For institutional clients only.

An Introduction to US Credit Private Placements

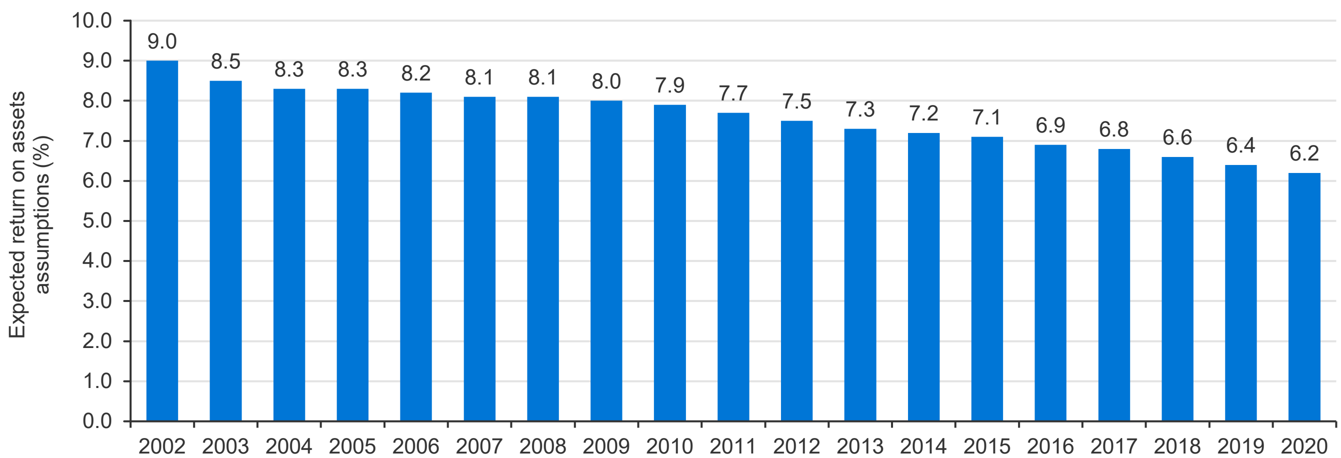
Determining the strategic asset allocation is one of the most important and impactful decisions for institutional investors. Unfortunately, there is no golden rule for the proper allocation as every investor has their own set of objectives and constraints. For some, like insurance companies, the overall yield of the portfolio is a priority. Others, like corporate defined benefit plans, must weigh their decision in the context of their liabilities and select an appropriate asset mix that ensures they are able to meet future obligations. The current low rate, low return environment has forced investors to reassess their portfolios and asset allocation in hopes of giving themselves the best chance of achieving their goals. Falling Treasury yields and, in turn, declining expected return assumptions has only made this pursuit more difficult. As illustrated in *Figure 1*, these expected return assumptions have been trending lower for years. Given market dynamics, we do not anticipate this theme to change dramatically going forward. Investors have increasingly explored other asset classes in the hopes of boosting returns, diversifying their portfolio and enhancing yield.

In the following sections, we discuss the details of US Credit Private Placements (USPPs) and their possible inclusion in institutional investors' portfolios. USPPs are largely investment grade bonds issued outside the public bond market and are exempt from registration with the Securities and Exchange Commission (SEC). Issuers of USPPs tend to fall broadly into two sectors: 1) corporate and alternative finance, and 2) infrastructure finance. Within LGIM America, USPPs are typically part of the broader Private Credit asset class, which may include investments in commercial mortgage loans. In the following sections we will further examine USPPs and the unique advantages they can offer institutional investors.

