

## PRIVATE CAPITAL

# Private Placement Debt is an All-Weather Investment Strategy

## Introduction

The unique characteristics of private placement debt help position the asset class to perform well despite the potential for an economic slowdown or recession. Private placement debt is predominantly investment grade, comes with structural protections, and offers the potential for incremental income. Therefore, in addition to providing diversification and an upfront spread premium to public bonds, we believe private placement debt offers downside protection which can be especially valuable in more challenging economic climates.

## Strong Structural Protections Help Limit Downside Risk

Private placement debt is **predominantly an investment grade market**. It offers an upfront spread premium to public corporate bonds to compensate for lower liquidity. Regardless of the rate environment, business cycle or pace of economic growth, private placement debt also offers **important structural protections** which are designed to limit downside risks. These structural protections are not available in public bond markets.

Typically, private placement debt occupies a **senior position** within an issuer's capital structure and ranks *pari passu* to other senior creditors such as bank debt. Financial covenants (maintenance tests, not incurrence) are negotiated in virtually all deals and typically set maximum leverage and minimum interest coverage levels, amongst other terms. Covenants serve the critical function of acting as an early warning signal; thus, allowing lenders to engage in discussions with an issuer if a business begins to struggle or underperform, and to ensure equitable treatment versus other senior lenders.

## Potential for Lower Losses and Incremental Income

Historically, **loss rates have been favorable vs. comparable investment grade public debt** due to the financial covenants and various other structural protections. Private placement debt has a 14% absolute advantage in ultimate recovery rate for senior unsecured debt versus public bonds, according to a 2019 Society of Actuaries study.<sup>1</sup> Given this ability to likely protect against loss, private placement debt has been an excellent place to be invested through past cycles. And, while less liquid than public bonds, a well-developed secondary market has evolved for privates. We believe it is also worth remembering that in a volatile or down market, liquidity can become scarce even in liquid sectors.

Private placement debt also offers the potential for incremental income. When a borrower's business underperforms, it may request that lenders temporarily loosen financial covenants in order to remain in compliance. In return, lenders may negotiate amendment fees, coupon bumps, or mandatory prepayments, depending on the severity of the situation. Negotiations may also allow private placement lenders to protect their position with new temporary or permanent enhancements to terms. Make-Whole amounts due upon prepayment of debt above the market value of the notes can also offer additional income. We believe that over time, the combination of lower losses and incremental income can add to private placement debt's favorable economic value versus public bonds.

## Attractive New Investment Opportunities

Most private placement debt issuers do not issue public bonds. Therefore, the private placement market expands the universe of investment grade lending opportunities and can help add **valuable diversification** to a fixed income investor's portfolio.

We see during periods when the public bond market is volatile the private placement market tends to remain open. Privates are a relationship market where deals are negotiated either bilaterally or amongst a relatively small group of lenders. This allows transactions to proceed, at a price reflecting current market conditions, even in times of broader dislocation. The structural protections included in private placement debt help provide comfort and can likely be enhanced in return for certainty of execution. As a result, we believe attractive new deal opportunities can often be found during periods of market disruption.

## Navigating the Private Placement Debt Market

Private placement debt is a labor-intensive asset class. Successful investment requires a disciplined credit culture and in-depth analysis of the sector, credit, relative value and structural aspects of every deal opportunity. Oftentimes issuers in this market do not have ratings from a rating agency, so assigning an internal rating is key to evaluating risk and relative value.

At MetLife investment Management (MIM), we also believe having access to the broadest set of potential investment opportunities is key to constructing an appropriate client portfolio and ultimate long-term success. Our team has built strong relationships over many years with companies, equity sponsors, bank agents and debt advisors. Given MIM's size and scale, along

with our experience and expertise, these relationships allow us to see and create many deals not shown to the broader market. Our clients can therefore benefit from timely deployment of capital in high quality transactions to create well-diversified portfolios.

## Conclusion

Regardless of the economic outlook, we believe private placement debt remains an attractive asset class for institutional investors looking to add diversification and increased yields to their fixed income portfolios. We see covenants and other structural protections have led to favorable historical loss rates for the asset class vs. comparable investment grade public debt over time. The current volatile market environment does not change the thesis for investing in private placement debt, and is likely to create attractive opportunities, which is why we believe private placement debt remains a compelling all-weather strategy.

### Endnote

<sup>1</sup> Society of Actuaries 2003-2015 Credit Risk loss Experience Study: Private Placement Bonds, April 2019, Section 2.5.4 Loss Severity.

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<sup>2</sup> At estimated fair value as of 12/31/2022. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

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