PRIVATE CAPITAL

Private Placement Debt Investments

November 30, 2020

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MetLife Investment Management

Summary

Before there was a public bond market or a Securities and Exchange Commission, the private placement market was actively providing capital to borrowers. Initial issuers were railroads, mining and canal companies – deals that might be considered Infrastructure financings today. After the market crash of 1929, and the resultant financial market reforms, the Securities Act of 1933 ("Act") was created requiring public bonds to be registered in order to sell such securities to the general public. Private bonds continue to be exempt from registration provided that they meet certain exemptions under the Act. Private placements remain an important source of funding for corporations today and are in strong demand from issuers and investors alike.

Dating back over 100 years, the private placement market provides investors with credit and geographic diversification, good asset-liability matching via strong call protection and compelling economics through enhanced yield, lower losses and potential for incremental income due to financial covenants.

Underwriting, negotiating, documenting and monitoring these investments is labor intensive. Extensive and deep relationships with investment bankers, issuers and deal sponsors is the key to sourcing transactions and building a diversified and well-structured portfolio with attractive yields. While some firms have built in-house expertise in this asset class, others have elected to outsource such investments to asset managers due to the substantial time and resources needed to participate in private placements.

> **Debt Private Placements:**
> Fixed Income investments that offer enhanced yield and downside protection.

What is Privately Placed Debt?

Under the Securities Act of 1933, any offer to sell "securities" in the United States must either be registered with the Securities and Exchange Commission ("SEC") or the bond offering must meet certain qualifications to exempt the bonds from such registration. If such exemptions are met, issuers are permitted to offer and sell their bonds in the private market to accredited investors without registration.

The debt private placement market allows companies to raise capital without the need to meet the legal and financial requirements of the public market. This can be seen as attractive for borrowers who do not want to widely publicize their financial statements, for unrated public companies with limited access to other capital markets, for companies whose financing needs are small and therefore do not justify the costs of a typical SEC registration or companies wishing to have greater flexibility over the terms of their debt offering.

Historically, many mid-cap companies have tended to be private placement debt issuers. Today, however, many large-cap companies also access the market. Oftentimes, they do so to diversify their funding sources away from the more traditional banks or public market, or to simply supplement other funding options. During the global financial crisis, many corporations learned first-hand the value of having a wide variety of financing sources, including the private placement debt market.

Private placement debt securities have characteristics of both the public bond and commercial bank loan markets as described below:

	Private Placement Debt	Public Bonds	Bank Loans	Municipal Bonds
Tenor (years)	5-30	3-30	Up to 7	1-30
Fixed / Floating	Fixed; small floating issuance	Fixed	Floating	Fixed
Avg. Deal Size	$100 million – $1 billion+	$500 million – $1 billion+	$1 billion+	$30 million+
Covenants	Maintenance	Limited, incurrence	Maintenance	Maintenance
Prepayment Risk	No (Make-whole)	Varies by indenture	Yes	No

Based on MIM estimate as of 2020.

Characteristics of the Private Placement Market

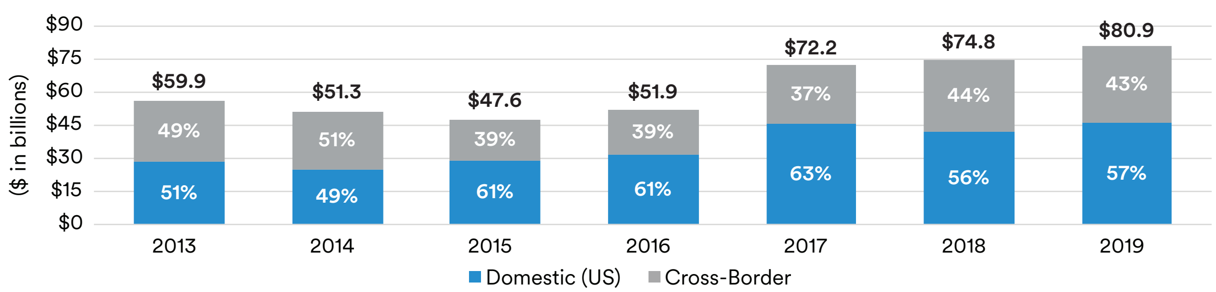
- $81 billion of issuance reported in 2019 in over 300 transactions[1]
- Average deal size of $230 million, with range from $20 million to $1 billion+[2]
- Buyers are typically insurance companies or other long-term oriented investors
- Primarily, although not exclusively, an investment grade market[3]
- Intermediate to long-term maturities; mostly fixed rate
- Protective covenants that are generally not available in the public market
- Consistent demand for non-USD currencies
- Uses model form of Note Purchase Agreement ("NPA")
- Physical settlement vs DTC or Euroclear

