THE POPULARITY OF PRIVATE PLACEMENTS IN THE US IS CATCHING ON OVER HERE, WITH MORE EUROPEAN FIRMS EAGER TO GET A SLICE OF THE PP ACTION, SAYS **MONICA INSOLL** OF FITCH.

BECOMING PUBLIC KNOWLEDGE

Until recently, a UK treasurer might have been forgiven for not being familiar with a typically American instrument of funding – the US private placement (PP). However, following a boom in demand for foreign risk from US investors in the past couple of years, most medium- and large-sized companies across Europe have been marketed this funding option by eager bankers. Still, little independent information remains published on the market and mechanics of PPs, so getting to grips with it may be a challenge. Read on – and you may be able to impress the boss next time PPs are mentioned.

MARKET GROWTH. While PPs have been around in the US for decades, in the past, foreign issuers could only access the market if they had significant subsidiaries or brand names recognised in the US. As investor demand for diversification has increased, the market has grown strongly to reach $46bn in 2003 (see *figure 1*). While overall market volumes have been relatively stable in recent years, the foreign portion has expanded at the expense of the US portion to a staggering two-thirds of total volumes in 2003. Initially, Anglo-Saxon countries such as the UK and Australia were of greatest interest to investors, although in the past year issuers from across Europe have joined the PP club.

Reflecting this development, the chances are high that the banker calling you about PPs these days is one of the main UK clearers. Banks with large corporate lending books, such as The Royal Bank of Scotland and Barclays, have taken market share from the traditional US arrangers, utilising their existing corporate relationships, as well as building more. As a fee-earning product, not utilising the bank's own balance sheet, but acting as a broker for investors, PPs are a popular instrument for banks mindful of Basel II restrictions.

WHAT ARE US PPs? PPs are long-dated, mainly fixed-rate, notes sold by issuers to US investors, typically insurance companies or mutual funds with long-term liabilities requiring long-term assets for maturity matching. Maturities vary, but can be up to 30 years, although 12 to 15 years are more common. This means PPs offer longer-term funding than either the public debt market or bank sources for the vast majority of companies. Deal sizes range from $30m to $1bn. Investors are limited in number, typically no more than 10 to 15, even for larger deals. Issuers are mainly investment grade and lending is unsecured.

FIGURE 1
HISTORICAL PRIVATE PLACEMENT ISSUANCE

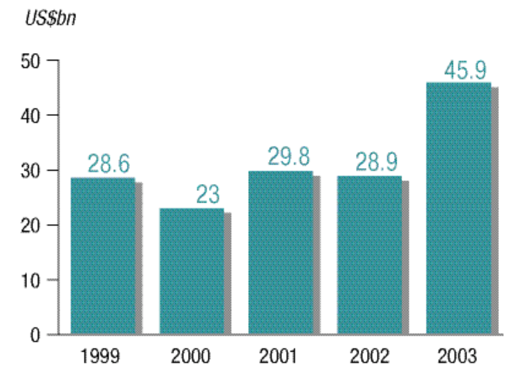

TABLE 1
A SELECTION OF UK AND IRISH ISSUERS OF US PRIVATE PLACEMENTS IN 2003

Rolls-Royce	$500m
British Land	$154m
Wilson Bowden	$100m
BPB	$200m
HIT Entertainment	$117m
Amec	$180m
Rank Group	$530m
Meggit	$250m
Electricity Supply Board (Ireland)	$1,034m
Greencore (Ireland)	$302m
Bord Gais (Ireland)	$440m

However, financial covenants are a standard feature, typically in line with any established bank covenants with the aim of PP investors being *pari passu* with existing lenders.

A typical development path for funding by a company can be seen in *Figure 2*. However, the rapid increase in supply during 2003 has meant many companies that have already accessed the public debt capital markets have returned to the PP market to take advantage of keen funding costs.

