The U.S. privately placed debt market

Considered investment grade credit, with structural benefits

As investors worldwide continue their search for yield in a global environment increasingly marked by negative interest rates, it’s not surprising that an important niche of the fixed income market is drawing increasing interest — private placement bonds.

One particular segment of the privately issued debt market, commonly referred to as the USPP (or U.S. private placement) debt market, can be an attractive option, particularly for investors such as life insurance companies and pension funds. This is because private placements can offer a yield premium to comparable investment grade public corporate bonds as compensation for the perceived illiquidity of the assets. In addition to this yield premium, there are also structural benefits to USPP debt, such as covenant protections, which are typically built into each debt agreement. These aspects of USPP debt can make this asset class, for certain investors, a potentially meaningful supplement to their existing fixed income strategies.

Key facts about the USPP market

- The USPP market is well established, existing for more than three decades. Issuance can be broad based, with non-U.S. issuers often accounting for 50% or more of annual USPP issuance.

- While typically unrated, USPP debt is generally considered comparable to investment grade public corporate bonds and generally receives a credit quality designation from the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) that corresponds to credit ratings from nationally recognized statistical rating organizations (NRSROs).

- Because privately placed securities are seen as relatively illiquid assets, this type of debt typically offers a yield premium to public corporate debt. But it is the perceived illiquidity, not increased credit risk, that accounts for the premium. USPP debt is not at all similar to private equity, mezzanine debt, or other alternative investments, which generally have higher credit risk.

- Among the most important features of the USPP market are the structural protections — covenants — built into each private placement agreement that can protect the investor through the term of the bond.

Please see back cover for important information.
New interest in the USPP debt market

As global investors search for yield, the USPP market, comparable to public investment grade corporate bonds, can offer potential benefits beyond yield premium

Understanding the USPP market

Although the USPP market is less well known in the market at large — and perhaps misunderstood as many believe it to be comprised of high-risk, alternative assets — the market for these privately issued bonds is well established. Private placements have been issued for more than three decades, even if the market size continues to be a sliver of the public fixed income market. In 2015, new issues of private placements amounted to $49 billion.* This compares with more than $1 trillion in the public corporate bond market* during the same period.

*Sources: Private debt, Bank of America Merrill Lynch; public debt, Securities Industry and Financial Markets Association (SIFMA)
For a general understanding of how private placements can fit into certain fixed income strategies, we begin with an overview of the market and a profile of typical issuers of these debt securities.

Next is a discussion of how purchasers can negotiate favorable positions, along with protective covenants, in the document governing each transaction, known as the Note Purchase Agreement (NPA).

Finally, based on our 30-plus years of experience of investing in the USPP market, we provide examples of how the structure of these securities — such as financial and other covenant protections that generally are not present in public bonds — can be advantageous to investors. These structural protections can provide investors with a voice if there is a material change in the issuer during the term of the investment. The protections provide investors with the ability to, among other things, renegotiate, reprice, or even force prepayment of the bonds, as is appropriate in each particular situation.
What the USPP market looks like

A key fact about USPP debt, which distinguishes this segment of the fixed income market from other privately placed debt in general, is that this can be considered similar to an investment grade asset class.

Unlike public corporate bonds, USPP market debt is often unrated; however, because insurance companies are the predominant buyers, USPP bonds usually are assigned, generally after being issued, a credit quality designation from NAIC that corresponds to agency ratings. (For example, NAIC 1 corresponds to a rating of A- or better, and NAIC 2 corresponds to an agency rating of BBB- to BBB+.) In recent years, 97% or more of new-issue private placements were either rated by an NRSRO such as Moody’s Investor Services, or they were designated as NAIC 1 or NAIC 2 by the NAIC — that is, investment grade.¹ At the same time, our experience has shown that private placements may offer yield premiums anywhere from 10 to 50 basis points or more over similar-quality, public corporate bond investments, depending on factors such as the issuer, jurisdiction, or note structure.

On the surface, this may seem like faulty logic because, in the public bond market, a yield premium is usually associated with perceived incremental risk. However, USPP debt is not at all similar to riskier investments such as private equity, mezzanine debt, or leveraged loans. In fact, USPP debt is frequently issued by large, established, multinational companies with household names.