It should be noted that as a private market, not all transactions are publicly disclosed or reported (particularly directly negotiated deals). Therefore, it is likely that published numbers are understated and do not fully reflect the entirety of the market.

Market Size – Borrowers wishing to issue in the private placement debt market are able to raise a significant amount of capital with deals ranging from $25 million to over $1 billion in size. Total issuance in this market is estimated at $80 billion – $100 billion annually;[4] however, it should be noted that many transactions are negotiated directly between the borrower and the investor and these transactions may not be formally reported in the market statistics. In fact, MIM believes the true size of the market may well be greater than $100 billion annually.

As shown in the chart below, reported issuance in the private placement debt market exceeded $80 billion in 2019 with over 300 deals completed.

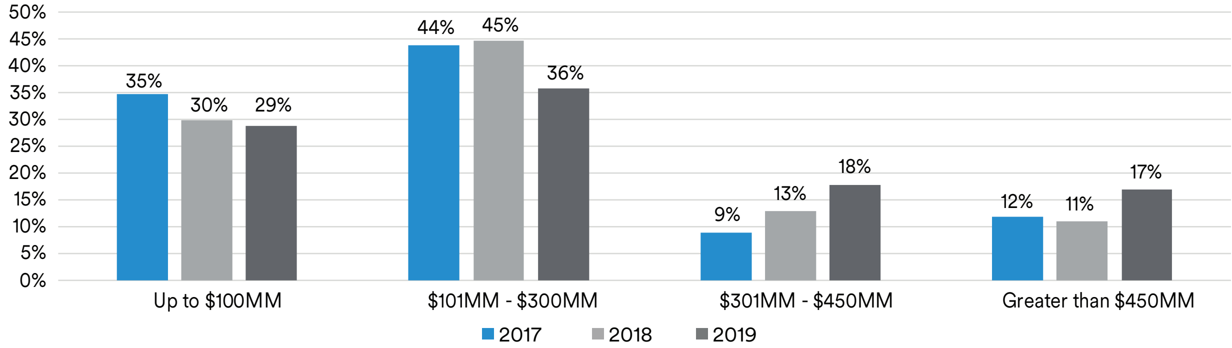
Annual Private Placement Market Volume



Source: Wells Fargo, 2019 Debt Private Placement Review

Average Deal Size – The average deal size was $230 million for 2019.

Issuance by Transaction Size (% of Total Issuance)

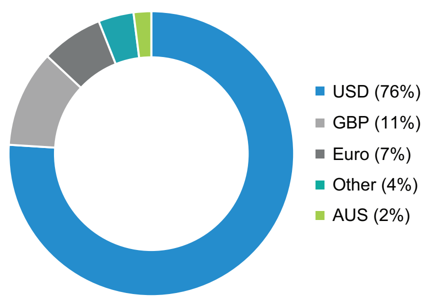


Source: Wells Fargo, 2019 Debt Private Placement Review

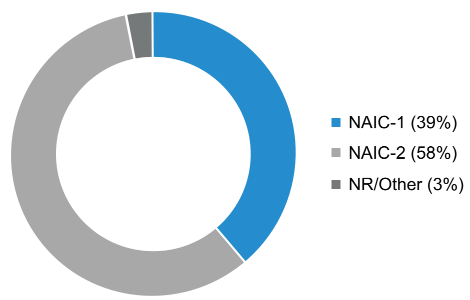
Currency – The private placement debt market is still heavily weighted towards USD issuance. However, foreign currency has become a meaningful component of issuance as borrowers and lenders have been increasingly willing to provide it.