Issuing in the private placement market

Borrowers access the private placement market for a variety of reasons. One of the primary reasons is when a company isn't registered with the SEC, and thus, doesn't have access to the US public bond market. This most commonly occurs when a company is either privately held

Figure 1: Expected return assumptions trend lower



Source: Goldman Sachs Asset Management. Reflects an equal-weighted average expected return assumption of S&P 500 companies, US plans only. Based on company reports as of March 2021.

or foreign domiciled. Privately held companies can maintain their confidentiality when issuing a USPP because they are not subject to the public disclosure that the SEC requires of public bond issuances, while foreign companies are focused on the USPP market because it's often the deepest source of dollar denominated fixed-rate debt available for unregistered companies. There may also be a cost saving for issuers of USPPs by avoiding the registration process and legal expenses associated with public bond issuance.

The public bond market is highly effective for SEC registered companies that are frequent, repeat issuers of index eligible securities. These bonds will be eligible for inclusion in a standardized, market-based benchmark like the Bloomberg Barclays US Long Credit Index. They also tend to be highly liquid and are strongly preferred by a wide universe of institutional investors that manage their portfolios against an index. To qualify for index eligibility, each tranche must be at least $300 million in size and must have at least one credit rating assigned by Moody's, Standard & Poor's, or Fitch. Unfortunately, many publicly traded companies are either unrated or unable to routinely issue bonds that meet these size requirements, and as a result, would pay an illiquidity premium along with high issuance costs in the public bond market.

It is also common for publicly traded companies to issue USPPs when they're seeking to issue debt in a non-standard format. This includes issuing from a subsidiary that isn't otherwise SEC registered or from a foreign subsidiary seeking non-dollar denominated debt. Companies may also choose the USPP market when they need to confidentially disclose material, non-public information to investors such as while arranging financing for a merger or acquisition.

A significant part of the USPP market is comprised of infrastructure debt and other asset-backed issuers. These are largely single purpose entities issuing debt for the construction or acquisition of single or multi-asset infrastructure projects such as solar projects, wind farms, toll roads, ports, pipelines and government sponsored public-private partnership. These issuers tend to raise highly structured debt infrequently over the infrastructure project's life. As a result, these issuers tend to be illiquid and are often not index eligible. Other asset-backed issuers in the market include equipment trusts and cash flow securitizations.

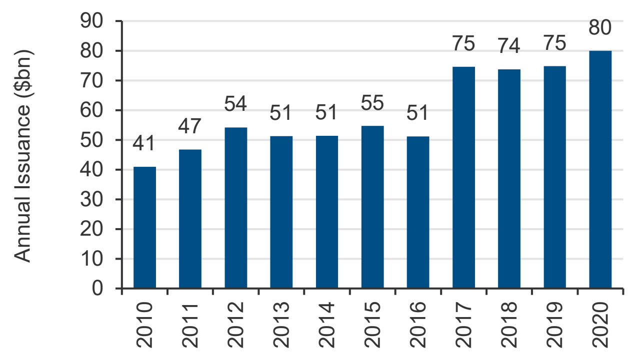
Another advantage of the private placement market is the flexibility to offer customized payment structures. The public market is generally most liquid for bullet maturities with 2-year, 5-year, 7-year, 10-year and 30-year tenors. If an issuer is looking for a debt maturity profile outside these standard maturities or wants to include amortization or varying payment frequencies, they will find more appetite for non-standard structures in the private market. This flexibility defines the private placement market as deals can often be custom-built to meet the financial needs of both the issuer and investors. These unique payment structures can be particularly attractive to insurance companies and pension funds that have similar cash flow liability structures.