It is the perceived lack of liquidity inherent in these securities that accounts for the extra yield that issuers must pay. (We say “perceived” illiquidity because a secondary market for USPP debt exists, and, depending on the bond in question, there is typically liquidity available in the USPP secondary market.)

Considerations for issuers

There are a number of reasons why certain issuers with solidly investment grade credit profiles would choose to borrow in the USPP market, in spite of higher costs and structural concessions.

1. Confidentiality. Privately held entities, such as large family businesses that are not traded publicly, or organizations such as U.S. sports leagues and franchises, might use private placements in order to preserve the privacy of their financials. By issuing bonds privately, they can limit the dissemination of information beyond their lenders that would not be possible in a public deal.

2. Cost considerations. The yield paid on a bond is not the only cost to an issuer. If companies issue debt publicly, they will typically also need to maintain public debt ratings, which require significant fees as well as an infrastructure for ongoing discussions and disclosure requirements with those rating agencies. For a multinational company, even one with publicly traded equity that issues debt infrequently, such as when it is funding a major acquisition, the incremental cost in terms of coupon on a private placement bond can be far less than the costs associated with infrequent public bond issuances.²

3. Diversification of capital providers. The USPP market also offers issuers the option to both diversify their lending sources away from just traditional bank lenders, and access longer-duration capital that banks generally do not provide.

¹ Source: Bank of America Merrill Lynch
² Note: There may be some differences for non-U.S. issuers offering private placements to U.S. investors. See information on back cover.

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Comparing public and private debt

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<tr>
<th>PUBLIC DEBT</th>
<th>U.S. PRIVATE PLACEMENT (USPP)</th>
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<tr>
<td>Large volume of issues; range of credit quality</td>
<td>Relatively fewer issues; generally considered comparable to investment grade in NAIC ratings</td>
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<tr>
<td>Issues rated by credit rating agency</td>
<td>Usually unrated but can have equivalent credit designations from the NAIC</td>
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<tr>
<td>Deals are transparent</td>
<td>Terms kept private, limited to deal’s counterparties</td>
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<tr>
<td>Assets generally are liquid, but the issue’s yield can be subject to market conditions</td>
<td>Perception of less liquid assets although there can be liquidity; nonetheless, offers yield premium, appealing to buy-and-hold investors</td>
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<tr>
<td>Limited special protections for investors if default or other problems occur</td>
<td>Offers customized covenant protections to bond holders as part of a contract agreement</td>
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4. Flexibility. Bonds issued in the USPP market are negotiated contracts between an issuer and a qualified institutional buyer (QIB). The individual NPAs that are developed for debt issued in the USPP market are not limited partnership agreements, which are commonly used in alternative investments such as private equity. Because of the negotiated aspect of this type of debt — another material difference between the USPP market and the public investment grade bond market — issuers have the ability to negotiate customized debt structures that more closely fit their financing needs. Examples include the ability to issue debt:

- In multiple currencies
- With multiple maturities
- In amortizing structures
- With delayed funding.

In essence, the negotiated aspect forms an à la carte menu where an issuer can decide how best to structure a financing, and the market determines for each deal what that customization may cost the issuer relative to what it could issue in the public market at that time.

Who invests in the USPP market?

Traditionally, the principal buyers of USPP debt have been U.S.-based life insurance companies. However, any QIB from any part of the world can invest in the USPP market and receive the same potential benefits of this market as the traditional investors.

Those benefits include:

- Issuer diversification in their fixed income portfolios
- Potentially higher yields relative to public bond comparables
- Structural protections typically not available in investment grade public bonds.

It is worth noting that this market is commonly referred to as the United States private placement market primarily because the traditional investor base comes from the U.S. — not because the issuers that finance in this market are exclusively U.S.-based. In fact, in a typical year, non-U.S. issuers can account for 50% or more of the total debt issued in the USPP market.*

The conservative tilt of the traditional USPP investor base, largely comprised of life insurance companies, is an important factor in tipping this market toward predominantly investment grade issues. Insurers typically hold large allocations of fixed income for asset-liability matching (ALM) purposes, and insurance regulators require them to hold capital against those investments, which varies based on the relative risk of those investments. For example, an insurer must hold much more capital against a BB-rated bond than it does against an A-rated bond due to the increased risk associated with the high yield bond.

