The need for a European private placement market

WITH PRIVATE PLACEMENTS HAILED BY MANY AS A SOURCE OF FUNDING DIVERSIFICATION, **MIKE NAWAS** AND **STEVE CURRY** EXPLORE WHAT CAN BE LEARNED FROM THE US MARKET, WHETHER THERE IS A NEED FOR A EUROPEAN PRIVATE PLACEMENT MARKET, AND HOW SUCH A MARKET COULD EVOLVE.

This article will focus on the more traditional definition of private placements: bonds typically issued by unrated corporates, privately negotiated and placed with institutional investors. Historically, this type of bond has almost exclusively been the preserve of the US capital markets and US investors (see The Treasurer, February 2011, page 32).

THE EUROPEAN REGIME Prior to the collapse of Lehman, European companies had uninterrupted access to a plentiful supply of cheap, medium-term bank debt. A Standard & Poor's report towards the end of last year (The Shift from Bank Lending to Capital Markets for UK Corporates) revealed that at least 76% of borrowing by UK corporates was provided by banks.

Hindsight is a wonderful thing, but it is not difficult to see how such circumstances arose. The effects of too many banks operating in Europe along with corporates prioritising the cost of debt over other considerations (such as diversification) were the root causes of companies becoming so reliant on bank funding. Faced with intense competition, commercial banks often ultimately found that to get noticed they had to give in on volume, price, tenor and structure. It was a buyers' market where treasurers were calling the shots.

After years of this being the norm, and with no economic storm clouds on the horizon, there was limited pressure for corporates to pay more for their debt just to diversify their lender base. Diversity was achieved by having a larger number of banks rather than by having different classes or groups of investors/lenders.

Circumstances are, of course, very different now. There is undoubtedly less competition as many banks have been forced to reduce their reach (focusing on clients close to their home markets or where they genuinely have a deep and meaningful relationship). Bank capital is, more than ever, a scarce resource and this will remain the case under Basel III. Bank funding costs have risen materially (although this has now eased somewhat) and differ much more markedly between banks than they used to. Faced with these circumstances, banks are seeking to minimise the tenor of their commitments to three years where possible.

So from a European loan market perspective, circumstances are no longer dissimilar to North America: banks are less willing to commit capital and prefer shorter-term maturities. On the demand side, the need for corporate borrowers to fund growth or simply refinance existing borrowing is unlikely to diminish. Somehow the gap needs to be filled: step forward European private placements?

The conditions described above for Europe are likely to be sustained for a long period of time. Therefore, it is in the interest of the financial system as well as medium-sized corporate borrowers that such a private placement market takes off. There is no better evidence of this than some recent US private placements closed for European borrowers.

Take Dutch dredging company Boskalis, which issued a $450m private placement to 26 US and UK institutional investors in July. The transaction had three tranches with seven, 10 and 12-year maturities and was raised alongside a €650m five-year bank facility. And in September, UK soft drinks company Britvic issued a $175m private placement, similarly with seven, 10 and 12-year maturities and with dollar and sterling tranches. Britvic had tapped the US private placement market in the past and was returning for more. For Boskalis it was an inaugural deal.

The fact that these European borrowers turned to the US private placement market is clear evidence that there is a place for this form of debt in the funding strategies of medium-sized European corporates. Why, though, do European investors not seize the opportunity? Boskalis specifically commented that it would convert its US dollars to euros.

NOW IS THE TIME TO STEP FORWARD We feel that there should be much greater urgency, activity and initiatives to establish a European private placement market, similar to that in the US. We don't mean to suggest that nothing is happening on this front in Europe – there is. For example, M&G and Aviva and a number of European operations of US insurance companies are active in Europe, both in sterling and in euros, and we applaud this.

There was cause for optimism in 2009 when M&G launched a fund targeted at filling the funding gap, which emerged as UK banks pulled back from lending to UK corporates at the height of the crisis. However, this fund was a generic UK credit fund and did not specifically target private placements. The market needs more depth.

The reality is that European corporate borrowers still have to turn to the other side of the Atlantic when it comes to private placements. With the US cross-border private placement market standing at around $20bn a year before the crisis, surely the scope of the opportunity should warrant greater interest from European investors?