Quality – Primarily an investment grade market, 2019 volume of private placement debt was comprised of 39% NAIC-1s (rated A- or higher), 58% NAIC-2s (BBB+ to BBB-) and a limited amount of below investment grade bonds (BB+ or lower).[5]

USPP Deals by Currency



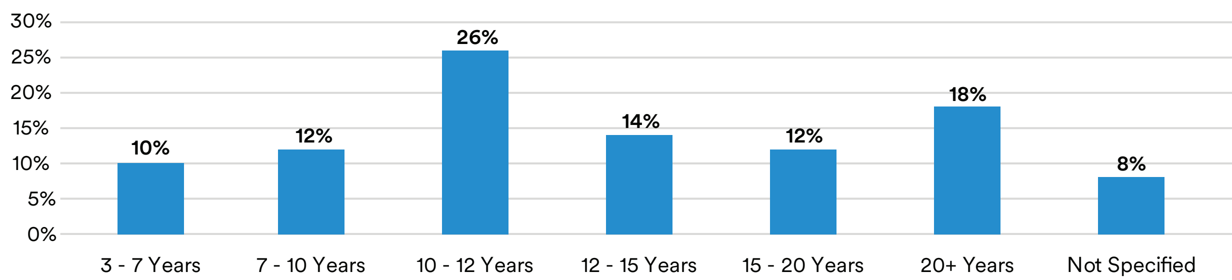
USPP Deals by Rating



Source: Wells Fargo, 2019 Debt Private Placement Review

Maturity – Average maturities in the private placement market are around 14 years with a majority of issuance offering 10 years and longer.

USPP Deals by Maturity

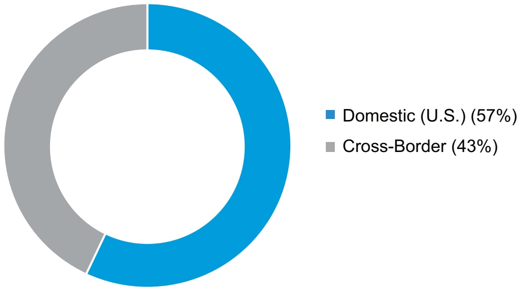


Source: Wells Fargo, 2019 Debt Private Placement Review

Geographic diversification – Private placement debt issuance by companies domiciled outside the USA has been increasing over the past decade. The 'cross-border' volume is primarily from developed markets such as the UK, Australia, Canada, and Western Europe.

Sourcing – The majority of private placement debt transactions are brought to the market by commercial or investment bankers who offer them on an agented (not fully underwritten) basis. Some private placement investors also maintain calling efforts whereby they negotiate with issuers on a direct basis to improve their overall deal flow and allocations within a transaction.

USPP Deals by Geography



Source: Wells Fargo, 2019 Debt Private Placement Review

2019 Traditional Domestic Private Placement League Table
Rank by Market Share

Rank	Institution	# Deals	Volume	Market Share
1	Bank of America Securities	60	9,624.00	24.0%
2	JP Morgan	34	3,569.00	16.2%
3	Wells Fargo Securities	25	2,746.00	6.8%
4	Mitsubishi UFJ Financial Group	20	2,687.00	6.7%
5	KeyBanc Capital Markets	23	2,454.00	6.1%
6	Mizuho Fianancial Group	16	2,126.00	5.3%
7	Goldman Sachs & Co	12	1,838.00	4.6%
8	US Bancorp	24	1,735.00	4.3%
9	Citi	12	1,447.00	3.6%
10	Scotia Capital	10	1,081.00	2.7%

2019 Traditional Global Private Placement League Table
Rank by Market Share

Rank	Institution	# Deals	Volume	Market Share
1	Bank of America Securities	82	13,672	21.0%
2	JP Morgan	51	8,702	13.3%
3	Mitsubishi UFJ Financial Group	30	4,432	6.8%
4	Citi	28	4,001	6.1%
5	NatWest Markets	28	3,243	5.0%
6	Wells Fargo Securities	25	2,746	4.2%
7	US Bancorp	25	1,848	2.8%
8	KeyBanc Capital Markets	25	2,543	3.9%
9	Barclays	18	2,065	3.2%
10	Scotia Capital	17	2,263	3.5%

Source: Wells Fargo, 2019 Debt Private Placement Review (excludes Project Finance)

Buyers – For decades, the principal buyers of private placement debt have mainly been life insurance companies. However, in recent years, there has been growing interest from other less traditional buyers.

