Debt finance on the quiet

Private placements offer a major capital source with relatively competitive pricing. Andrew Moorfield of bfinance.co.uk provides some background.

A private placement is a debt capital market transaction that generally has covenant features similar to a bank loan and is often used as an alternative to bank funding. Unlike a traditional public debt market transaction which is distributed to a wide range of investors and can trade in an active secondary market, a private placement is not actively traded. Typically a private placement is marketed to a much smaller number of long-term 'buy and hold' investors, with the deal eventually being distributed to between 6-12 interested parties.

Although private placements can be issued in any major currency, most are fixed rate, US dollar denominated transactions, due to the fact that the majority of private placement investors are located in the US. Private placements are issued for a range of long-term maturities over three years for amounts ranging from £10m to £300-400m (although some recent issues have exceeded this upper limit).

When weighing up their options, private placement investors tend to be very focused on covenant protection as illiquid markets mean they may be unable to sell their private placement investments in the event of a credit downturn. Although an issuer of a private placement almost inevitably cedes covenants to investors this is more than compensated for by the fact that it is able to issue capital markets debt without acquiring a formal long-term debt rating. In contrast, a formal rating from at least one recognised debt-rating agency is required for most public debt issues.

Why a private placement?

From a treasurer's perspective, the private placement market represents a major capital source with relatively competitive pricing. Accessing the private placement market also allows the treasurer to free up often-scarce credit lines with relationship banks. Indeed, the vast majority of private placement transactions are undertaken by treasurers that want to refinance existing term loans from banks, but who would rather not go to the trouble and expense of obtaining a credit rating.

- **Competitive Pricing.** Although pricing is typically competitive in comparison with other forms of debt, as with all capital market transactions private placement pricing will vary depending upon the name of the issuer, currency and the current state of investor appetite. As an example, in the sterling market, private placement investors can demand a spread of between 10 and 30 basis points Libor depending upon the issuer and the tenor of the transaction.
- **Capital Source.** The treasurer will typically find that while the capital markets are somewhat cyclical in their demand for corporate paper, they are a major source of funding for UK companies. Sourcing long-term funding from the capital markets will allow a treasurer to reduce the number of his lending banks. With a smaller number of competitors, this reduction should provide financial motivation for a treasurer's banking group to be even more proactive.

Bank selection

Private placement mandates represent prestigious fee income for relationship banks. Competition for a major role in a transaction is intense and treasurers will face a bank group that will aggressively use their 'relationship' and 'lending' cards to win a role in the transaction.

Although by definition a private placement transaction is private, a transaction which is poorly marketed or priced due to inappropriate bank selection will inevitably leak into the public domain. A transaction that is received negatively by investors will impact a corporate's reputation with the fixed income community such that future transactions are more likely to be expensive as investors will require a premium to compensate them for the potential risk of another poorly structured deal.

As a result, it is in the treasurer's long-term interest to ensure the selected private placement bank is the strongest bank for their corporate and their transaction. Despite the pressure of large lending banks to win a private placement role, the treasurer will need to select banks on an objective basis and not on a 'reward the lenders' basis.

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Usually only one or two banks will be required to lead a private placement, in contrast with the often very large syndicate structures of public transactions. As the number of private placement investors tends to be considerably smaller than a public transaction, the need for a wide distribution (via a large syndicate group) is reduced.

The choice of private placement lead manager is challenging. To increase objectivity, it is useful for a treasurer to maintain a set of criteria to rank each financial institution. These criteria differ markedly from those of a public transaction which are often based around secondary market trading abilities, fixed income credit coverage and distribution capabilities. In contrast, a private placement calls upon a different set of skills from a treasurer's bankers. These include:

- **Understanding client needs.** Relationship banks that have an understanding of their client's debt profile, funding and corporate strategies should have already commenced a proactive capital markets dialogue with the treasurer. Such a dialogue would indicate an understanding of the issues facing the treasurer when launching a private placement such as the purpose of the funding, pricing, covenants and distribution. This is a (often very strong) leading indicator as to the bank's private placement capabilities.

- **Credit Skills.** Due to the absence of a credit rating, a private placement is often highly intensive in terms of the credit research which the bank needs to undertake in order to present the issuer in the best light to potential investors. Nevertheless, there is an inevitable trade-off between covenants and pricing. Banks which can demonstrate a deep credit knowledge as to the issuer and the issuer's industry will often be better placed to assist the treasurer with finer covenant and pricing judgement calls. A bank's credit skills do not necessarily equate with a large balance sheet – the ability to lend large amounts of money is not necessarily a signal that a bank has credit skills (a cynic could argue that often it is the reverse). More important is that the bank is able to coherently state likely credit and pricing issues and have a strategy to address and resolve these issues.

Not only can these criteria assist the treasurer in objectively ranking each financial institution, but they can also be provided to the banks prior to a beauty parade presentation. This will allow banks to tailor their presentation to the treasurer's specific needs and avoid bankers concentrating on inappropriate material (such as league tables) during their pitch.