Because the liabilities against which these investments are matched tend to be of long duration, any relative illiquidity of USPP market debt is not viewed as a significant negative by insurance companies since they typically employ a buy-and-maintain strategy for their ALM purposes, rather than a total return strategy.

*Source: Bank of America Merrill Lynch

Any QIB from around the globe can invest in USPP debt and potentially reap its benefits.
Notable deal structures

In addition to offering issuer diversification within an investment grade portfolio, and the potentially higher yield as a liquidity premium to comparable public bonds, another important consideration that draws investors to the USPP market is the structural protections that can help protect the investor through the term of the bond.

USPP market debt tends to be long duration, with maturities, we have found from our experience, typically ranging from 7 to 15 years (or longer). As noted, this corresponds to the need of insurers to invest in long-duration assets for ALM purposes. Participants in this market tend to understand that events will frequently occur over these extended time periods that may materially change the risk profile of the issuing company. For example, the issuer may add leverage to acquire another company, or the issuer can become the target of an acquisition itself that could make the investment much riskier for the investor than the deal it originally underwrote.

Beyond merger and acquisition activity, any number of micro- and macro-level events may occur that can cause the credit quality of an issuer to deteriorate. This is where the other chief negotiated aspect of the USPP market can come into play — covenant protections and other structural enhancements that are negotiated as part of each NPA as protection against these types of unforeseen or unpredictable events. These types of protections typically aren’t available in public deals, making them one of the key advantages of private placements.

In general, the objective in negotiating a favorable structure is to make sure that the private placement investor has a seat at the table should one of these events arise. By allowing the investor a say in negotiations with the issuer, the investor’s position is strengthened by the ability to hold discussions with the issuing company at a key point in time — before an acquisition is completed or before a negative trend develops into a material credit event. The result of these negotiations could include responses such as obtaining security, renegotiating coupons for extra spread as compensation for the increased risk, or granting the issuer a waiver (in exchange for appropriate compensation) to help it avoid a covenant issue. The outcome also might include requiring the issuer to refinance — that is, prepay — the USPP debt if the investors are unwilling to live with the change in the issuer’s circumstances.

On the public side, often the only recourse for investors when these situations arise is to sell at the current market price, which will often be at a loss given the increase in risk, or to wait and hope that the market will recover eventually and that the issuer will continue to service its debt.
Post funding events

There are a number of different types of covenant protections, several of them commonly used. Here are examples of how some structures work and how they have been used to protect private placement holders.

1. **Sale-of-assets covenant.** In one recent example, a large public company, which had issued both USPP and public debt, announced plans to split its business into two entities. While the stock market reacted favorably, bond rating agencies downgraded both entities to below investment grade. Holders of the original company’s public debt had no recourse other than to either hold their now high yield debt or to sell it at much wider spreads. By contrast, the company’s restructuring plan would have violated the sale-of-assets covenant in the USPP debt agreement. As a result, the company was left with little option other than to prepay the USPP debt at the contractual “make-whole,” which resulted in prepayment of the private debt at a premium of approximately 7% to par.

2. **Priority debt covenant.** Even well-managed companies can run into trouble when market forces disrupt their business models. This has been true for companies in the commodities and energy sectors, which have been challenged with volatility and falling prices in recent years. In one example, a coal company that saw a drop in prices of its mainstay product agreed to provide its bank lenders with collateral. As in the sale-of-assets covenant example above, this company also had both public and USPP debt outstanding. Because of a priority debt covenant in the NPA governing the USPP debt, the company was required to amend the NPA to provide the private noteholders with the same collateral the banks were receiving in order to avoid violating this covenant. In general, a priority debt covenant limits how much priority, or secured, debt an issuer can layer in ahead of an existing class of debt. In this case, the structural protections in the NPA resulted in the private placement noteholders’ maintaining their priority in the company’s capital structure, while the public bondholders were left in a subordinate, or unsecured, position relative to the banks and private noteholders.

