Assessing the US private placement market from a corporate perspective

Tim Hayter
Group Treasurer, Bunzl plc
Email: Tim.Hayter@bunzl.com

Background

The US Private Placement ("USPP") market is a US private bond market which is available to both US and non US companies. The principle attraction of this market is that it provides an alternative source of liquidity from the traditional bank market without the need for a formal credit rating and reporting requirements which are a pre-requisite of the public bond markets.

There are around 50 active investors – mainly US insurance companies. Although this market is small in comparison to the public bond market, it is very flexible in terms of size of issue ranging from less than $100m to up to $1bn (under normal market conditions). Total capacity for a strong investment grade company would be in the region of $1.5bn.

The USPP market typically provides fixed rate US dollar debt in tranches of between three and 15 years though longer maturities are available for certain issuers. Pricing is typically at a small premium to the public bond market, to reflect the private nature of the instrument, although there are companies for whom pricing is similar in both markets. One of the main attractions from an investor's perspective is that USPP's usually come with covenants similar to those in a company's bank credit facilities.

The USPP market has proved to be resilient in recent years and was largely open throughout the period of financial turmoil in 2008/2009.

Summary of the process

The whole process of issuing a USPP usually takes around 12 weeks from taking the initial decision internally to receiving the actual funds although the timetable can be shortened if necessary. The company will typically appoint one of its relationship banks to act as Placement Agent ("Agent"). The Agent and the company then prepare the Offering Memorandum (OM) as well as a Road Show Presentation (if applicable) which serve as the primary marketing documents. Legal counsel is appointed to draft the Note Purchase Agreement ("NPA"), the legal document to govern the issuance, which will be reviewed by the Agent and the company. The NPA includes the financial covenants which will be determined in consultation with the Agent before the transaction is launched.

The OM and NPA are distributed to the potential investors upon launch of the transaction and typically followed up by a road-show about a week later. The road-show is usually attended by two senior officers and may include the Finance Director and Group Treasurer as well as the Agent and can last two to four days. After this there will be a period of up to two weeks when the Agent will respond to questions from potential investors with likely significant input from the company. Bids by potential investors are then received on a set day and the company will then accept the relevant bids the following day. A "pricing" conference call then takes place which determines the fixed coupons of the bond together with any hedging requirements. A couple of weeks later the investors finalise their due diligence with a site visit. Finally the NPA is signed and the funds are received.

A typical timeline for this process is shown below.

Internal work requirements

The amount of work internally should not be underestimated. It is likely that the treasury, group accounting and legal departments as well as senior management in the Business Units will need to contribute (particularly to the OM). One area which is likely to be new for first time issuers is the level of detail asked by the investors which may not be covered by the normal monthly or yearly accounting processes. For example, extensive information may be required on operating lease commitments, which is not already disclosed in the Annual Report and Accounts. If so, it is possible that the information will need to be gathered from Business Units and aggregated by the central finance function. It may be worth asking the agent to provide a list of likely questions posed by the investors in advance. Additionally investors may ask about customers, suppliers and related contracts – information which in the past the company may have kept confidential.

Which agent(s) to select

The role of the agent includes preparation of the marketing materials (OM, Road Show presentation and NPA); selling the company's credit to investors to achieve both the best possible price and terms, while ensuring that the whole process runs efficiently. The appointment of a good agent is therefore important to a successful bond issue.

One method of choosing an agent is to carry out a 'beauty parade'. This would typically involve sending a Request for Proposal ("RFP") to several relevant relationship banks who are then requested to submit a presentation on their capabilities in the Private Placement market. The company can provide a list of questions that should be addressed and these can serve as a "score card" when comparing the banks. Typical questions can be found in Appendix 2. These are just examples and clearly will need to be tailored to specific circumstances and requirements.

The advantage of this process is that it gives relationship banks the opportunity to pitch for the business. It is common to reward two relationship banks by appointing joint agents – the only additional factor to consider is to ensure that they can work well together for the benefit of the company.

Assessing an agent's response

As explained above the RFP can act as a scorecard. Clearly companies will have different reasons for selecting an agent; but there are probably several key areas to differentiate:

- *Positioning the credit* – the bank's ability to sell the credit story (position the credit strengths while mitigating the weaknesses) is key to stimulating investor demand and maximising terms.
- *Pricing* – the important point to consider here is not just the absolute price that the prospective agents "pitch" but their robust rationale for such pricing. What are the "comparables" that they will be using in their discussion with the market and importantly why are they choosing that particular company to compare?
- *Covenants* – have they considered the covenant package in detail and have they flexed the pricing to show how the pricing might change with changes in covenants?
- *Track record* – what experience does the agent have to back up their proposals?
- *Team* – it is the distribution person who will be selling the company's credit story to the investor not the origination team so how well does that person know the company?
- *Bank credit commitment* – how much credit does the bank provide to the company through bilateral or syndicated facilities. The USPP mandate will be valuable ancillary business for the bank which makes it a good opportunity to secure extension of a bank credit facility.