A useful aid when selecting a lead manager is to speak to a number of fixed income investors. Banks will usually provide access to likely fixed income investors, but the treasurer should ensure he meets them alone (ie without the banks present). Large fixed income investors are usually constantly in the fixed income market and often very amenable to identifying their favoured (and disfavoured) fixed income banks. As the investors are the ultimate customers of the treasurer, this advice should be carefully heeded.

Covenants

As a private placement does not need an external rating, investors normally request and are reliant upon covenant protection.

Although a treasurer will clearly aim to replicate the covenants contained in the loan agreement which the private placement is typically used to refinance, it is often inevitable that this will not be possible. Investors (particularly US investors) will value certain covenants – often coverage covenants – highly and will often want them defined in a US style format.

The issuer may also be at a different part of the credit cycle and new creditors will require additional (or less) covenant protection. Therefore, the treasurer needs to adopt a somewhat pragmatic approach to covenant negotiation – as well as having a very detailed knowledge as to what his existing loan documentation will allow him to cede (particularly in respect of the perennial difficulty of negative pledge carve out amounts).

A treasurer may be able to improve his covenant bargaining position (or improve his pricing) by obtaining a private rating from an external rating agency. As this will involve additional expense, the treasurer should rely on his bank for its advice as to the benefits of pursuing a private rating.

As most banks now have a rating advisory capability, a banker should be able to estimate an issuer's likely rating with some accuracy prior to approaching a rating agency. Confident treasurers should also be able to convince their banker to provide a rating advisory service for no charge in return for leading the private placement.

In the sterling market, a financial covenant is required for any issue with a maturity of greater than ten years or a rating less than a single A. Covenants in the sterling market vary according to the maturity of the deal and the industry sector of the issuer. As a note, the nature of covenants imposed on utilities has increased in severity of late whilst step up covenants are now a common feature amongst telecom issuers.

Funding purpose

In communicating to a bank or banks, the treasurer will need to make clear the purpose of the funding raised by the private placement (for example, refinancing debt or financing an acquisition). This will allow the treasurer to determine the levels at which the all-in cost of a private placement makes economic sense for the company relative to borrowing from relationship banks. Treasurers must be careful to ensure that the private placement really is the most cost effective option.

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A long-term commitment

Private placement funding is generally medium to long term (in excess of three years). Although a private placement can be repaid early, this redemption will require the issuer to make a costly 'make whole' premium (usually around 50 basis points). Although derivative transactions have been devised to amortise the make whole premium over a period of time rather than the company taking a one-off charge, such transactions fall within the realm of 'creative' and do not obscure the fact the company has taken an expense. For cost reasons a private placement will usually run until its final maturity.

Swapping the proceeds

The majority of private placement investors are located in the US. Therefore, most private placements are fixed rate, US dollar denominated transactions.

As with public capital market transactions, the US private placement market often has standard fees that banks are somewhat inflexible to reduce publicly. One means for a lead manager to discretely reduce a treasurer's arrangement fees is via a subsidised swap. Unless the treasurer requires his private placement to be denominated in US dollars at a fixed interest rate, the treasurer must undertake a cross-currency swap to return the proceeds to his functional currency.

A subsidised swap is simply an off market swap in the treasurer's favour. If the proceeds were swapped from a fixed interest rate to a floating rate, the swap would normally be executed at the bank's bid rate (the rate at which it will 'buy' a fixed rate obligation). A subsidised swap is a rate better than the bid rate and this level is pre-negotiated with the bank before the private placement is settled (for example, a subsidised swap could be a swap at the mid rate plus half a basis point).

Clearly, a requirement for a subsidised swap is that the swap is executed with the lead manager. Prior to the swap, two parameters must be agreed (and confirmed in written – usually email – format):

- the reference rate (normally Libor) at the time of the private placement settlement. The Libor rate must be agreed by reference to a specified Reuters or Telerate screen with both the Treasurer and lead manager agreeing to the rate prior to the execution of the swap; and
- the definition of 'mid' and the level of subsidy must be clearly agreed. If a corporate generally receives an interest rate swap with an average spread (ie difference between bid and offer) of 3 basis points, it is reasonable to assume that the mid rate is the bid rate +1.5 basis points. A 1 basis point subsidy therefore equates to the bid rate +2.5 basis points. This calculation must be agreed with the bank (preferably in writing) prior to the swap execution.

Post-deal communication

If the treasurer is likely to be a repeat private placement issuer, it is important to maintain an on-going dialogue with his major fixed income investors. An often-heard complaint from fixed income investors is that they "only hear news from issuers when it is bad news." Fixed income investors value an on-going dialogue and such a dialogue will allow the treasurer to create a 'halo effect' around the company as an issuer.

Establishing a dialogue is relatively straightforward despite the fact that so few do it. A treasurer should add fixed investors to the company's press release list, invite investors to bank presentations and offer an investor conference call if the company undertakes any significant corporate event.

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Critical note

Although the success of a private placement transaction is significantly influenced by market conditions, the role of the treasurer is critical. Indeed, it could be argued that the treasurer has a more pivotal role in a private placement than with a public transaction. This is because a treasurer's judgement and negotiation skills will be intensively required for covenant discussions and explaining the credit to long-term investors. Such discussions will often closely resemble those discussions a treasurer already undertakes with his relationship banks. ■

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