THE INVESTOR PERSPECTIVE. The low interest rate environment is resulting in changes of strategy among many investors. For US PP investors, the search for yield has led to increased geographical diversification. The largest investors undertake detailed due diligence and have gradually become comfortable with issues such as the variation of bankruptcy regimes across jurisdictions. PP portfolios have also benefited from the relative strength of performance versus public debt portfolios in recent years of record bond defaults. US PP investors are allowed to hold up to 10% of their PP assets in non-domestic paper. Most still hold only a few per cent, allowing for continued expansion in Europe and elsewhere.

RATINGS AND REGULATION. There is no regulatory requirement for ratings of PPs. However, Fitch notes that ratings are increasingly demanded by investors and banks can find placings run more smoothly with the support of independent research and a rating by an international rating agency. Whether market participants desire it or not, the National Association of Insurance Commissioners (NAIC), the industry regulator, will assign ratings through its Securities Valuation Office (SVO). Such ratings are driven by the need to assess asset quality and capital weighting of investors and only take place post-financial year end.

The SVO has been overwhelmed by increased deal flow and has decided to allow a new streamlined ratings procedure, known as the filing exempt process.

As from January 2004, one rating from a nationally recognised statistical rating agency (NRSRO), the main ones of which are Fitch Ratings, Standard & Poor's and Moody's, will automatically be accepted instead of the SVO also making its own assessment of the credit risk. As a result, issuers will be able to achieve certainty of final rating by obtaining a rating from an agency in advance of the notes being placed with investors (see *table 2* for comparisons).

When accessing a new funding market, this approach should ensure that a successful long-term relationship is built with investors. The latter are not amused if they have bought notes on the basis of a bank's assurance of, say, an NAIC-2 credit profile, only to find that the SVO rates the paper NAIC-3 a few months down the line. At the industry's main annual conference this January, the largest US investors stated publicly that they are firmly in favour of PPs being rated by NRSROs.

RECENT MARKET DEVELOPMENTS. As can be expected in a market benefiting from strong investor demand, pricing has become increasingly keen. Fitch believes there is also a danger that the shifting balance of bargaining power results in a softening of covenants. A small number of investors have expressed their intent on expanding their currently limited non-investment grade portfolios, down to NAIC-3 and NAIC-4. At this level, structures are typically secured and issuers are almost exclusively US domiciled. Fitch has seen some evidence of secured, non-investment grade PPs being tentatively arranged by bankers also for European issuers, but is not aware of any such closings to date.

A PAN-EUROPEAN PP MARKET? While the Eurobond market needed the introduction of the common currency to take off as a serious competitor to the US bond market, the development of a home grown alternative to the US PP market appears to be held back by other factors.

Currently, most European issuers of US PPs swap their dollar proceeds into euros, sterling or another domestic currency. There is no shortage of fixed-income investors on the continent in general, although major insurers and fund managers have proved extremely reluctant to enter the private market. Domestic PP markets exist in many European countries, including Germany (*Schuldscheine*), the Netherlands and Sweden. However, such local markets tend to be characterised by name-driven, short-term lending, without covenants and little cross-border activity. Fitch has identified a number of possible barriers to market growth and is currently conducting a survey of major European investors. (Publication of the conclusions was planned for end of February 2004).

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FIGURE 2
A TYPICAL DEVELOPMENT PATH FOR FUNDING BY A CORPORATE

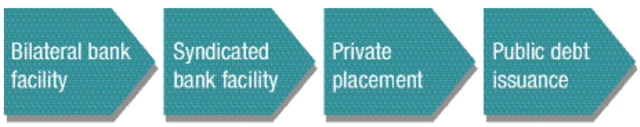

TABLE 2
RATINGS CORRESPONDENCE

NAIC ratings	Fitch ratings range
Investment grade	
NAIC-1	AAA to A
NAIC-2	BBB
Non-investment grade	
NAIC-3	BB
NAIC-4	B
NAIC-5	C
NAIC-6	D