Ratings – Borrowers are not required to obtain ratings for their debt from an NRSRO ("nationally recognized statistical rating organization" such as Moody's or S&P) in order to issue debt in the private placement market. However, issuers who have NRSRO ratings account for a significant portion of market volume. The existence of an NRSRO rating helps minimize the uncertainty of the NAIC designation outcome for investors who use the NAIC designation to determine their capital charges (for US insurance companies, the NAIC may view NRSRO-rated bonds, if filed properly, as filing exempt and accept the NRSRO rating for NAIC designation purposes). Many investors assign their own internal ratings to each transaction and therefore do not require or need an NRSRO rating to participate in the private placement market.

Documentation – There was a time when private placement documentation was a tedious and time-consuming process, with hours spent between issuers, lenders and their respective counsels going through the NPA page-by-page to comment on the document provisions.

Thankfully, about 20 years ago a consortium of interested parties created the "model form loan agreement" to make the process more efficient. Now, there is boilerplate language on all important provisions such as representations and warranties of the issuer and the lender(s), reporting requirements and other affirmative covenants, etc. Model form documents have greatly simplified and shortened what used to be a fairly labor–intensive and costly process.

Why do Companies Borrow via the Private Placement Debt Market?

- Diversification of funding sources
- No need for external ratings
- Lower all-in costs vs. public market
- Standardized loan documentation templates
- Can customize the issue / flexible terms (maturity, funding date, currency, amortization)
- Longer maturities than available in bank market
- Confidentiality / Privacy
- Other considerations (size, structure, story credits, etc.)

Diversified funding sources – Lessons learned in the global financial crisis in 2008/09 caused borrowers to appreciate and to utilize a wider variety of funding vehicles, including the private placement debt market. This market provides borrowers with quick and efficient access to a large pool of capital.

No need for external ratings – In most cases, the private market does not require such ratings as most buyers utilize an internal or external team of credit analysts who assess the credit and establish internal ratings for each issue.

Cost savings – Borrowers seeking private placement debt capital can save the time and legal fees associated with filing a registration statement. Cost savings are also available if an issuer chooses to forego external debt ratings. Further savings are possible if the borrower negotiates directly with an investor rather than hiring a banker to market the transaction.

Standardized documentation – The private market utilizes "model" forms to document the transactions. These templates contain standard provisions with respect to representations and warranties made by the borrower and the investor, thereby minimizing the need for lengthy and costly negotiation.

Flexibility / Customization – Subject to receptivity from the investors, borrowers can: choose amortizing or bullet maturity structures; customize their maturity profile to fit into their existing debt maturity schedule; issue in various major world currencies based on their needs; and select either fixed or floating rate formats. Another attractive feature for borrowers is the potential to delay funding draws for up to one year, allowing issuers to lock in today's rates for an additional charge, subject to investor demand.

Longer maturities – While bank loans are typically 5-7 years or shorter, private placement financing gives issuers the opportunity to borrow up to 30 years or longer.[6] These longer maturities may allow the issuer to more appropriately match their liabilities to the useful lives of their assets.

Confidentiality – While investors expect to see financial statements of the borrower issuing the private placement debt on a regular basis, the dissemination of that financial information and other proprietary company/industry information is required to be submitted only to the lender base, not to the broader market. This may be particularly appealing to privately-held borrowers or companies who are in the midst of an acquisition and are interested in lining up their financing prior to the market's knowledge of the transaction. It may also appeal to those borrowers that wish to borrow at an operating entity or subsidiary level and who do not wish to disclose that entity's financial position to the broader market. Confidentiality provisions are typically a part of the loan documentation whereby noteholders are precluded from sharing such financial information with the public.

Why Invest in Private Placement Debt (vs. Public Bonds)?