The author can make available a list of detailed questions to assist readers in the selection of an agent. Please contact pmatza@treasurers.org

Agent due diligence

The agent bank will need to do specific due diligence on the company. This will take the form of the bank making enquires so that they fully understand the company probably to a level of detail that they haven't done in the past. Although the relationship manager is likely to know the company well, this due diligence will be performed by the agent bank's USPP team who may be less familiar with the credit story of the company. They will also use the knowledge gained from this due diligence process in preparing the marketing documents and in marketing the USPP to potential investors.

Offering Memorandum

The main marketing document to be produced internally will be the OM. It is usually produced by the agent following due diligence but will require considerable input from the company. This is a comprehensive document detailing the company's operations and includes key financial ratios. As mentioned earlier, there is likely to be considerable internal work if this is the first such document that the company has produced as it will go into more detail than the Annual Report and Accounts.

Note Purchase Agreement

The legal document governing the transactions is known as the Note Purchase Agreement (NPA). Although there are standard clauses, many are specific to each individual transaction. The company will be required to appoint legal counsel for itself and can propose council for the investors. Many companies will have retained law firms but as the bonds are issued in the US and are governed by New York law, it is common to appoint a US legal firm familiar with Private Placements documentation. There are several firms who regularly act for the investors.

Although the NPA is generally completed (from the issuer side) before launching the transaction, there could be clauses that investors require amending if they are to bid, so some further negotiation can take place closer to the bid deadline.

Covenants

This is a very important area of the NPA to get right as subsequent amendments to the document (financial or otherwise) can be extremely challenging:

The USPP market provides finance for a longer tenure than the bank market so covenants need to be designed to work for the company over many years. It is essential that the covenant package gives the company strategic flexibility over the life of the Notes.

Whereas bank debt can be repaid at par (if it is at floating rates) USPP's could have a significant negative mark-to-market value together with an early repayment penalty known as "make-whole". The negative mark-to-market could be offset by interest rate swaps if the original bond was swapped from fixed to floating. However the make-whole amount could still be significant. It is therefore not usually desirable to repay USPP's early.

The starting point could be the covenants in the bank credit facilities but thought should be given if these are already fairly tight. It might therefore be advisable to amend the bank covenants before going to the USPP market to ensure the covenant package is acceptable over the medium-term.

Depending on the market sector and the credit profile of the company, there are likely to be one or two financial covenants from the following:

- net debt /EBITDA;
- interest cover; and
- minimum net worth.

In addition, USPP investors might require a priority debt test where there is a restriction on debt which is in the balance sheet of subsidiaries i.e. not in the issuing entity nor in the guarantor. Again, the limits can be calculated in different ways so it is critical to ensure that it is right for the business.

There can be a trade-off between how tight the covenants are and what price the potential investors are likely to bid at since investors may want to be compensated for looser covenants. Clearly it is essential to understand what impact the covenant package has on the likely pricing.

It is very important that the covenant analysis is done before launch as it is harder to keep all options open post launch because of perceived reputational consequences of having a "failed deal".

Amendments

One of the issues with USPP's is that the relationship with the investor is not maintained in the same way as with bank lenders. For example they are generally buy and hold investors and so there is no natural conversation regarding refinancing every few years. Also personnel can change and transfers of the bonds can take place making it difficult to maintain relationships.

The process of obtaining an amendment to the NPA (even a straightforward one) from someone that is not well known and not up to date with the company's financial position or strategy can take time and be problematic especially if the financial position has worsened since the bond was issued.

Therefore to maintain relationships the company does need to be proactive towards these USPP investors.

As well as the management time involved, the likely cost of an amendment is a fee and/or increase in coupon depending on the change requested. Clearly the best course of action is to minimise the chance of an amendment being required.

Board approval

It is likely that board approval will be required for the transaction. The exact amount of the final transaction will depend on the bids that come in from investors so it is best to consider approval for a range of outcomes and ensure this is obtained prior to the launch of the transaction.

Distribution process

Once the decision to launch the deal has been taken, the agent bank will distribute the Offering Memorandum and the NPA to the investor community. The distribution process is undertaken solely by the agent bank and also includes talking to the investors about the company.

