



Private Placements – Myths, Reality, Opportunity

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Private placements constitute a significant share of some life insurance company investment portfolios, but most companies have little, if any, allocation to this asset class. Why such a dispersion of investment appetite? What do certain insurers know that is not discerned by the broader community of investors? In this article, we shall dispel some myths, clarify others and make the case for an allocation to private placement assets within an institution’s investment portfolio.

Nothing secret or scary

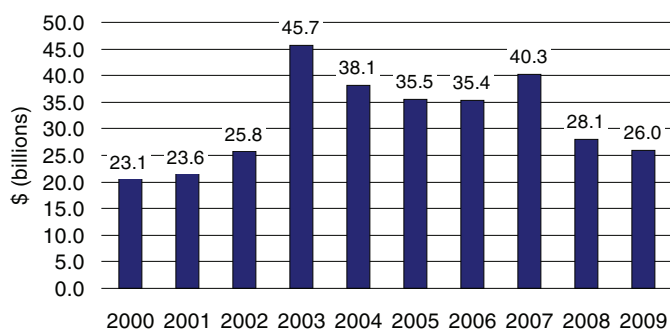
A private placement is nothing more than a security that is not registered with the SEC. It is sold directly by the issuing company (usually through an investment bank intermediary) to accredited investors. Many investors view private placements as a “stand-alone” asset class and target a specific portfolio allocation to privates. They fill this allocation with what they perceive to be the best of the transactions that come to the private market.

Our approach at Conning is different in some important respects. We view private placements as a subset of the corporate bond market. We use an allocation to privates to the extent that opportunities are found in the private market that offer good value relative to investment options available in other asset classes. If value is not found in the private market, the allocation to privates should not be filled. Over the past four years, Conning has committed to just 15% of transactions reviewed, with offerings rejected for credit, pricing or structural issues. In effect, an allocation to privates simply opens the door to potentially attractive opportunities not found in the public market.

How large a market?

In 2009, \$26 billion of debt was placed in the traditional private market in nearly 150 transactions. Issues ranged in size from less than \$50 million to more than \$1 billion, with the average being approximately \$190 million. The companies that issue debt in the private market range from public blue chip corporations to small privately-owned niche companies (more on this later).

Figure 1. Private Placement Volume / Source: Bank of America



The universe of private placement buyers is diverse, and includes institutions with bite sizes that can range from \$1-2 million per transaction

to more than \$100 million. Despite this broad range, the need for specialized credit, legal and back-office personnel to support the asset class historically has created a barrier to entry for many investors.

What drives the demand for private placements?

Demand is evident in both the number of institutions that are allocating a portion of their portfolios to privates, and the size of bids being submitted by institutions for transactions that come to market. Investors see long-term value in privates, typically found in additional covenant protection, name diversification and incremental spread.

Value Driver #1 – Additional covenant protection – Most private placements contain financial covenants that are more restrictive than those typically found in public bonds. The purpose of these covenants is 1) to limit future actions by the borrower that would introduce significant additional risk to the credit, and 2) to give the lenders a “seat at the table” to work with a borrower whose financial profile has deteriorated.

In addition, privates often benefit from event risk protection through covenants that either specifically give investors a “put” in the event of a change in control of the obligor, or require prepayment (often with a make-whole premium) if a financial covenant is breached.

A 2006 study by the Society of Actuaries assessed credit risk loss experience of private versus public bonds (for the period 1986-2002). It found that public bonds in all ratings categories lost an average of 116 basis points annually through defaults, while private placements lost only 31 basis points annually on defaults, restructurings and distressed sales taken together. The default rate frequency in both public and private debt was similar, but the severity of default was markedly lower for private obligations. Conning attributes this to private investors utilizing covenant violations to negotiate for collateral and structural improvements, strengthening their position in the capital structure versus unsecured debt – a clear advantage.

The benefits of covenants can be observed in a debt restructuring that occurred in 2009 (see Figure 2 below). Cemex is a multinational cement manufacturer that experienced financial distress due to the global decline in construction activity following a large debt financed acquisition. In consideration for a modification of financial covenants

Figure 2. CEMEX EXAMPLE

PUBLIC Cemex Finance Europe 4.75% // 3-05-14	PRIVATE Cemex Espana Finance LLC Multiple issues
• Not subject to restructuring	• Restructured debt secured by stock of principal operating subsidiaries
• No coupon step on public bonds	• Coupon stepped up 329-414 basis points depending on issue to 8.91%
• No priority payment from new equity or asset sales	• Restructured debt prepaid by all equity proceeds and most asset sale proceeds. Outstanding balances have already been reduced by 32%
• No consideration at date of restructuring	• Coupon steps up 50 basis points if certain operating metrics are not reached by December 2010 and December 2011 • Restructure fee of 200 basis points and additional notes equal to 8.27% of outstanding principal. Equivalent to a make-whole premium
• Market price - \$84/85	• Market price - \$98/99

and an extension of debt maturities for several years, private placement lenders were able to achieve a significant increase in financial compensation as well as improve their position versus Cemex's public debt.

