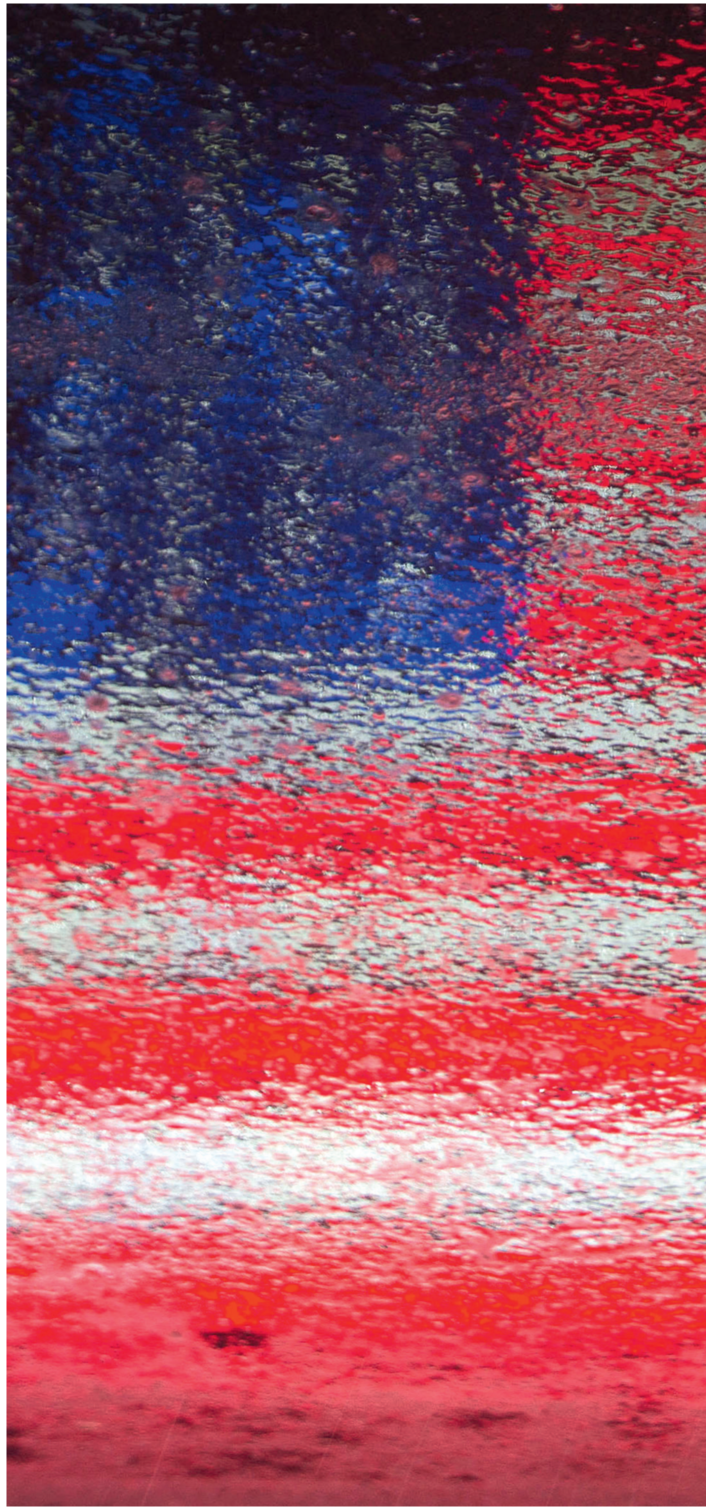
Private placements: tapping the US market

European corporates are turning to the US private placement market in growing numbers, as they seek to broaden and diversify their sources of funding while locking in some attractively priced long-term debt.



When Smith & Nephew plc, a UK-based medical technology business with more than US$4 billion in global sales, needed to raise US$325 million to repay existing bank debt in January 2014, it opted not to seek out new terms with its existing bank lenders.

Instead, it raised the much-needed US funds via a traditional private placement. These products, sold pursuant to the private placement exemption under Section 4(a)(2) of the US Securities Act of 1933, are securities that are placed with a select group of sophisticated institutional investors, and are exempt from public disclosure and reporting requirements. Issuers are not required to obtain a credit rating for such placement, although the investors typically require that the issuer be investment grade-equivalent (an analysis done by the investors through their in-house credit teams).

For Smith & Nephew, securing US$325 million of debt through a private placement served a number of purposes. Attracting an average fixed rate of 3.7 percent and an average maturity of just over nine years, the company was able to lock in long-term debt at attractive rates while meeting an ambition to spread its funding sources.

"Not only were the interest rates appealing, but it also felt sensible to make a start in diversifying the firm's funding base," says Tim Allison, group treasurer at Smith & Nephew.

The move was indicative of a broader trend across the industry, which has seen corporate treasuries seek out private placement structures with growing enthusiasm.

The need for diversification of funding has echoed across corporate treasury departments since the onset of the global

financial crisis in 2008, which restricted bank credit and triggered increased capital holding requirements under Basel III.