- Diversification of issuers and geographies vs. public market
- Portfolio protection – affirmative and financial covenants
- Economics
  - Lower historical losses
  - Incremental income
  - Spread over public bonds
- Asset liability matching
- Senior position, pari passu with other senior lenders such as banks
- The ability to conduct in-depth due diligence on borrowers

Diversification – A potential benefit for investors in the private placement debt market is diversification, both in issuers and geographies vs. the public bond market. While there is some crossover between a private placement portfolio and a typical public bond portfolio, there are many companies who utilize only the private placement debt market, providing name diversification to the investor. On a geographic basis, in recent years private placement debt issuance from outside the US has been approximately 40% of total volume.[7]

Downside Protection Features – Financial convenants are a critical feature of the private placement market. It is also an important difference relative to the public bond market. Each private placement issuance is governed by a legal contract, the Note Purchase Agreement (NPA). The NPA sets out the basic terms of the bond, such as maturity and coupon to be paid, and also provides limitations on certain actions of the issuer increasing the probability that the notes will be paid.

Financial covenants are usually contained in each transaction. These covenants are similar to those on the issuer's bank facilities and act as an early warning signal to alert investors to any potential issues with the underlying credit. The covenants enable the private placement lenders to have an early discussion with issuer management when a business underperforms or is going through some type of capital structure change, as well as ensure pari passu treatment relative to other senior lenders such as banks.

Economics – The potential benefits for investors looking at private placement debt as an asset class can be explained by the following;

- **Spread:** There is usually a higher yield offered on private placement debt vs comparable public bonds to compensate investors for the reduced liquidity. This incremental spread is variable over the full market cycle and subject to a number of factors such as supply/demand dynamics and market fundamentals.
- **Lower historical losses:** Due to the financial covenants and other structural protections on each individual private placement debt issuance, historical loss rates have been favorable vs. comparable investment grade public debt. Private placement debt has a 14% absolute advantage in ultimate recovery rate for senior unsecured debt versus public bonds, according to a recent Society of Actuaries study.[8]
- **Incremental income potential:** The structural protections offered on private placement notes may provide investors with additional income. Issuers that need amendments to their loan terms may be assessed amendment fees, coupon bumps, etc. resulting in incremental income to the investor. Make-Whole amounts on prepayments above the market value of the notes also offer additional income.

Asset–Liability Matching – Many investors in the private placement debt market require long-term credit securities with fixed cash flows that they can match against their liabilities. The longer duration and typically higher yielding issues of the private placement debt market vs the public bond market make the asset class a natural home for liability matching investment strategies. Additionally, a standard feature of private placement debt is call protection that allows an issuer to call the bonds only with Make-Whole, (i.e. at a price that protects against reinvestment risk), thereby protecting the investor's cash flow.

Seniority – Investors in private placement debt typically occupy a senior position within the issuers' capital structure. This is typically pari passu to other senior creditors such as bank debt. Private placement debt also has financial covenants that may allow the private debt investors to be in voice, ahead of public bond noteholders. This factor has proven beneficial in stressed market conditions as financial covenants serve as an early warning signal, potentially increasing recovery rates.

Due Diligence – Private placement debt transactions, owing to their structure and covenant protections, are usually negotiated over a longer period than typical public bond transactions.

This enables investors to conduct in depth due diligence on the borrowers, generally over a period of weeks. In addition to an introductory "road show" conducted in person or via conference call, investors also benefit from an in person due diligence meeting prior to funding their investment. This latter meeting typically involves an on-site visit to the company's headquarters or principal manufacturing facility as well as access to a wide spectrum of senior management. This provides the investor with substantial opportunity to build up a detailed understanding of the company and the relative creditworthiness of the investment as well as establish a relationship with issuer management. Private placement deals are typically announced and then closed over a period of 4-12 weeks, whereas public bond deals can be announced and closed in the same day.

What Skills and Resources are Needed to Invest in USPPs?

- Credit and underwriting
- Legal and documentation
- Pricing comparisons
- Relationships to source deals
- Ability to conduct due diligence
- Support services / infrastructure

Potential investors in the private placement debt market should be aware that investing in this asset class is labor intensive. Investors in these deals are skilled in the above areas or tend to outsource their private placement debt investing to others who have the appropriate relationships and skill set.