Public vs. Private credit markets

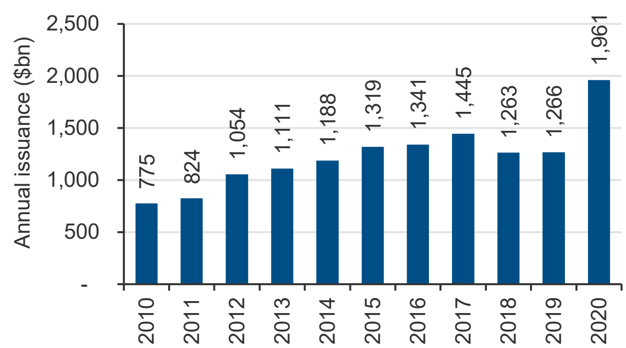
At a high level, private placements are like their publicly issued counterparts. Each typically involves a company sourcing long-term financing from a select number of investors. For USPPs, the pool of investors will often be more limited, possibly even a single investor for a bond issue. USPP bonds, much like publicly issued debt, pay a set coupon on a negotiated schedule. In both markets, bonds are priced based on a US Treasury yield plus a credit risk premium known as the credit spread. The interest payment on these bonds is typically paid quarterly or semi-annually. Although there are some similarities, as illustrated in *Figure 2*, the opportunity set and market structure is vastly different. For example, USPPs can offer institutional investors additional diversification that cannot be achieved in the public bond market.

Figure 2: Annual issuance totals

US private placement market volume



Public corporate debt market volume

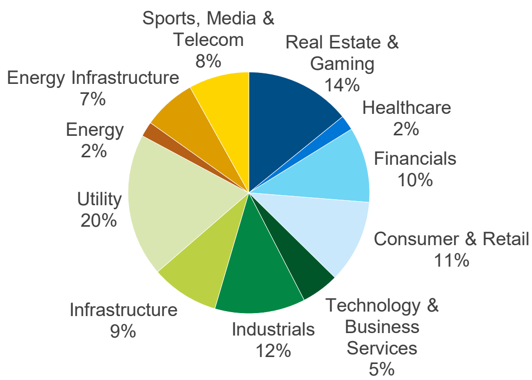


Source: Private market issuance details are sourced from Bank of America as of December 31, 2020. At the time of publication, the 2020 figure was a preliminary estimate and is subject to change based on final league table determinations. Public issuance details are sourced from Goldman Sachs as of December 31, 2020.

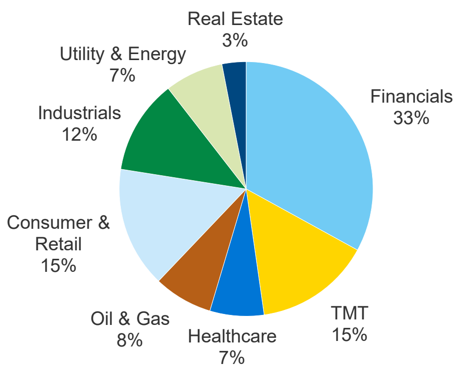
Figure 2 showcases the annual issuance totals between the private and public bond markets. The sheer size and growth of the public credit market dwarfs the private placement market. Investors seeking liquidity, and issuers targeting a larger pool of investors, will find advantages accessing the public investment grade market through a standardized offering. However, the private market offers additional flexibility from the structuring of deals, tenors and payment schedules that provides its own advantages.

Figure 3: 2020 Sector issuance

Private placement market



Public bond market

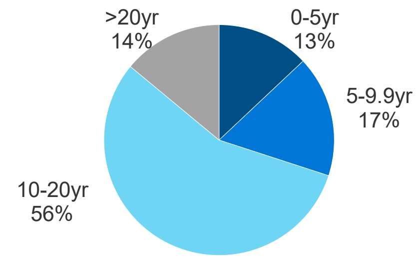


Source: Private market issuance details are sourced from Bank of America as of December 31, 2020. Public issuance details are sourced from Goldman Sachs as of December 31, 2020.

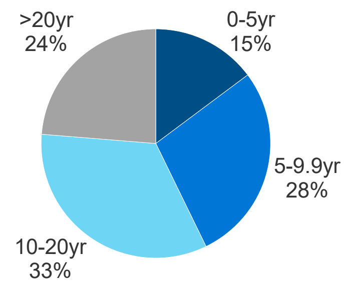
As outlined in *Figure 3*, from a sector perspective, investors can source additional diversification from the private market. For example, financials made up one third of total issuance in 2020 in the public investment grade credit market, while only accounting for 10% of the private placement issuance. There are entire sectors that play a vital role within the private market that are nearly absent from the public market. For example, sport leagues and infrastructure are two areas that tend to favor the private placement market, offering investors a source of sector diversification. There is very little issuer overlap between the markets offering investors significant diversification benefits compared with the relatively static pool of issuers in the public bond market.

