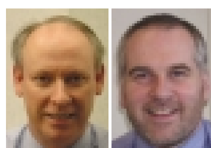
THE APPEAL OF PRIVATE PLACEMENTS



JOCELYN MONK OF THE ROYAL BANK OF SCOTLAND AND **ALAN DICK** OF SCOTTISH & NEWCASTLE PUT THE PRIVATE PLACEMENT MARKET THROUGH ITS PACES.

During 2002, an increasing flow of international corporate borrowers rejected the public capital markets in favour of the lesser known private placement market. One of them was Scottish & Newcastle plc, which raised $850m over maturities as long as 12 years. Here, we will explore the market and explain why it has particular appeal to a broad range of corporate borrowers, including Scottish & Newcastle.

Although most commodity borrowers, including sovereigns and supranationals, continue to focus on the high-profile public Euromarkets, the volatile and sometimes uncertain reception offered to many corporate borrowers during the latter part of 2002 exemplifies why many have been prepared to look for alternative sources of capital and to redirect their attention towards the less-well publicised, but perhaps more transparent and predictable, market of senior debt private placements.

Debt private placement volumes saw a significant increase in 2002 and the market is offering ever larger amounts of finance for borrowers without the unwelcome glare of publicity and, sometimes, the risks, that accompany corporate public offerings.

HOW DOES THE MARKET WORK? Most private placement financings are structured to be eligible for purchase by US institutional investors by using the safe haven exclusion provisions of the Securities and Exchange Act of 1933 (the 1933 Act). This was enacted to protect the 'investing public' by requiring issuers to register with the Securities and Exchange Commission (SEC) prior to any public offering or sale of securities.

At the time, the investing public was considered to be comprised largely of unsophisticated, individual investors who were unable to gather information on issuers and to analyse investment opportunities in a satisfactory manner and, therefore, required SEC protection. The US Congress, however, recognised that the offering and sale of securities to a limited group of sophisticated investors was an accepted practice that did not necessarily require the review or protection offered by the SEC registration process.

For this reason, Section 4(2) of the 1933 Act, the private placement exemption, and the subsequent promulgation in 1982 of Regulation D, have defined the traditional private placement market by waiving registration requirements for transactions by an issuer not involving any public offering. Therefore, such transactions are directed exclusively at sophisticated investors with significant credit analysis skills to evaluate and understand the particular credit characteristics of an issuer's business directly who are not able without relying upon the view of any rating agency (as is required by the 144A and, most often, the public dollar and euro markets).

Over recent years, the investor universe has broadened significantly as institutional investors' geographical investment guidelines have globalised such that today, there is regular participation by a number of non-US investors who use the same regulatory framework, but provide direct local currency availability.

WHAT IS A PRIVATE PLACEMENT? In legal terms, it is an agreement between a willing seller and a willing buyer(s) to exchange an unlisted, negotiated, registered promissory note tailored

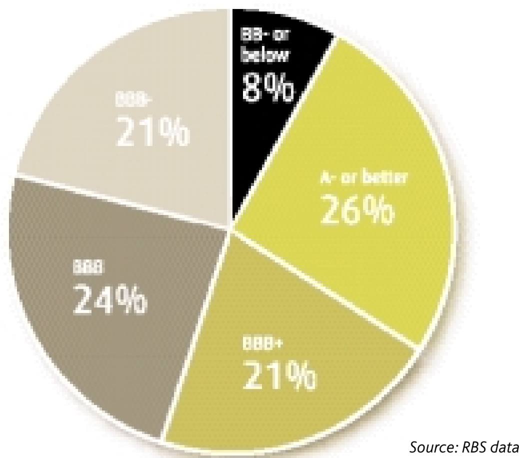
Features of a senior debt private placement

- Predictable pattern of investor demand.
- No publicity required.
- Low issuance cost.
- Offering process ensures the lowest available pricing.
- Flexibility through negotiated terms and conditions.
- No requirement for long-term debt ratings.
- No Securities and Exchange Commission registration required.
- No US GAAP reporting requirement.
- International issuers are the most prized.
- Direct investor relationship.