Value Driver #2: Diversification – In each of the past two credit cycle downturns, many public bond investors experienced losses when large issuers to whom they had significant exposure ran into difficulties. A renewed appreciation for the benefits of name diversification within a portfolio should lead investors to look to the private market as a source of quality issuers that can be added to their portfolios. A large number of private placement issuers do not issue debt in the public markets, so unique name diversification can be added to investor portfolios, enabling single issuer exposures in the public portfolio to be reduced, while still maintaining a stable allocation to corporate credit.

The diversification benefit within privates goes beyond just issuers. The public corporate bond market has had a growing weight of financial sector issuance over the past decade, and even as financial institutions shrink in scale, Conning expects financial issuance will be heavier than industrial over the next several years. In contrast, the amount of financial sector issuance in the private placement market is limited (7.8%), with more than 30% of issuance coming from the industrial sector.

Figure 3. Sector Issuance / Source: Bank of America

GICS Sector	Inv. Grade Corporates	Private Placements
Industrials	7.4%	30.2%
Materials	3.2%	13.4%
Utilities	10.1%	13.3%
Consumer Staples	5.9%	12.1%
Consumer Discretionary	10.2%	8.7%
Financial	42.7%	7.8%
Energy	4.8%	7.4%
Telecommunications	8.9%	4.9%
Health Care	3.9%	2.2%
Information Technology	2.9%	0.0%

Value Driver #3 – Incremental spread – Historically, the rule of thumb was that a private placement should command a 25 basis point liquidity premium over comparable public bonds. However, the premium has ebbed over time as more investors recognized the value proposition of privates and secondary liquidity in the asset class improved. The average now is 10-15 basis points for vanilla transactions. However, private spreads tend to lag the public market directionally; private spread premiums remained wide during much of 2009 when public spreads were tightening.

Higher spread opportunities continue to exist, generally in smaller issues, new issuers or transactions with structural complexity, e.g., delayed funding, amortizing balances, project financing or leveraged leases. These transactions command additional premium because large buyers of privates decline to participate in deals where allocation size frequently will fail to meet investor minimums. Fewer large buyers results in decreased pricing negotiation strength by the issuer.

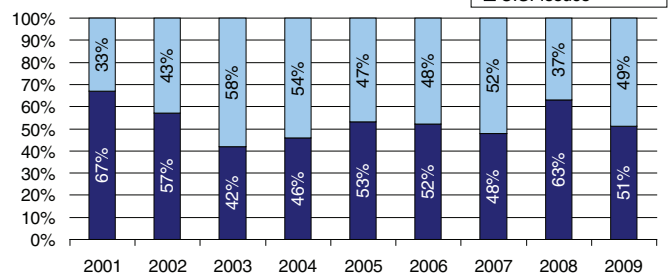
Private placements are treated as admitted assets by the NAIC and reported on Schedule D. Many issuers carry ratings from public rating agencies, while others are rated by the NAIC's Securities Valuation Office. While the majority of issuers in the traditional private market are rated NAIC 2 (the equivalent of triple-B), NAIC 1 issuers (primarily in the single-A credit quality range) are not uncommon.

Domestic vs. Cross-Border? Large vs. Small? Ownership?

In recent years, domestic issuers have accounted for about half of new private issuance. The balance has come largely from issuers in Western Europe and Australia, with the bulk of this cross-border issuance in

U.S. dollar denominated debt. Issuers in the private market range from very large to small companies, and include companies that are publicly, privately and state owned. To give just a small taste of the market, among the entities that have accessed the private market in recent years are: American Electric Power, BMW, Energizer, Smucker's, Adidas-Salomon, Andersen Windows, BNSF Railway, Deutsche Borse (Frankfurt Stock Exchange), Copenhagen Airport, Rolls Royce, major league sports (both leagues and franchises), major public accounting firms, the U.S. Internal Revenue Service, and the owner of Spain's electric transmission grid.

Figure 4. Domestic vs. Cross-Border Issuance
Source: Bank of America



Borrowers choose to issue debt in the private market for a number of reasons. The private market offers diversification of funding sources and fills a void between commercial banks and the public debt market for smaller issuers. It can eliminate the need to obtain credit ratings from public rating agencies. It enables a privately-owned company to keep financial and other information confidential. As mentioned earlier, the private market lends itself to complex debt structures, which frequently fit the liability profile of insurers. Also, because this is a market that values relationships, and the typical investor group includes fewer than fifteen institutions, if the need arises, it is more manageable for the borrower and the investor group to work together over the life of the transaction.

Closing thoughts

We believe that the private placement market offers good value to the disciplined investor. This value may come through higher coupons that add directly to return, or it may take a less visible form of reduced event risk, stronger covenant protection or name diversification. In any event, all of these sources of incremental value can reasonably be expected to contribute to superior portfolio performance over time. ♦

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