Market Insight

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Borrower push and investor pull: Will the European Private Placement market take off?

London, 09 November 2010, by Steve Curry

Ask any European CFO or treasurer what have been the salutary lessons from the credit crisis and their list will almost certainly include the need to move away from an over-reliance on bank funding. With private placements being hailed by many market commentators as part of the solution for companies seeking diversification of funding, we explore what can be learned from the US market, whether there is a need for a European private placement market and in which way a European market could evolve.

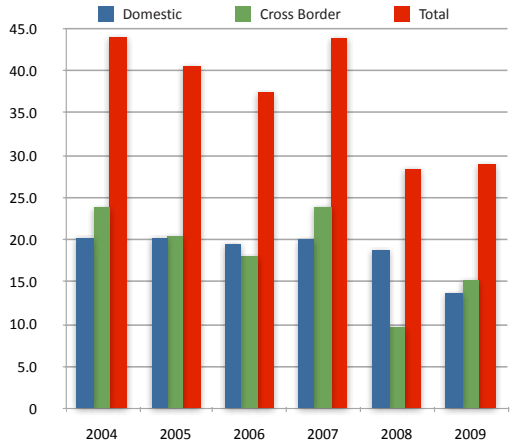
What do we mean by Private Placements?

The term "private placement" has been tripping off the tongue much more frequently in the financial markets over the last year. This is in part because the phrase tends to be used in two different contexts. It sometimes refers, confusingly to our way of thinking, to the placement of listed bonds to a small number of investors which would historically have been undertaken by way of an extensive roadshow, auction and distribution process. At Bishopsfield Capital Partners we like to think of this more as reverse inquiry for public bonds. For the purposes of this article, we are focusing 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.

Lessons from across the pond

Private placements have been a common feature in North American capital markets for decades. The product is a critical source of financing for medium-sized US companies. Although it is still dwarfed by the US public bond markets in both volume and number of deals, each year between 2004 and 2007 the US private placement market averaged US$ 42 billion of new issuance. Not surprisingly, issuance volumes dropped off following the onset of the credit crisis to US$ 29 billion per annum, but the market seems to be returning to pre-crisis volumes. US$ 22 billion of bonds have been issued in the first half of 2010 almost reaching the level of issuance for the whole of last year. It is also worth noting that in the five years to 2009 (excl. 2008) somewhere between 45% and 55% of the issuance volume has been cross-border (i.e. not to domestic US borrowers). See chart for further detail.

US Private Placement Issuance Volumes (US$ billions)



Source: Private Placement Monitor

In the US, banks have historically focused their lending towards shorter maturities. The private placement market has been a source of medium

to long term funding for US corporates. So bank lending and private placements occupy a different zone in the maturity curve which means that fundamentally they don't compete. The European history is different. We will explore this later on in this Market Insight.

Large US insurance and pension providers such as MetLife, New York Life and TIAA have historically dominated the investor base for US private placements. The number of investors is relatively small. The market is of course private and therefore somewhat opaque but most market participants concur that 80% to 90% of deals are placed within the same group of 20 to 25 investors. Recently non-traditional investors in the hunt for yield are emerging in the private placement market. They are mostly focused on the sub-investment grade part of the market and remain a minority at present.

Private placements v public bonds

There are significant differences between private placements and public bonds. They lead to various advantages and disadvantages when looking through the eyes of an investor and a borrower:

Investor view

Advantages of PP v public bond

- Higher yield
- Detailed insight and disclosure
- Thorough due diligence
- Tighter covenants

Disadvantages of PP v public bond

- No liquidity
- Typically hold to maturity
- Detailed credit analysis so special resources required
- Time consuming investment

Borrower view

Advantages of PP v public bond

- *No public rating required*
- *Information disclosure remains private*
- *Investors hold to maturity*
- *Long maturities*

Disadvantages of PP v public bond

- Higher yield
- Largely US$ based, so currency risk
- Shallower, largely US investor base

Arguably the most significant advantage from a borrowers perspective is the ability to avoid a public credit rating from the mainstream rating agencies. The type of borrowers who would consider a private placement may be on the cusp of achieving an investment grade rating and both the initial and ongoing demands of obtaining a public rating are often too daunting. In the US, private placements are required to be rated by the National Association of Insurance Commissioners (NAIC). The NAIC rates to a numerical scale from 1 to 6. Ratings 1 typically are compared to AAA to A- public ratings and 2 to BBB+ to BBB-. NAIC ratings 3 to 6 usually map to non-investment grade ratings. The bulk of investors require a NAIC 1 or 2 rating. The purpose of the NAIC rating is principally to govern the level of reserves an insurance company must hold against an asset. It is typically obtained once a transaction is closed although, normally, it is accurately predicted before closing. The post-closing ascribing of a rating by NAIC is quite a contrast with the public credit rating process that is designed principally to assess and monitor risk and always is in place before a public bond is issued.