Credit and Underwriting – A key skill necessary to invest in private placement debt, or fixed income in general, is the ability to undertake the credit analysis needed to determine whether or not an opportunity is a money-good investment. In-depth analysis of the specific issuer and the industry in which it operates are critical determinants of whether an investment opportunity is suitable and attractive. Assigning an internal credit rating to the transaction is an important step in evaluating private placements as oftentimes the issuer does not have ratings from a rating agency.

Legal and Documentation – Evaluation of the terms, covenants and conditions of the bonds are critical to ensuring that the purported protections are indeed in place. External counsel representing the entire investor group to make sure that the business agreement is satisfactorily documented is important. While the model note agreements have reduced negotiation on standard provisions such as reps and warranties, it is critical to have experienced analysts and legal staff to negotiate other key provisions such as financial covenants and default language.

Pricing Comparisons – The ability to evaluate the suggested pricing on the private placement debt transaction relative to other opportunities in the public and private markets is important to ensure that the deal is priced appropriately for the risk involved and offers sufficient relative value.

Deal Sourcing Relationships – Deals are obtained both through investment/commercial bankers as well as through investment opportunities directly negotiated with the borrowers. Deep and extensive relationships with both sources is essential to ensuring good access to deal flow. Not all investors supplement their banker deal flow with transactions that they directly negotiate with borrowers; however, those who do find it another source of attractive transactions in which they can typically attain more meaningful allocations.

Due Diligence – A unique aspect of the private placement market is the opportunity to conduct detailed due diligence on the issuer and management team prior to funding an investment. This typically involves a site visit and an opportunity to meet with senior management to hear a detailed investor presentation and to participate in a Q&A session wherein investor questions are addressed. Although rare, if the results of this diligence session are not satisfactory, the investor has the opportunity to cancel its investment authorization. Having an experienced credit staff to conduct these due diligence sessions is an important step in thorough underwriting and analysis.

Support Services / Infrastructure – Of course, it is essential to have support to handle various and sundry items such as insuring receipt and review of periodic financial statements and newsworthy items, tracking wire payments between the borrower and the investor, interacting with the NAIC on ratings (if applicable), pricing the portfolio, handling amendment requests, etc.

Risks / Barriers to Entry

- Credit skills to evaluate, negotiate and monitor transactions
- Considerable legal, credit and back office resources
- Potential for reduced liquidity vs. public bonds
- Need relationships with issuers and agents
- Typical bond risks: credit, interest rate, etc.

Credit Skills – An experienced and skilled analytical staff is critical to the proper evaluation, structuring and pricing of private placement debt transactions. This skill is not only useful at the onset when the initial “buy” decision is made, but also on an ongoing basis in order to effectively monitor the investment, follow up with questions of management when performance is not as originally contemplated, to negotiate amendments (if any) over the life of the investment, and to potentially make “sell” recommendations if warranted. A strong risk management culture embedded in the organization is necessary in order to effectively manage credit risk and exposure.

Resources – As previously stated, a notable barrier to investing in the private placement debt market is the substantial legal and back office resources and expertise needed in order to participate in this asset class. Generally, outside counsel is retained for the benefit of all noteholders and is paid for by the issuer. However, most buy-side shops also have in-house counsel who look after their investors.

Liquidity – Investors in the private placement debt market tend to be long-term buy and hold investors. It is this long term buy and hold nature that gives rise to the perceived illiquidity of the market. This is more a function of the reluctance of owners of these securities to sell rather than a lack of interested buyers. That said, typically there is an active secondary market with buyers looking to increase their holdings in existing issuers. Notwithstanding, it is prudent for investors to not buy private placement debt investments with a view towards reselling them.

Relationships – Access to the market volume is key to building a good size and quality private placement debt portfolio. Establishing and maintaining relationships with investment and commercial bankers is important to sourcing these transactions. Noteworthy is that some large investors may also source transactions directly from issuers in order to improve their allocations.

Other Risks – As with any fixed income investment, private placement debt investments are exposed to credit risk, interest rate risk, liquidity risk, etc.

Myths about the Private Placement Debt Market

- There is no liquidity in the asset class
- All of the issuers are riskier small to mid-size companies
- You must have a lot of capital to participate in this business
- The loan documents take an eternity to negotiate and document
- You need a banker to access the market

No Liquidity – While private placements are less liquid than public bonds, it is a common misconception that private placement debt market is completely illiquid. The principal reason for lower trading volume in the private debt market is that many investors are “buy and hold” investors and, therefore, private placement bonds are rarely offered. Given reduced dealer inventory in the public market, it is prudent to ask how liquid the public bond market actually is.

