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# KIK Consumer Products: Can KIK Use a Drop-Down Transaction to Incur Debt to address Liquidity under its Bond Covenants

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Research Date: September 8, 2025

## KIK Consumer Products: Can KIK Use a Drop-Down Transaction to Incur Debt to address Liquidity under its Bond Covenants?

### The Bottom Line™:

- KIK would have at least approximately \$915 million of investments capacity under the Notes (assuming that this capacity has not already been used).
- Two J. Crew blockers prevent a drop-down transaction with respect to Material Intellectual Property.

### Overview

Bloomberg [reported](#) that KIK Custom Products Inc. (“KIK”) is working with PJT Partners to evaluate its options to shore up liquidity amid earnings pressure. Additionally, a group of creditors to KIK have engaged Centerview Partners as an adviser.

In our report, [Can KIK Use an Uptiering Transaction to Incur Superpriority Debt under the Secured Bond Covenants?](#) (the “Prior Report”), we explored how an uptiering transaction would implicate the covenants for KIK’s outstanding Secured Notes. We assume that subscribers have read the Prior Report; defined terms used in this report without definition have the meanings assigned to them in the Prior Report.

We have examined how much Restricted Payments and investments capacity KIK has under the covenants for its Secured Notes and the \$450 million of 10.75% Senior Notes due 2032 (the “Unsecured Notes” and together with the Secured Notes, the “Notes”). KIK potentially could use this investments capacity to divert valuable assets to an Unrestricted Subsidiary and raise new debt at that Unrestricted Subsidiary. The Unrestricted Subsidiary would not be subject to the covenants for the Notes, so there would not be any restriction on how much debt it could incur or how it could use the proceeds of that debt. Accordingly, KIK could offer this new Unrestricted Subsidiary debt in exchange for, or use cash proceeds of, the new debt to shore up its liquidity needs. Just like in the J. Crew transaction, this new Unrestricted Subsidiary debt would prime the existing debt to the extent of the assets transferred.

While J. Crew used its investments capacity to transfer valuable intellectual property to an Unrestricted Subsidiary, investors should be aware that the J. Crew maneuver need not be limited to intellectual property assets but could be accomplished by “investing” any valuable assets into an Unrestricted Subsidiary.

### **Sources of capacity under the Notes to make investments in Unrestricted Subsidiaries.**

Under the covenants for the Notes, to divert assets to Unrestricted Subsidiaries, KIK could use (1) general purpose capacity under the Restricted Payments covenant<sup>1</sup> to make Restricted Investments in Unrestricted Subsidiaries and (2) capacity under any Permitted Investments basket that permits investments in Unrestricted Subsidiaries. KIK would require capacity equal to the fair market value of the entity designated or the assets transferred.

<sup>1</sup> See *Limitation on Restricted Payments* in the Final OM.

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## ***Meaningful Sources of Investments Capacity Under the Notes***

### Leverage-based carveout

The “Permitted Investments” definition for the Notes contains a leveraged-based carveout that allows the Issuer and its Restricted Subsidiaries to make any investment if the pro forma Consolidated Total Leverage Ratio (net debt: Consolidated EBITDA) would not exceed 6x<sup>2</sup>. Investments made under this carveout would not reduce basket build-up capacity. If we assume that KIK would exceed a 6x Consolidated Total Leverage Ratio pro forma for diverting assets to Unrestricted Subsidiaries, then this carveout would not be available.

### Restricted Payments build-up basket

Restricted Payments build-up basket capacity<sup>3</sup> for the Notes builds from the greater of (1) 50% of Consolidated Net Income from the first day of the fiscal quarter in which the issue date occurred and (2) the Retained Excess Cash Flow Amount, plus other customary components. There is a starter amount to the greater of \$310 million and 100% of Consolidated EBITDA. There is no Ratio condition that KIK must meet for it to be permitted to use any accumulated basket build-up capacity. Estimating Restricted Payments build-up basket capacity is always tricky because only KIK would have all the information required to accurately calculate the various contractual addbacks to the definition of “Consolidated Net Income” or to know the Retained Excess Cash Flow Amount.

As we warned in our [report](#) on the terms of the Notes, the absence of a financial ratio test as a condition to use of the build-up basket could make it considerably easier for KIK to transfer value out of the credit at a time of financial stress.

### General Restricted Payments basket

The Restricted Payments covenant also includes a general Restricted Payments basket.<sup>4</sup> The general basket under the Notes allows Restricted Payments to the greater of \$124 million and 40% of Consolidated EBITDA. Restricted Payments made under this carveout would not reduce build-up basket capacity, so it could be used concurrently and cumulatively with any available build-up basket capacity.

### Unrestricted Subsidiary investments

Restricted Payments clause (7) in the Notes is a basket for investments in Unrestricted Subsidiaries to the greater of \$124 million and 40% of Consolidated EBITDA.

### General investments

Permitted Investments clause (13) in the Notes is a general investments basket to the greater of \$232.5 million and 75% of Consolidated EBITDA.

### Similar Business investments

Permitted Investments clause (8) in the Notes is a basket for investments in a Similar Business (which arguably could include an Unrestricted Subsidiary) to the greater of \$124 million and 40% of Consolidated EBITDA.

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<sup>2</sup> See clause (28) of the definition of “Permitted Investments” in the Final OM.

<sup>3</sup> See the second paragraph of the Limitations on Restricted Payments section in the Final OM.

<sup>4</sup> See clause (11) of the Limitations on Restricted Payments section in the Final OM.

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## J. Crew blocker

The Notes include two J. Crew blockers. They appear as the last sentence of the Restricted Payments covenant and the last paragraph of the Unrestricted Subsidiary definition. Each blocker begins with “Notwithstanding” language which means they override anything else in the terms of the Notes. The blocker at the end of the Restricted Payments covenant provides that the covenant shall not permit an IP Separation Transaction. An “IP Separation Transaction” is generally when the Issuer or a Restricted Subsidiary transfers or contributes Material Intellectual Property to an Unrestricted Subsidiary (excluding bona fide operational JVs formed for legitimate business purposes), and after the deal, the Issuer or a Restricted Subsidiary licenses that Material Intellectual Property back from the transferee for ordinary-course use. Arrangements that are only short-term transition services or standard customer / supplier-style licenses do not qualify.

The final paragraph of the Unrestricted Subsidiary definition generally provides that the Issuer cannot designate a Restricted Subsidiary that holds Material Intellectual Property (whether owned or exclusively licensed) as an Unrestricted Subsidiary if, after the designation, the Issuer or any Restricted Subsidiary licenses that Material Intellectual Property back for ordinary-course use.

## **Summary**

Taken together, KIK would have at least approximately \$915 million of investments capacity under the Notes (assuming that this capacity has not already been used).

Material Intellectual Property, however, cannot be transferred to an Unrestricted Subsidiary because of the J. Crew blockers. Investors should consider whether there are other assets that could potentially be moved to an Unrestricted Subsidiary as part of drop-down transaction. If it is not possible to identify other assets that could be moved away from the main business, then a drop-down transaction may not be feasible as a practical matter, regardless of covenant capacity.

However, what constitutes “Material Intellectual Property” is not defined in the Final OM.

— *Covenant Review*

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