FIGURE 1

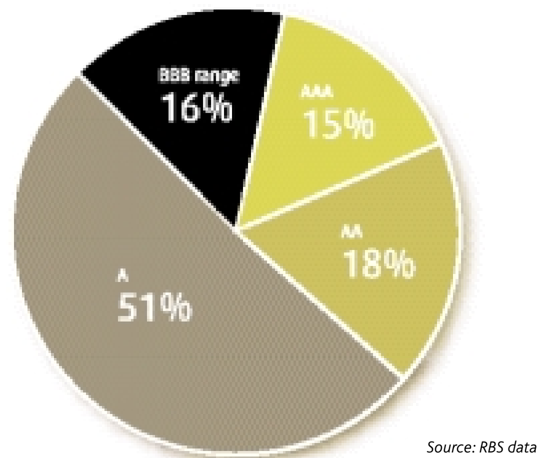
IMPLIED CREDIT QUALITY.

2002 Corporate private placements



Source: RBS data

2002 Corporate Euro public issuance



Source: RBS data

to the requirements of both parties. Both the lender and the borrower are brought together by an intermediary agent such as The Royal Bank of Scotland.

Private placement issuers are typically companies that may not be comfortable with or, in some cases, through lack of long-term debt ratings, are unable to tap the Euromarkets, but still derive significant value from access to long-term fixed rate debt finance to supplement and diversify their funding sources away from short-term, most often floating rate, bank lending.

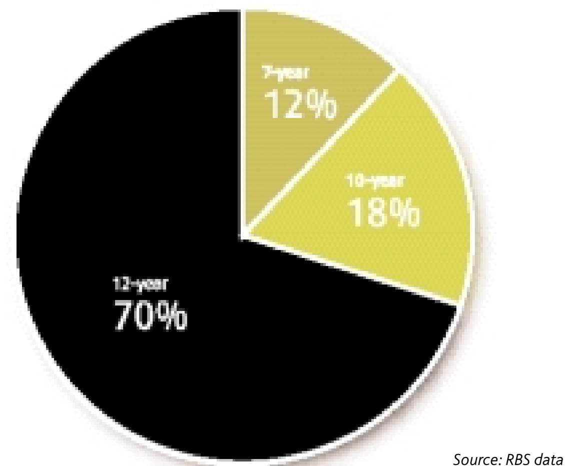
Investors are almost exclusively insurance companies or pension funds, many of which (but not all) are based in the US. Unlike many of their counterparts elsewhere, US insurance companies manage their investments on a global asset allocation basis, with a heavy fixed interest weighting, and in recent years have increasingly been looking for geographical diversification by investing in UK and European companies.

Some US insurers have opened offices in London in recent years to be even closer to the markets in which they want to invest. Lacklustre returns for equities, pension risk and accounting issues have rebalanced pension fund portfolios in the UK and Europe out of equities towards fixed interest, leading to some of the major European insurers becoming buyers of private placements.

Private placements are called ‘private’ because they are not listed on any stock exchange, are not normally traded, and are rarely publicised. Once the securities are issued, the placement typically remains with the buyer, or buyers, until maturity, although most have documentation facilitating change of ownership in certain circumstances. It is worth noting that following recent high-profile examples of corporate malfeasance in the US, today’s borrowers in the capital markets need to be increasingly alert to the role of the debt investor, which can be critical to the continued access to capital and, therefore, success of a company. Therefore, most issuers note the importance of knowing their investors – both institutionally and personally – and embrace the opportunity to sustain the foundation of a direct borrower/lender relationship (facilitated by the direct dialogue execution process) and reinforce it from time to time through investor updates. The anonymous nature of most Eurobond investors often makes this difficult to achieve.

FIGURE 2

BREAKDOWN OF SCOTTISH & NEWCASTLE ISSUANCE.