3. **Consent amendment waiver process.** Not all credit concerns are equally dire, and in many cases it’s in both parties’ best interest to negotiate a compromise or contingent agreement. In many cases, the issuer may come forward with a problem that could, potentially, trigger a covenant. That gives USPP investors an opportunity to negotiate a strategy for how to address each particular situation.

In some cases, it could be a minor, technical matter that’s not a significant credit concern. For example, a company might need a few additional days to deliver its quarterly financial statements because of an internal system glitch. If there isn’t a concern about the particular request, the company may be offered either an amendment, or a simple consent or waiver to the original covenant.

At the other extreme, more serious situations can increase the credit risk beyond what the private placement investors would deem to be acceptable levels. Here, there are a range of options. If investors believe it is short-term in nature, they might grant a waiver for a time period, such as a calendar quarter, until the problem is resolved, or the company comes back and negotiates a new waiver period. However, if there is potentially a long-term increase in credit risk, then investors have the ability to reopen the documents and renegotiate any and all terms of the deal, as necessary. This could result in a completely new set of financial covenants, resetting covenant levels, repricing the coupon(s), granting collateral, shortening maturities, or even requiring the issuer to prepay the notes, among other things. Typically, this would be done in conjunction with the banks as they renegotiate their loan agreements.
4. **Coupon bump.** A coupon bump is a frequently used amendment that allows investors to get paid a higher yield in return for accepting additional risk. Suppose a company comes forward with a projection that its leverage ratio will spike above the level specified in the original covenant — say 3.0x debt/EBITDA (earnings before interest, taxes, depreciation, and amortization — an indicator of a company’s financial performance). In this scenario, the company’s management projects that, over the next three quarters, its leverage will increase to 3.5x, recede to 3.25x, and then drop below 3.00x. In negotiating an amendment, one option (assuming holders agree with the company’s projections) would be to require the issuer to increase the coupon on the notes by 100 basis points when the leverage is above 3.25x but below 3.50x, and by 50 basis points when the leverage is above 3.00x but below 3.25x. If at the end of the agreed-upon three quarters, the leverage is in fact back below 3.00x, the coupon bump might fall away and the covenant level and coupon rate would continue at the levels originally negotiated at the time the notes were issued.

If the leverage problem appears to be of long duration, then the coupon bump could be set higher, and possibly persist to the maturity date. In more extreme cases, the company could be borrowing significant amounts to finance a major acquisition. If so, that would constitute a material change to the credit, which would require the issuer to refinance the deal and pay off the debt, typically at a contractual T+50 make-whole amount. (This formula is used at prepayment to discount expected cash flows to present value at the current U.S. Treasury rate plus 50 basis points, intended to make the investor whole; that is, provide enough to replace the interest income of the prepaid bond.)

**Skill set to manage private placements**

These specialized factors such as covenant protections give the USPP market a distinct place in the fixed income market. They also make the skill set needed to evaluate deal structures and covenants a main differentiator between teams managing public bond portfolios and those managing USPP portfolios. In the public market, credit quality and price are the two main variables, with structure being typically uniform across deals, but with public debt, there’s really no opportunity to negotiate price or structure: If the public bond investor doesn’t like the credit quality or the spread, it won’t buy the bond. Public bond issuance also happens quickly, with deals often marketed and sold in a single day.

With USPP debt, however, nearly everything is potentially negotiable. If an investor believes the offered structure is insufficient, there is typically an ability to add structural changes as conditions to a bid on the deal. Similarly, there is also frequently the ability to negotiate pricing on a deal, which can vary based on the degree to which the issuer also agrees to suggested structural changes.

The deal process in the USPP market can be a lengthy one. From the time the deal comes to market to the date when terms are finalized can be a span of several weeks. Bids are accepted by the issuer and the deal prices, and then it could be several additional weeks, if not months, before the deal actually funds and notes are issued.

In addition to the complexity and duration of negotiations, compliance is another important reason why investment firms need to have separate teams for public bonds and for privately placed debt. Many companies that issue USPP debt may also have public bonds or public equity outstanding. As a routine part of the private placement process, private placement analysts can frequently be given access to information that would be deemed to be material nonpublic information (MNPI) pursuant to applicable securities laws that must be handled accordingly. Failure to maintain adequate information barriers between the public and private placement groups for the handling of MNPI can result in serious conflicts of interest for the firm and for its clients.
Thus, it is essential that a private placement group cordon itself behind strict ethical walls, working separately from public teams. That way, private placement team members can review the MNPI information, keep it contained within the private placement group, and perform the necessary analysis, monitoring, and management of the private placement investment — all without impacting the rest of the investment firm’s work on public securities for other clients.

