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PIK Income Pressures BDC Cash Dividend Coverage

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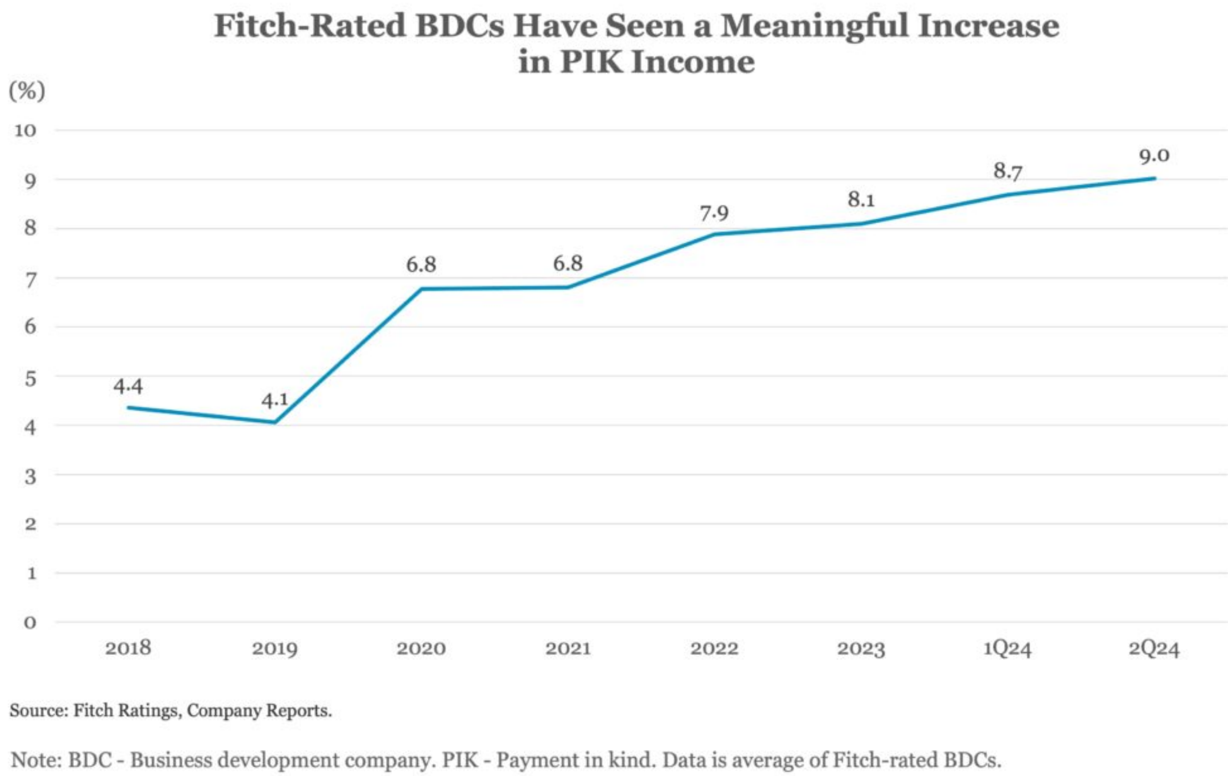

BDC Cash Income Dividend Coverage Pressured by Payment-in-Kind Income

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U.S. business development companies' (BDCs) cash earnings coverage of dividends is expected to weaken further from 2Q24 levels as the persistence of elevated interest rates will drive further increases in paid-in-kind (PIK) income, Fitch Ratings says. Potential rate cuts, spread compression and higher non-accruals are also headwinds to BDCs' net-investment income (NII).

While the introduction of supplemental dividend frameworks by many BDCs in recent years should preserve dividend coverage on a gross NII basis, coverage has already fallen below 100% on a cash earnings basis and is expected to remain under pressure.

In 2Q24, 18 Fitch-rated BDCs exhibited cash earnings dividend coverage (NII adjusted for net non-cash interest income/regular declared dividends) below 100% despite strong growth in NII from high rates. Sustained cash earnings coverage below 100% is viewed negatively. For 2Q24, PIK averaged 9.0% of interest and dividend income for the rated peer group, up from 8.7% in 1Q24 and 8.4% in 2Q23. BDCs are required to distribute 90% of taxable income, including PIK interest, and increasing PIK interest income could result in mismatches between cash interest received and cash dividends paid out.