Figure 4: 2020 Maturity issuance

Private placement market



Public bond market



Source: Private market issuance details are sourced from Bank of America as of December 31, 2020. Public issuance details are sourced from Goldman Sachs as of December 31, 2020.

Additionally, the two markets offer significantly different maturity profiles, allowing investors to target different tenors. Issuers looking for financing options in the 10-20yr maturity range or with amortization will often raise capital in the private market. The public investment grade market tends to focus on a few selected tenors with 2-year, 5-year, 7-year, 10-year and 30-year maturities, while the private market offers additional options for more bespoke financing objectives.

US credit private placement advantages

The characteristics of the private placement market deliver a range of potential advantages to institutional investors. These include downside protection through structural features such as covenants, the potential for attractive spread pick-up relative to public debt with similar credit ratings and a universe of issuers that is not available in the public market.

Diversification

The universe of opportunities in the private placement market vary significantly, offering access to issuers across an array of sizes, sectors and jurisdictions. This provides a greater depth and variety of investment opportunities and promotes diversified portfolio construction for institutional investors.

Investment in private placements should not be misconstrued as an increased allocation to riskier private corporations. Typically, the USPP market is almost entirely investment grade. Some of these structured financings involve large public companies, providing them with an attractive opportunity to secure financing without subjecting the company to the inefficiencies and regulatory pressures demanded by the public markets. Private placements also offer exposure to middle market corporations and infrastructure debt, where issuers rarely overlap with those in the public market.

While public investment grade new issuance focuses on benchmark maturities with 2-year, 5-year, 7-year, 10-year and 30-year tenors, the private placement market provides more flexibility throughout the middle part of the curve. Public market issuance between the 10- and 30-year maturities is infrequent, creating an opportunity for private placements to fulfill this demand.

Opportunity to add value

The unrated nature of some issuers in the private placement market creates an opportunity for the experienced investor. The diligence requirements in the private placement arena are typically more demanding given the lack of external verification from rating agencies and extensive independent research coverage. This allows for greater differentiation between opportunities and an ability to better understand which borrowers are more likely to be resilient through a full credit cycle. This is especially pertinent given that most private placement investors have long time horizons and do not actively trade these securities. For many, private placements serve a place in a “buy and hold” strategy.

As a result of the more limited public information, the responsibility of due diligence falls on the shoulders of the investor. Borrowers often allow a greater access to their management teams to aid in the due diligence process. This direct access to management teams is a hallmark of the private placement market and provides investors the opportunity to better understand the company’s business objectives, investment plans and targeted capital structure. With this in hand, investors can form a view about the fundamentals of the company and potentially work with the management team to structure protective covenants. However, because of the private nature of the deal terms and the limited access to public information, it is imperative that investors conduct thorough due diligence and avail themselves of every opportunity to access company information. Failure to do so, increases the risk of poor investments.