"European midcap firms were realizing that the debt side of the capital structure had become a bit too focused on relationship banks for their borrowing requirements. Many companies that were very solid in their own right got into difficulties when refinancing, as they were trying to preserve the tenor of existing facilities," says Angus Whelchel, managing director and co-head of private capital markets at Barclays.

For corporates looking to obtain fixed-rate funding at tenors that are longer than most banks are comfortable offering, private placements can be a very attractive option.

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> Andrew Weiler, partner, White & Case, London

A growing trend

The growth of the private placement market reflects a perfect storm of factors, notes Andrew Weiler, a partner at White & Case in London who has worked in the private placement market for more than 15 years and is one of the top advisors for European issuers targeting the US private placements (USPP) market.

"What makes it attractive right now is that interest rates are at historic lows and these are fixed-rate long-term securities. People can lock in at incredibly low rates for seven to 15 years, sometimes even 25 to 35 years, for issuers that want that kind of tenor," he says.

Issuers recognize that it is not too expensive to put long-term money on their balance sheets, explains Whelchel: "In many cases, private placements can provide a very competitive long-term financing tool for clients, which can help to diversify funding sources, alleviate any future liquidity issues and term out their debt funding profile."

Weiler points out that traditional private placement volumes totaled US$51.3 billion in 2013—slightly down from the tally in 2012, which was the largest ever for private placements.

"The number of large transactions over the past decade shows it is possible to do billion-dollar transactions," says Luke Reeve, a partner at Ernst & Young (EY) who co-heads its Capital and Debt advisory team and advises on private placement deals. "The big change now is that there are many companies doing smaller transactions, often self-arranged deals, on a more direct basis with investors."

The private placement market is particularly well-suited for companies seeking to raise unrated debt in smaller denominations, says Reeve: "If you want evidence that the market is maturing, look at the ever-increasing presence of the largest US insurers with a London office. They want to give their borrowers a relationship point of contact in Europe."

Issuers also like the fact that private placements offer greater flexibility, such as delayed drawdown facilities.

"For a £150 million bank facility or bond maturing in December, being able to issue your private placement in June with a five-month delayed drawdown can be helpful," says Reeve. "You don't have to run the gauntlet on what market conditions will be like in December; you can take out your maturities with enough breathing room ahead of time."

Corporate treasurers recognize that capital markets instruments of different types should ideally form part of the mix of their funding, whereas historically, many were content to stick with a group of banks with whom they had long relationships.

The appeal of the US market

The buyers of private placements are predominantly US insurance companies and asset managers. A growing proportion of investors are starting to come from Europe, as the market has grown and been receptive to European borrowers.

"The USPP market is one of the most advanced and deepest pools of capital that can be accessed by issuers. It's a natural port of call for companies that are unrated or have little experience in capital markets," says Whelchel.

Over the past 20 years, investors in the United States have become more comfortable with cross-border transactions and any associated legal risks, says Ian Clark, a partner at White & Case in London, who has been advising both issuers and investors in this market since the 1990s.

"During the most recent credit cycle, American investors saw their private placement investments produce far better returns than their investments in the public markets," he says. "This is due to the additional covenants and protections they

were able to negotiate, which meant that their recoveries were improved compared with other asset classes."

Treasurers are finding that their boards are looking increasingly favorably at private placement funding options.

"The board was very supportive of starting the process of diversification, having looked carefully at various funding options available to the group," says Smith & Nephew's Allison. "It was seen as sensible risk management activity. And just because we went for a private placement this time, it doesn't mean we won't consider other capital markets in the future."

There are challenges associated with tapping the private placement market. One frequently cited concern is that relationships with private placement investors can be more demanding of corporate treasurers' time. These investors may also require additional convincing when it comes to amendments and waivers.

"Remember, banks' relationships with corporates can be very broad," says White & Case's Weiler. "They are not just looking at the company as a borrower under a term loan, they're looking at the company's other activities as well. With private placements, the investors are really only focused on the particular transaction at hand, and thus they may not be as accommodating as banks that may be looking at other revenue streams from the issuer. That being said, the investors are practical and commercial—amendments and waivers are usually worked through efficiently and successfully."

US$1bn+

Angus Whelchel of Barclays notes there are more deals in the US$1 billion-plus range than ever, a trend that is likely to be sustained as the asset class becomes more widely accepted.

Euro private placements

A consistent issue with the USPP market has been the limited presence of European investors that will lend money to European corporates in natural sterling or euros (in other words, they will lend the currencies without the need for the issuer to swap US dollars into those currencies). European investors, like Prudential's M&G Investments, Aviva and ING, are regular participants in the USPP market, but few other European investors participate.

"Many issuers want dollars because they are global businesses and have a need for them. But if they also want other currencies, such as sterling and euros, they will swap them, and there is language available to protect US investors in the case of an early repayment in that currency," says Clark.