If a road-show is planned, this will start about a week after the launch. Once the investors have analysed the company and attended the road-show and/or conference call, they will probably require further explanations in certain areas.

A key point here is that they are effectively selling the investment story to the investors and answering questions so it is essential that the agent is well briefed and knows the company very well.

Road-show

A common question is: "will a road-show be required?"

A road-show gives the company the ability to tell the investment story directly to investors rather than relying on the agent to do it through the distribution process. Factors which will determine whether it is necessary include:

- *First or repeat issue* – if the issuer is unknown to the investor community it can help.
- *Size of intended issuance* – for small deals it may not be necessary but for larger transactions it may make a difference.
- *How complicated is the "investment story" that is being sold to potential investors?* – the more complicated the more likely a road-show will be necessary.
- *Management time* – is there time for a road-show?

Therefore, whether a road-show is required is fairly company specific.

Acceptance of bids

A deadline is given to the investors for them to make their bids. The bids will be in the form of a credit spread over US treasuries, for a certain maturity. Some investors will provide bids in more than one maturity. Also, some investors may make multiple bids in the same maturity i.e. X amount at one price or Y amount at another price depending on their appetite for the particular credit.

An example of a pricing matrix is shown Appendix 3. For each maturity there will be a "clearing" spread which means that for all bids accepted, all investors will get the same spread. When all bids are in, there can be movement between maturity buckets to try and match the requirements of the company with investor's appetite.

Circling

When the bids have been finalised, the coupons are fixed by reference to the relevant treasury yield. This is know as

"Circling" and at this point the investors have made a verbal commitment to buy the bonds subject to final due diligence.

A conference call is held between the agent, the company and the investors at a pre-arranged time (when the treasury market is liquid) to agree the current yield on the relevant treasuries. The agreed credit spread is then added to give the resultant fixed coupon.

Pre-hedging

For UK companies it is common to receive bids London time on day one and then final bids and pricing occurs the following day. So between the time that bids are received until Circling, the treasury yield is likely to move and if the company is leaving the bond in fixed rates i.e. not swapping to floating rates, the yield will rise if treasury yields rise in the intervening period.

To eliminate this risk, it is possible to execute a "Treasury Lock" – this effectively fixes the US treasury yield. This Treasury Lock can be transacted at any time prior to "Circling" but clearly if the there is no underlying bond or the final amounts change, there will be a derivative which does not match the underlying instrument with the resultant hedge accounting implications.

Swapping to floating rates and/or another currency

It is likely that most investors will offer fixed rate US dollars. Although floating dollars and other currencies may be available, it will probably only form a small percentage of the overall total. Therefore if the company does not want fixed rate dollars, an interest rate or currency swap will be required. The mandate for this transaction can be awarded to the agent bank or any of the group's other banks – the latter option does have the advantage of involving a third bank which will earn ancillary business from the transaction.

Typically the swap arranger (whether the agent bank or a third bank) can complete the market hedge at the time of pricing. It must be done at this point to make the hedge effective. All that needs to happen is for the swap arranger (if a third bank) to join the pricing call when the coupons are fixed. Subsequently the swap arranger can syndicate the swap credit charge by holding an auction on behalf of the company. This achieves two objectives: getting the best possible price and sharing the business around other relationship banks.

Key issues to consider when appointing swap arranger:

- How transparent is the bank in explaining the process?
- Pricing – what is the agreed spread from screen pricing?
- Can they underwrite all/part of the swap thereby guaranteeing a worse case rate?

Investor due diligence

Investors will have done substantially all of their credit analysis before Circling but final due diligence is performed a couple of weeks later. This often involves a visit to one of the companies operations to give the investors a better sense of the depth of management and a chance to review the operations.

As mentioned earlier, investors verbally commit at Circling subject to their final due diligence. But due to the level of disclosure during the process up until the bid deadline it is very rare for investors to pull out after Circling but they are not legally committed until completion.

Funding

Once the investors have performed their due diligence, the NPA is signed at completion and funding can take place on the specified date. It is possible to delay funding for a period of up to several months if the funds are not required at the time. There may or may not be an additional cost depending on the shape of the yield curve, investor appetite and period of delay.

Ongoing investor relations

While USPP investors are generally "Buy and Hold" investors and do not look to trade their holdings, nor do they take initiatives to maintain relationships with the company. As a result, the responsibility is on the company to take the lead to engage investors in on-going communication e.g. a conference call post the annual results.

Given that the investors are long-term holders and the bonds have financial covenants, it is in the interest of the company to maintain strong investor relations. This could also facilitate follow-on issuance in the future.

Timeline