin compression or liquidity constraints may activate toggle features or seek amendments to convert cash interest into partial or full PIK. These reactive uses of PIK, especially when tied to deteriorating fundamentals, can be more concerning and may signal elevated credit risk.

Exhibit 4

PIK Toggle Feature in Credit Agreements Executed in 2024



Source: S&P Global Ratings’ “Private Credit And Middle-Market CLO Quarterly: Unknown Unknowns Q2 2025”. S&P Global reviewed 304 credit agreements executed in 2024 to identify loan structures with a PIK toggle.

1. Private Middle Market comprises loans of \$750 million or less. The Private Middle Market loan data set includes 250 private credit agreements with 17 PIK toggle features.

2. Private Large Market comprises loans greater than \$750 million. The Private Large Market loan data set includes 54 private credit agreements with 22 PIK toggle features.

A Dual Narrative: Innovation and Stress

The growth in PIK reflects both structural innovation and cyclical pressure. On one hand, it enhances the private credit value proposition through flexibility and customization. On the other, it can serve as a short-term bridge for borrowers under financial strain.

Recent data illustrates this duality. Structured PIK—where PIK is embedded at origination—began rising in 2021 as lenders increasingly used it to offer bespoke financing solutions to larger borrowers entering the market (see Exhibit 5). This trend leveled off by 2023, suggesting normalization of the feature in deal structuring. In contrast, materially modified PIK—defined as amendments where the PIK spread increases by 250 basis points or more—began climbing in late 2022, coinciding with

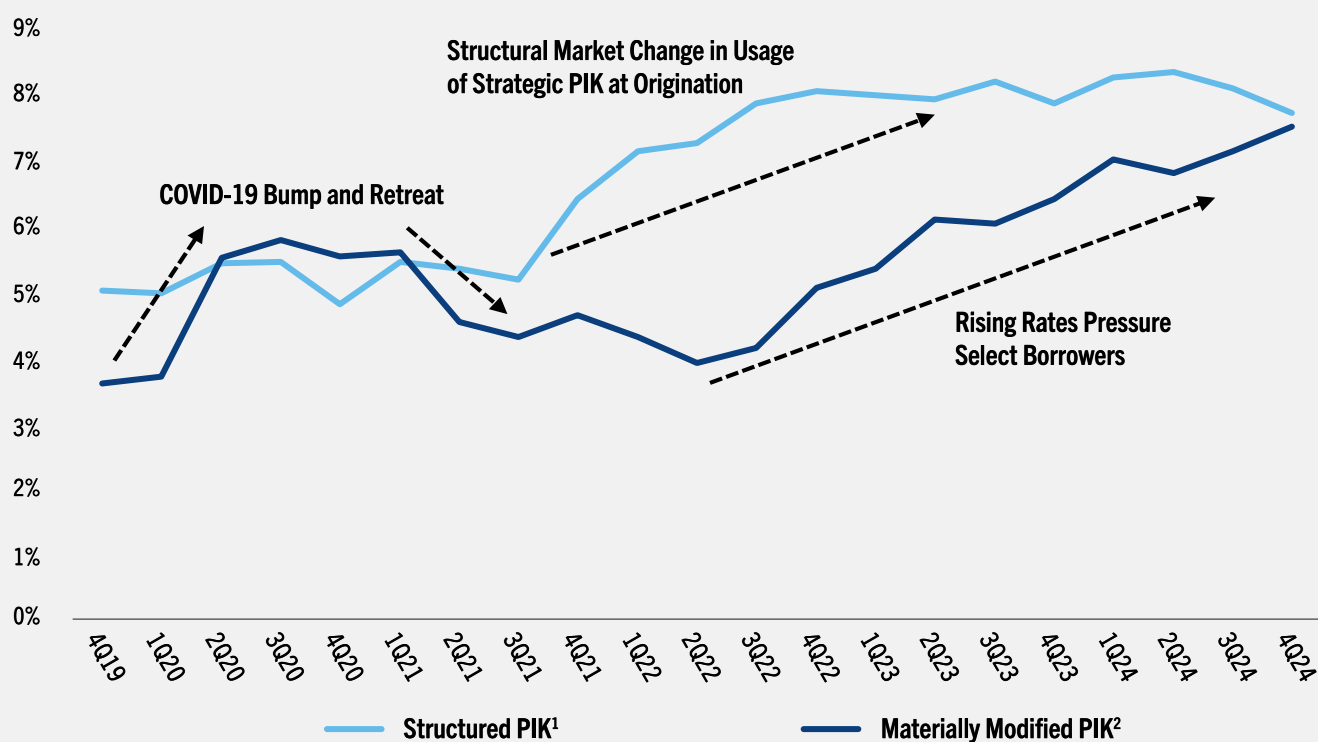
the lagging impact of the Federal Reserve’s rate hikes as borrowers sought relief from rising debt service costs.

Importantly, structured PIK and materially modified PIK have contributed roughly equally to the rise of PIK over the past four years, underscoring that this growth is driven by a blend of structuring innovation and reactive adjustments, not by a single factor. Together, these trends reinforce the fact that PIK growth is not monolithic. Understanding which dynamic is at play is essential to interpreting the credit signal behind PIK.

Exhibit 5

Drivers Behind the Rise of PIK

Weighted Average Portfolio Composition with PIK—Competitive Structuring versus Reactive Liquidity Tool PIK



Source: Golub Capital internal analysis utilizing the underlying data set provided by Raymond James Research. The data set represents approximately \$160 billion in business development company assets under management as of December 31, 2024.

1. Structured PIK refers to loans that included a PIK component at origination, where the PIK spread has not materially changed post-origination (defined as a change of less than 25 basis points).
2. Materially Modified PIK refers to loans where a PIK component was either introduced post-origination or the existing PIK spread had increased by 250 basis points or more.

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The Credit Stress Toolkit was developed by the Golub Capital Insights team to help investors better understand these commonly cited signs of credit stress—clarifying what they do (and don't) tell us in the context of private credit.

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