In our view, were a European market to take off, once established, annual issuance volumes could comfortably reach €25bn, exceeding the US market. It would take time to reach these levels but if the ramp-up of the European market were to coincide with the refinancing bubble between 2011 and 2013 we could see annual volumes reaching €10bn to €15bn over this period.

Three main groups of stakeholders hold the answer to this question: regulators, borrowers and investors.

REGULATORS Given the constant calls from politicians, regulators and central bankers for businesses not to rely in the future on single sources of debt, we would have thought that this camp could do more to help to encourage a European private placement market. The European Commission issued a report in 2008 analysing barriers to cross-border private placement activity and possible solutions (now being addressed via the Alternative Investment Fund Managers Directive).

In addition, the UK government is currently working alongside the ACT and the CBI to raise awareness of private placements. In both cases, however, it is difficult to see any concrete progress being made. One can question whether it should be part of a regulator's remit to help set up a market, but from a policy point of view regulators appear to embrace whole-heartedly the idea of a European private placement market, and their intervention could ensure standards are maintained in documentation, disclosure and market behaviour.

BORROWERS Here, things start to get a bit trickier. Possibly the biggest impediment to corporates viewing private placements as a core funding tool is legacy thinking:

- concern that bond holders are less relationship-driven than banks and will make life more difficult in times of trouble;
- concern that bond structures are less flexible than bank debt;
- concern that margins may be higher than bank borrowing; and
- concern that the extra work and cost of developing a new source of debt is not worth the investment.

While these concerns may be real in the eyes of corporate treasurers, they must be

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weighed carefully against the opportunity to access alternative sources of debt to bank financing. What if one of their core banks retrenches from their sector and walks away come the next refinancing/extension? What if there is additional pressure on bank balance sheets from Basel III which makes bank debt for borrowers of their type more costly going forward?

It is our view that developing new sources of debt is best done while traditional sources are still available. In these circumstances a borrower is under less pressure to accept whatever is available. It allows time to build understanding with new investors in a benign environment. Contrast this with trying to raise new debt or refinance existing debt after the banks have already turned off the funding tap. The crux of our point in relation to borrowers, though, is that they should push for a European private placement market by engaging with investors on their own funding needs. Push is as important as pull.

INVESTORS And now for the camp that really has the ability to drive the establishment of a European private placement market. It strikes us that, from an investor's point of view, there may never have been a better moment to get this market on its feet. There is already demand as evidenced through European borrowers turning to the US market, attractive yields compared with public bonds, the creation of a new asset class, and the ability to tailor covenants to mitigate specific investor concerns.

But there are still big hurdles for investors to overcome.

- **Credit analysis infrastructure**. Investors need to invest in staff with the skills to appraise and analyse corporate credit risk in detail. The investment in people is not massive, though. Even the largest teams at US insurance companies are no more than around 20-strong.
- **Lack of liquidity**. Take and hold strategies do not suit all investors, but for those with long-term liabilities it should be an attractive asset class.
- **Competition from banks**. The risk that banks re-emerge offering cheap funding cannot be ruled out, but if a European private placement product were to establish a meaningful foothold, we believe it would create its own momentum.

The investors most suited to create this market are the large European insurance companies and asset managers that already have corporate fixed income or credit funds. They have the advantages of existing scale, staying power and credibility in the eyes of borrowers as well as the ability to provide meaningful ticket sizes. We would see medium-sized insurance companies and asset managers entering the market over time as it becomes more established.

In terms of geographic focus, there are already signs that the product in Europe might be driven by currency, with a euro and sterling investor base emerging. We would expect this to continue with some cross-over among the largest investors with UK and European operations (such as insurance company Axa).

Once the market becomes established, it is not inconceivable that non-European borrowers (Australian businesses, for example) might wish to tap the market, although we doubt this would lead to significant scale as the more established US market would be a direct competitor. Once again, exchange rates are likely to drive issuance volumes in this case.

PULL IS AS IMPORTANT AS PUSH Further questions could, of course, be posed. However, cutting to the chase, there is evidence of clear demand for private placements by European borrowers and evidence that US insurance companies have overcome the hurdles mentioned above. This begs the obvious question: what are European investors waiting for? It is time for European investors to step out of their comfort zone and for European borrowers to engage with institutional investors.

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