Perhaps one of the more material disadvantages of a private placement versus a public bond is that the former is largely a US dollar driven market. For borrowers whose base currency is not US dollars, this presents a currency exposure that would not exist if they borrowed in their base currency. Whilst this currency exposure can of course be managed, it can drive the economics significantly given the typically long tenor of private placements. Therefore the shape of the exchange rate curve impacts the decision whether and when a company should access the market. The currency factor goes some way to explain why the US market is intermittently rather than continuously open to European borrowers.

Meanwhile, back in Europe…

Prior to the collapse of Lehman, European companies had uninterrupted access to a plentiful supply of cheap, medium term bank debt. A recent report from Standard & Poors (*The Shift from Bank Lending to Capital Markets for UK Corporates, 22 Sept 10*) stated for example that

currently at least 76% of borrowing by UK corporates was provided by banks. At Bishopsfield Capital Partners we believe that the reliance upon bank debt by Continental European borrowers is likely to be even higher. 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, combined with corporates prioritising the cost of debt over other considerations (such as diversification) were the root causes of companies becoming so reliant upon 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 consider paying more for their debt just to achieve a more diverse lender base. Diversity was achieved by having a larger number of banks and not by 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 eased somewhat) and differ markedly between banks much more so than in the past. 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 less willing to commit capital and preferring 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 Boskalis, the Dutch dredging company, which issued a US$ 450 million private placement to 26 institutional investors (US and UK) in July. The transaction had three tranches with 7, 10 and 12-year maturities and was raised alongside a EUR 650 million 5-year bank facility. In September, Britvic, the UK soft-drinks company, issued a US$ 175 million private placement similarly with 7, 10 and 12-year maturities and also with US dollar and Sterling tranches. Britivic 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 they would convert their US dollars to Euros. So, surely, had Boskalis been able to borrow in Euros from European private placement investors this could have been an interesting proposition for them.

Now's the time to step forward

At Bishopsfield Capital Partners we feel that there should be much greater urgency, activity, and initiatives to get a European Private Placement market, similar to that in the US, established. 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 £1bn 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 cor-

porate 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 being approximately US$ 20 billion per annum (pre-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 EUR 25 billion, 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 to 2013 we could see volumes reaching EUR 10 to 15 billion per annum over this period.

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

Regulators

Listening to the constant calls from politicians, regulators and central bankers not to rely, going forward, 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 Association of Corporate Treasurers and the Confederation of British Industry to raise awareness of private placements. In both cases, however, it is difficult to see any concrete results being made. Of course one can question whether it should be part of a regulators remit to help "set-up" a market. However, from a policy point of view they appear to whole-heartedly embrace the idea and could ensure certain standards are maintained in documentation, disclosure and market behaviour.

Borrowers

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

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

Whilst these concerns may be real in the eyes of corporate treasurers, they must be 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? These counter-questions also represent real concerns.

It is our view that developing new sources of debt is best done whilst 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 against 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 who really have the ability to drive the establishment of a European private placement market. It strikes us that there may never have been a better moment to get this market on to its feet:

What are the attractions for investors?

1) there is already demand - evidenced through European borrowers turning to the US market
2) attractive yields v public bonds
3) new asset class

4) ability to tailor covenants to mitigate any specific investor concern

What are the hurdles for investors to overcome?

1) credit analysis infrastructure – investors would need to invest in resources 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 around 20 strong.
2) 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
3) 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 establish this market are the large European insurance companies and asset managers that already have corporate fixed income or credit funds. They have existing scale, staying power and credibility in the eyes of borrowers and 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 who have UK and European operations (e.g. AXA and alike). Once the market becomes established it is not inconceivable that non-European borrowers (Aussie for example) may wish to tap the market but 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

There are of course further questions that could be posed. However, cutting to the chase, there is evidence of clear demand for private placements by European borrowers and there is 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… "pull is as important as push."

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com). If you are considering your debt raising strategy and interested in discussing diversification of funding, including private placements, you know where we are.