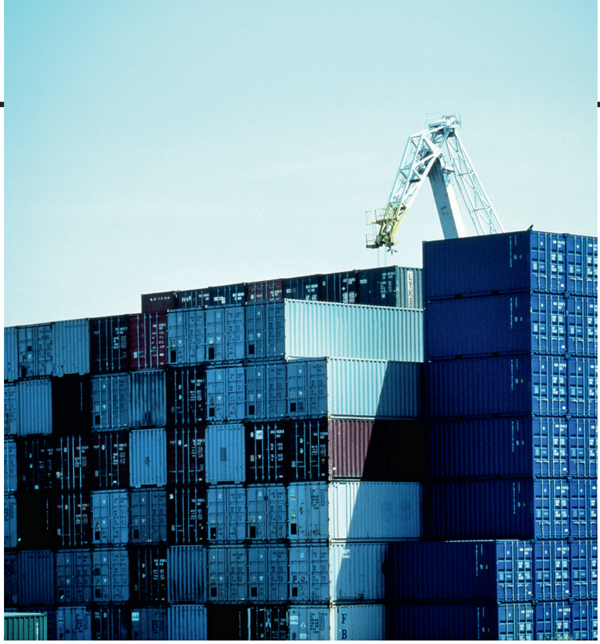
But due to the limited number of European investors, there are also built-in limits as to how much European issuers can raise in non-dollar currencies on the local market.

"It may be hard to fund much more than US$100 million worth of sterling or euros in Europe," says Clark. "If you want to do a £400 million issuance, for example, there may not be enough natural sterling investors there."

As a consequence, there is now much discussion about whether a true, pan-European private placement market offering natural sterling and euros can develop, one that can both compete with and complement the USPP market. As Weiler notes, a number of organizations have recently created "Euro PP" initiatives, including the Loan Market Association and the International Capital Market Association.

To determine whether a Euro PP market can grow to rival the USPP market, it is important to understand why the latter is drawing in European issuers in the first place. The investment-grade USPP market is attractive to issuers and competes successfully with bank products for several reasons: long maturities available at fixed rates; low execution costs; no requirement for external credit rating; favorable regulatory environment for investors; standardized but flexible documentation with less onerous covenant requirements than the bank market; a stable and sophisticated investor base; and a streamlined due diligence and disclosure process.

In the European context, Weiler notes that, while efforts at creating standardized documentation may help address one of the USPP market's strengths, the substantial variation between countries as to the regulatory and capital



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treatment of unrated and unlisted investments, as well as varying tax withholding rules, are likely to be major impediments to a unified product. USPP investors have an advantage over their European counterparts, from a regulatory standpoint, in that there is a common approach to capital treatment of investments that have a designation from the National Association of Insurance Commissioners.

Clark agrees: "I expect the legal form that the Euro PP product ultimately takes will be dictated by what legal form/ structure ticks as many of these boxes as possible—and it may well be that the different regulatory environment in Europe will lead to somewhat different products developing there than in the United States. Indeed, it will be interesting to see if a truly European PP product develops as a result of the current initiatives, or whether different national PP products, such as the German Schuldscheine, or the recent euro products in France, will be the norm."

Despite these developments, the US market is expected to remain dominant, at least for the foreseeable future. The continued need by many global corporates for dollars remains a strong draw. If corporates require other currencies, these are available through embedded swaps in the USPP documentation.

A bright future: new sectors and markets

The outlook for 2014 appears robust. Even with a revival in bank lending, private placement products are attractive to issuers and investors alike.

Whelchel notes that there are more deals in the US$1 billion-plus range than ever before, a trend that is likely to be sustained as the asset class becomes more widely accepted: "Whereas US private placements would once have been thought of as an opportunity to fill a gap in the financing plan, now they are considered mainstream funding tools," he explains.

According to EY's Reeve, future corporate demand will come from sectors that were once funded by the bank market, but where Basel III requirements now restrict the banks' return on that lending. New private placement issuers are expected to emerge in sectors like shipping and aviation where, traditionally, banks have accounted for the bulk of financing, and also in non-Western European countries from which investors have usually shied away.

"We have recently worked on private placements for JetBlue and a German shipping company," notes Weiler, "and we are seeing a significant trend towards more secured private placements in these markets and also for private placement debt forming a part of project financings. We have also just advised Coca-Cola on a private placement in Turkey, which shows that, under the right conditions, investors are prepared to invest in notes from issuers in non-traditional European jurisdictions."

Appetite will continue to hinge on where companies sit on the credit curve. Those more vulnerable to any future credit squeeze will need to think ahead about raising long-term debt beyond the bank market.

Bank lending will continue to form an important part of the funding mix for most companies, particularly when it comes to M&A activity. Equally, corporate treasuries will continue to value diversification, even in a shifting interest rate environment.

"There will be some circumstances when changes in the interest rate environment make five-year bank financing much more attractive, compared with seven- or ten-year fixed-rate money," says Clark. "But in the long-term, the US private placement market is here to stay."

For information about any of the issues covered in this publication,
please contact:

Julie Parsons, Marketing Communications Director
T +44 20 7532 2931
E: julie.parsons@whitecase.com

Published by Caspian Media Ltd on behalf of White & Case LLP
E: info@caspianmedia.com

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