There is a healthy secondary market for debt private placements with secondary traders estimating that $2 billion to $4 billion of bonds trade hands annually.[9] Selling bonds may not present much of a problem but buying opportunities may be limited due to the weight of investor demand.

Issuer Size – The private placement debt market is largely an investment grade market with more than 90% of issuers rated investment grade.[10] While historically it may have been the case that only small to medium sized companies sought capital in the private placement debt market, this has not been the case for many years. The market has seen large companies with household names turn to private placement debt for capital and is seen as a viable funding option for large multinational corporates. Furthermore, the Global Financial Crisis emphasized to borrowers that it is wise to maintain access to multiple markets to have sufficient access to capital as needed.

Investor Size – Investors of all sizes participate in the private placement debt market and are typically long-term investors seeking to match their long-term liabilities with private assets.

Documentation – The standard NPA model form was developed approximately 20 years ago by a group of investors, law firms and placement agents. It is well known in the market, easy to understand, and forms the backbone of the investment documentation. It is also readily adaptable and can be structured to individual issuers and/or investor requirements. It is a tried and tested process for issuance both new and repeat.

Banker Access – Investors do not have to work via bank agents to access the private placement debt market. Often negotiation is done directly between the issuing company and the investors. Alternatively, an issuing company can approach two or three investors through a ‘Club Direct’ deal.

Conclusion:

There is very little press about the private placement debt market – perhaps due to the private nature of the instrument itself. While this little known sector of the bond market may be overlooked due to its relatively small size and labor intensity, it can offer very attractive characteristics to investors: potential for higher income, lower historical losses and credit diversification vs. comparable public bonds. Despite its appeal, we believe investors should build or hire the significant analytical and structuring skills needed to participate in this market. Since the SEC does not provide regulatory oversight of the private placement market, it is critical that investors have a robust team to properly evaluate these investment opportunities.

Endnotes

[1] Source: Wells Fargo.

[2] Source: Wells Fargo.

[3] Source: MIM internal ratings.

[4] Based on MIM estimates.

[5] NAIC-1 corresponds to deals rated the equivalent of A3 or higher. NAIC-2 corresponds to deals rated the equivalent of Baa1 to Baa3.

[6] MIM estimate.

[7] MIM estimate.

[8] Society of Actuaries 2003-2015 Credit Risk loss Experience Study: Private Placement Bonds, April 2019, Section 2.5.4 Loss Severity.

[9] MIM estimate.

[10] MIM estimate.

Author

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Client Portfolio Manager - Private Capital

Jason Rothenberg is a client portfolio manager for MetLife Investment Management (MIM) private placement clients.

Upon joining MIM in 2002, Rothenberg spent four years in the Santiago, Chile office as a Latin American corporate bond analyst. He then moved to London in 2006 to join the private placement team. Rothenberg managed the London corporate private placement team for 10 years, covering the U.S. Private Placement markets in the UK, Ireland and continental Europe. He relocated to MetLife's Investments headquarters in New Jersey in 2018 to join MIM's Client Portfolio Management group. Prior to joining MetLife, Rothenberg held similar positions with Principal Capital Management and Orix Financial Services.

Rothenberg holds a Bachelor of Arts in public policy from Brown University and an MBA from the Thunderbird School of Global Management.

About MetLife Investment Management

MetLife Investment Management (MIM),[1] MetLife, Inc.'s (MetLife's) institutional investment management business, serves institutional investors by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Capital and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building tailored portfolio solutions. We listen first, strategize second, and collaborate constantly as we strive to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of the MetLife enterprise helps provide us with deep expertise in navigating ever changing markets. We are institutional, but far from typical.

For more information, visit: **investments.metlife.com**

1 MetLife Investment Management ("MIM") is MetLife, Inc.'s institutional management business and the marketing name for the following affiliates that provide investment managemewnt services to MetLife's general account, separate accounts and/or unaffiliated/third party investors: Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), and MIM I LLC.

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