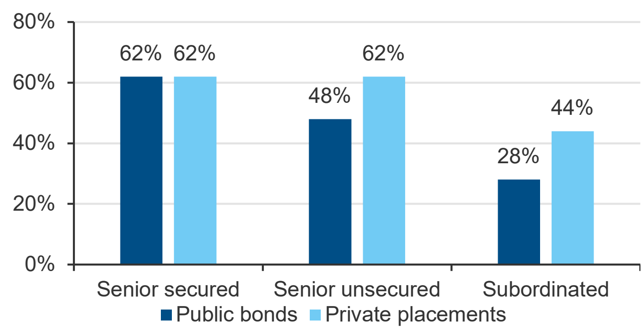
Covenant protections

Periods of significant market volatility, like the Great Financial Recession and the COVID-19 pandemic, have taught the investment industry many things. In these times of uncertainty, the value of capital structure seniority, security and protective covenants increases. Covenants are obligations to maintain certain credit metrics or restrictions on incurring further debt and are designed to protect a company’s creditors. The covenants associated with private placements tend to be extremely robust in nature, aimed at providing investors with protection from event risk while also positively influencing management behavior in ways that help reduce defaults and downgrades through the cycle. They typically allow lenders to engage with management early if credit metrics begin to erode and negotiate alongside the bank group for additional protections that often aren’t available to other investors that don’t have robust financial covenants, such as the holders of publicly traded bonds. Using the COVID-19 pandemic as an example, we witnessed the disruption of many companies’ business models due to the virus’s impact on economic activity. The structural protections inherent in investment grade private placement offerings typically provide investors with an additional layer of comfort relative to publicly traded debt securities and, in our view, are likely to be more valuable during such periods of uncertainty.

Recovery rates

Private placements have illustrated a similar credit default profile to that of public securities, but the asset class has typically amassed smaller credit losses over comparative asset life cycles. Seniority in the capital structure, security and stringent covenants enable private placements to demonstrate higher recovery rates, on average, than public credit. According to a study conducted by the Society of Actuaries (*Figure 5*), in scenarios of default, the recovery rates for Senior Unsecured Private Placements are on average between 19% and 33% more than public counterparts at the same level.

Figure 5: Private vs. public recovery by seniority[4]



Source: Society of Actuaries: 2003-15 Credit Risk Loss Experience Study: Private Placement Bonds.

Potential for enhanced yield

For plans with longer investment horizons, we believe the potential for enhanced yield associated with the private placement market offsets any potential concerns associated with decreased liquidity. To compensate for this liquidity risk, as well as the complexities of private deal structuring, private placements are usually issued with a material up-front spread premium. From our experience, institutional investors can secure between 30-120 basis points in up-front spread premium versus a comparable basket of publicly issued bonds[1]. The size of the premium will vary based on current market dynamics, credit ratings and issuer. In addition, private placements covenants not only have the potential to impact company behavior, but they also may generate additional value through the cycle in the form of fees for amendments and waivers, coupon adjustments and make-whole prepayments. In a “search for yield” environment, the inclusion of private placements within a long-term investor’s strategic asset allocation could be beneficial.

Considerations facing private placements

One of the defining characteristics of the private placement market is the notion of an “illiquidity premium.” Private placements offer a premium over the lifetime of the investment to investors to compensate for the bond’s illiquidity and complexity. The concern for investors is a scenario where they need to raise cash and are unable to source any bids from the secondary market. Although there isn’t as active a secondary market as their public counterparts, we feel the lack of liquidity is overstated. Liquidity is specific to the issuer, much like in the public markets. Borrowers with deteriorating fundamentals may exhibit more illiquidity than those who are in a strong financial position. Since the investment grade private placement market is dominated by buy and hold insurance companies where the asset class is in high demand, the reduced liquidity is driven by the absence of sellers and an abundance of buyers. This makes it much easier to sell an asset than to buy (given the credit is in good financial standing), benefitting investors whose main concern is the ability to raise cash if necessary.

From an issuers perspective, one consideration is the possibility of paying a higher yield versus similar debt issued in the public market. In general, most private placement issuers do not have a competitive option available to them in the public debt market and are incentivized to seek financing privately. Private placements are often not assigned an official credit rating from an agency, increasing the investor’s responsibility for due diligence. Investors will demand a premium to compensate them for this lack of liquidity and added risk. Due to the sensitivity of the deal terms and the limited availability of public information, it is critical that investors conduct thorough due diligence and take advantage of all available resources. Failure to do so, increases the risk of poor investments.

