Open for business

THE CONTINUING RESTRAINTS ON BANK LENDING MAKE ALTERNATIVE SOURCES OF FINANCE INCREASINGLY ATTRACTIVE TO BUSINESSES. **VAN THORNE** AND **JASON ROTHENBERG** OFFER AN OVERVIEW AND UPDATE OF THE US PRIVATE PLACEMENT MARKET.

The US private placement market has been an important source of debt financing for UK and European corporations since the late 1980s. Total market issuance has averaged approximately $35bn over the past five years, and for the first nine months of 2010 volume is already at the $30bn mark, reflecting very favourable market conditions.

Corporate treasurers tap the US private placement market because it offers issuers many advantages: funding diversity, entry to the world's largest capital market (the US), longer maturities than are available from banks, simplicity (no debt ratings or SEC registration required), low up-front fees and expenses when compared to public markets, market stability, flexibility (staggered drawdown dates, maturities, fixed and/or floating rate, multiple currencies – all possible in a single transaction), callability, a lender base that does not expect ancillary business, and a publicity level tailored to the issuer (ranging from strictly confidential to a press release).

A wide array of companies use the private market, including public, private, smaller sovereignties and quasi-sovereign entities. They range from household names to mid to smaller cap issuers. Transaction sizes range from $30m to over $1bn, and typically 40% to 50% of the market volume comes from non-US issuers.

RESILIENCE THROUGH THE GLOBAL FINANCIAL CRISIS The private placement market was open throughout the global financial crisis and funding new transactions for quality corporate credits. This was in contrast to the public bond markets in the US and Europe, which were faltering or were completely closed for new issues, and banks, which were significantly reducing lines of credit. Conversely, most life insurance companies had steady inflows of premiums to invest and did not have to rely on the health of the capital markets for their own funding flows. For many borrowers, the crisis was a bold reminder of the importance of funding diversity. Even some corporations with two debt ratings and historically unfettered access to public markets tapped the private market, due to its continued availability.

CURRENT MARKET CONDITIONS From the investor standpoint, demand for private placements is robust, particularly given their performance versus public bonds over time and particularly during the crisis. With increased economic and market stability, credit spreads have narrowed substantially for borrowers over the past year. This, coupled with historically low global interest rates, makes it an unparalleled time to lock in medium to longer-term debt. An increase in M&A activity has also fuelled recent financings.

THE INVESTOR BASE Private placement investors are mainly US and a few UK insurance companies, with the largest investors tending to drive market demand and volume. Several of the large US insurance companies (including MetLife) have London-based staff dedicated to private placements issued by UK and European corporations.

Corporate treasurers take different approaches to their relationships with private investors over the life of a financing and the investors are very accommodating. Some corporate treasurers wish to provide only annual updates, whereas others make a concerted effort to foster deeper relationships over time. The investor is generally amenable and does not represent a drain on corporate treasury resources. Most insurance companies "buy and hold" private placements since they are matching specific liabilities to discrete assets.

While no debt ratings are required for a private placement, most investors seek companies that have an investment-grade profile and can retain it during the life of the transaction. Unlike equity analysts, debt private placement investors are paid to model downside risk. The premium over the risk-free rate is small on debt, yet investor bite sizes tend to be large and the market illiquid. The potential loss on a $100m or $200m investment is daunting. So, by nature, private placement analysts tend to be conservative. Private placement lenders also tend to be relationship-focused and knowledgeable about the needs and challenges of corporate treasurers.

RECENT MARKET TRENDS

- **Non-US dollar issuance.** The US private placement market is not just about raising US dollars. In fact, most of the large investors can provide issuers with any major currency or multiple currencies in the same transaction. Since most are natural US dollar investors, they are typically executing a swap with a third party to provide the non-US dollar funds. In such cases, if the company decides to call the notes, the investor would be expected to be made whole on any associated currency swap.
- **Delayed drawdowns.** Some private market investors can handle multi-month delayed drawdowns, which can be very attractive for issuers that may have a funding need in the future but are attracted to current spreads and interest rates. Many corporate treasurers are currently taking advantage of this market feature. By setting the coupon immediately, they can lock in both the underlying benchmark yield and the credit spread, thus removing both interest rate and credit spread risk in one simple, non-derivative step.
- **Documentation.** The creation of the Model Form of Note Purchase Agreement has been a significant, positive development for the market, greatly streamlining documentation and enhancing the private placement process and experience for both issuers and investors. Because the model form is a market-accepted template, it removes uncertainty for corporate treasurers and makes long-drawn-out negotiations a thing of the past. Investors benefit as well since certain standard language is already incorporated. It is truly a win-win for both issuer and investor in this relationship-driven sector of the capital markets.

Box: What do investors seek in a private placement issue?

There are several factors which come into play when a private placement analyst evaluates a new transaction. In a nutshell: credit, structure and pricing.

- **Credit:** What are the financial characteristics of the company – stability, cyclicality? Input cost structure and volume/price drivers? Trends, conditions and position within the industry? Competitive advantages? Management's track record and philosophy regarding leverage? Acquisition history? Dividend policy? Historical performance (margins, debt/EBITDA levels, etc)? These are questions a private placement analyst will consider when evaluating an investment. At MetLife, our analysts specialise in certain industry sectors and regions, and can often uncover the hidden value of a company that might not be apparent to the broader public market.
- **Structure:** There are very few subordinated private placement issues. Most issuance is senior unsecured, though it would be very rare for private investors to go unsecured if other senior lenders had security. Investors also look at the financial covenant package offered, which can significantly influence an investor's receptivity and reflect directly on deal size and pricing.
- **Pricing:** Investors will value the offered bonds relative to:
  - public bond spreads; and
  - other private placements.

Because private placements are less liquid than public bonds, investors seek an illiquidity premium over comparable credit quality public bonds. This illiquidity premium tends to narrow with economic and market stability and widen with uncertainty.

MetLife is a leading private placement investor and has been active in the market for over 75 years. For more information on the US private placement market, please contact:
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