Source: RBS data

Scottish & Newcastle

Over the past few years, Scottish & Newcastle has evolved from a medium-sized UK borrower into one of the leading European brewing groups, with three of the top 10 brands in the European brewing sector (Baltika, Kronenbourg and Foster's), with a market capitalisation of some £3.5bn and significant capital needs.

Upon completing the assumption of control of the beer interests of Brasseries Kronenbourg in France from Danone in September 2002, Scottish & Newcastle moved to rationalise its financing by raising about £3bn of borrowings. It decided to split the total targeted funding between the bank and capital markets about 50/50. The first step in the process was to secure a short-term bank facility of £1.5bn from a group of relationship banks within a period of 60 days and immediately thereafter commence a review of their capital market refinancing options.

While Scottish & Newcastle Group benefits from access to medium term notes, sterling, Eurobond and a wide range of other markets, it wanted to source a tranche of debt finance at 10-years plus and, after analysing the options, decided, in November 2002, that the private placement market offered the most flexible and competitive source of financing. Scottish & Newcastle has long-term debt ratings of BBB+ (Standard & Poor's) and A- (Fitch).

The group's decision to turn to the private placement market was based partly in response to the prevailing uncertainty in the public market, where numerous corporate issues (Volvo, Lafarge, Parmalat and EdF) had been postponed in previous months because of lacklustre demand and a lack of interest from the Euro MTN market. But using the private placement market meant demand was overwhelming, creating a book in excess of $1.2bn and the $300m issue was significantly oversubscribed.

Scottish & Newcastle issued $850m of seven, 10 and 12-year senior notes with 24 institutional investors, at credit spreads fully competitive with the indicated public levels. This response represented one of the tightest BBB spreads in the market in 2002 and it remains today the largest-ever traditional corporate private placement.

WHERE DO INVESTORS INVEST? In 2002, the private market saw heavy issuance from rated corporate borrowers which had given serious consideration to undertaking public debt issuance using their pre-existing long-term debt ratings from the recognised rating agencies. In some cases, the companies concerned had announced publicly their intention to use the Euromarkets but then did not proceed because of the volatile and unpredictable response from the market. Some of these announced issuers had the financial flexibility to delay a market approach for better times – but some did not.

Examples of rated issuers which achieved a strong response and completed very successful private placements in 2002 include Compass Group plc in the UK, Rhodia SA in France, Holcim Ltd in Switzerland, Santos Ltd in Australia, M-real Oyj in Finland, and Scottish & Newcastle plc in the UK. All of these issuers have ratings in the BBB range, reflecting the level of implied credit quality where more than 65% of all private placement buyers focus their institutional requirements. In the Euromarkets in 2002, BBB investments represented only 16% of the invested capital.

STRUCTURING A FINANCING. The negotiated nature of the market allows issues to be structured in a variety of ways, often multi-tranche, multi-currency, using repayment structures differing from the vanilla bullet structures used in public bond markets. This is subject always to the proviso that structural subordination remains an issue in all markets and senior note financings require *pari passu* treatment with other senior creditors.

A typical structure would be for the 'plc' to borrow unsecured with other options being either to guarantee support from asset-holding subsidiaries or to limit subsidiary indebtedness. For Scottish & Newcastle, Royal Bank of Scotland was able to replicate structure and covenant provisions based upon the borrower's existing bank documentation, albeit for a longer maturity. Although private placements are transacted with maturities from five to 30 years, the deepest, and for UK borrowers the most competitive, area of the market is usually between five and 15 years, typically offering a longer maturity than most corporate borrowers can obtain in the bank market and sometimes even the public bond markets.

A GROWING AWARENESS. In the context of continuing uncertainty in both banking and global capital markets, the experience of Scottish & Newcastle and a number of other borrowers during 2002 demonstrates how the private placement market can provide long-term fixed rate finance in bond form, without the need to adopt the credit rating and structural framework that the public markets require. The foundation of the relationship which is created with the insurance company investor is also increasingly valued in these uncertain times.

The private placement market has proven remarkably resilient to political and economic shocks over the past few years and recent evidence suggests that the market will continue to grow as borrowers become increasingly aware of what it can provide.

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