Conclusion

Relative to public investment grade corporate bonds, LGIM America feels the attractive premium of investment grade private placements, paired with a potential decrease in tail risk and the diversification could have positive benefits for institutional investors. The private placement asset class also offers flexibility in terms of maturity range and debt repayment profile. Although there are challenges, we believe there should be strong consideration for the inclusion of private placements in a long-term investor’s strategic asset allocation. Furthermore, combined with a healthy allocation to public investment grade credit, we believe private placements are very attractive for institutional investors interested in Liability Driven Investing.

1 Based on the historical experience of LGIM America and LGIM within the private placement market.

Risks of Investing in Private Credit-Like all investments, there are risks associated with investing in a portfolio of private placements. Below is a description of the primary risks of investing in private placements. The description is not all-inclusive, and before making an investment in a portfolio of private placements, investors should carefully consider such an investment.

The primary risk to an investment in private placements is credit risk. Credit risk is the risk of non-payment of scheduled interest or principal payments on a debt instrument. In the event a borrower fails to pay scheduled interest or principal payments on its debt, a portfolio of private placements would experience a reduction in its income and a decline in market value.

Private placements generally involve less risk than unsecured or subordinated debt and equity instruments of the same issuer because the payment of principal and interest on private placements is a contractual obligation of the issuer that, in most instances, takes precedence over the payment of dividends or the return of capital to the borrower's shareholders and payments to public bond holders.

In the event of the bankruptcy of a borrower, a creditor could experience delays in receiving regular payments of interest and principal and may not receive the full repayment of its principal.

As described above, portfolios of private placements are also subject to interest rate risk. One risk related to interest rates is the potential for changes in the interest rate spreads for private placements in general. To the extent that changes in market rates of interest are reflected not in a change to the base rate, the U.S. Treasury, but in a change in the spread over the base rate which is payable on loans of the type and quality in which a portfolio invests, a portfolio of private placements could also be adversely affected. This is because the value of a debt is partially a function of whether it is paying what the market perceives to be a market rate of interest, given its individual credit profile and other characteristics.

However, unlike changes in market rates of interest for which there is only a temporary lag before a portfolio reflects those changes, changes in a placement's value based on changes in the market spreads on loans may be of longer duration.

If spreads rise as described above, for example, in response to deteriorating overall economic conditions and/or excess supply of new loans, the principal value of private placements may decrease in response. On the other hand, if market spreads fall, the value of private placements may increase in response, but borrowers also may renegotiate lower interest rates on their debts or pay off their debts by refinancing at such lower rates. In that case, the borrowers would be required to pay a make-whole amount, which would mitigate the risk.

Private placements trade in a private, unregulated market directly between loan market participants; although most transactions are facilitated by broker-dealers affiliated with large commercial and investment banks. As a result, purchases and sales of private placements typically take longer to settle than similar purchases of bonds and equity securities. In addition, because private placement transactions are directly between investors, there can be greater counterparty risk.

Moreover, despite the increase in the size and liquidity of the private placement market, the market is still relatively illiquid, particularly when compared to the markets for bonds and equities. As a result, portfolios invested in private placements may experience difficulties and delays in purchasing or selling private placements, with resulting adverse impacts upon the prices obtained. During periods of severe market dislocation, such as occurred at the end of 2007 and during 2008, the market can experience severe illiquidity and significantly depressed prices.

Finally, many borrowers are private companies and/or companies that have not issued other debt that is rated by rating agencies such as Moody's Investors Service, Standard & Poor, or Fitch Ratings. As a result, investment decisions related to private placements may be based largely on the credit analysis performed by the adviser to the fund or portfolio making the investments, and not on rating agency evaluation. This analysis may be difficult to perform.

Information about a private placement and the related borrower generally is not in the public domain, since private companies and companies that have not issued public debt or securities are not subject to reporting requirements under federal securities laws. However, borrowers are required to regularly provide financial information to lenders, typically in much greater detail than is available in the public markets. Furthermore, information about borrowers may be available from other private placement participants or agents who originate or administer private placements.