Public vs. private: Investment team differences

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<tr>
<th>PUBLIC DEBT TEAM</th>
<th>PRIVATE PLACEMENT TEAM</th>
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<tr>
<td>Credit quality and price are the main purchase variables; no opportunity to negotiate price or structure</td>
<td>Nearly all factors are potentially negotiable, including structure and pricing</td>
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<tr>
<td>Structure generally uniform across deals</td>
<td>Structure is customized by deal</td>
</tr>
<tr>
<td>Deals transacted quickly, often within a day</td>
<td>Issuance process can be lengthy, sometimes taking months</td>
</tr>
<tr>
<td>Transparent market for each deal on price, credit quality of issuer</td>
<td>Due to private nature of negotiations and issuers’ financials, need for adherence to strict compliance rules on nonpublic information</td>
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Why private placement can be a good fit for some

For many USPP market investors, private placement debt can be attractive because of the potential for additional yield — particularly in the current low-yield environment. However, privately issued debt has a number of other features that can further enhance the appeal of the asset class, especially for some fixed income investors who may be looking to supplement their fixed income investment strategies. Whether it’s the potential diversification benefits to the issuer, or the possibility of capitalizing on the specialized covenant protections that are negotiated into an USPP debt transaction, there can be multiple reasons for certain investors to consider the private placement debt market.

The same features that make this market appealing to some investors also mean that it’s important to align with the right investment firm. For the most effective investment in this market, investors ideally should seek guidance from a firm that maintains a separate private placement unit, staffed with seasoned investment professionals with specific experience in this area. In a market like USPP debt, where the entire deal flow is generally shared with every potential investor, it can make a difference to partner with an experienced team, which has developed the ability to gain full access to this specialized but important segment of the fixed income market.
About our private placement team

As one of the few independent asset managers with a strong private placement capability, the Delaware Investments private placement team is a highly experienced staff of analysts, with more than 30 years of experience investing in this specialized segment of the fixed income market. The team works to develop relationships with private placement agents to position themselves for access to deal flow, places a strong emphasis on underwriting and deal structure, such as negotiating appropriate financial covenants, and in addition to their own research can leverage affiliated resources within the firm, including the public credit research team. The private placement team is led by Brad Ritter and Alexander Alston.

Brad Ritter, CFA
Senior Vice President, Co-Head of Private Placements Group
Brad Ritter is co-head of the firm’s private placements group, which has responsibility for managing a portfolio of more than $13 billion of privately placed fixed income securities, as well as private equity and other alternative investments. He also has responsibility for the firm’s private placement trading effort. Prior to joining Delaware Investments in June 1998 as a senior analyst, he was a securities attorney for Lincoln National Corporation, focusing on insurance investment regulation, derivatives, structured products, and private placements. He joined Lincoln National in 1995 from the U.S. Securities and Exchange Commission, where he served as a senior counsel in the Division of Market Regulation (now known as the Division of Trading and Markets). Ritter earned his bachelor’s degree in economics from Virginia Tech, his juris doctor degree from The George Washington University, and an MBA from Indiana University.

Alexander Alston, CFA
Vice President, Co-Head of Private Placements Group
Alexander Alston is co-head of the firm’s private placements group, which has responsibility for managing a portfolio of more than $13 billion of privately placed fixed income securities, as well as private equity and other alternative investments. Before joining Delaware Investments in May 2007 as a private placements analyst, he was a high grade credit analyst with BlackRock Investment Management and Merrill Lynch Investment Managers. Alston began his career in 1996 with Prudential, where he held several roles, including private placements analyst within Prudential Capital Group, equity research analyst for the firm’s international growth funds, and new markets analyst for the firm’s international life insurance business. He earned his bachelor’s degree with a dual major in finance and economics from Rutgers University and an MBA from The Wharton School of the University of Pennsylvania. Alston is a member of the CFA Society of Philadelphia.
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