Private Placement Debt:

Diversification, yield potential in a complementary IG asset

By Ron Mendel, CFA, *Managing Director and Head of Investments – Private Sectors*

In low-yield environments, investors often turn to new and at times uncertain vehicles to meet their needs for income. The private placement debt market, however, is a long-established avenue that has helped deliver value to institutional investors – especially life insurance companies – for some 150 years. The asset class may provide corporate credit portfolios with incremental yield, favorable structural protections and enhanced credit diversification. It is ideal for portfolio managers who have a durable allocation to investment grade corporate credit and prefer not to pay a premium for the perceived liquidity of public market bonds. We examine the details and characteristics of private placements while making an argument for their inclusion in certain credit portfolios.

All Corporate Bonds Were Once Private

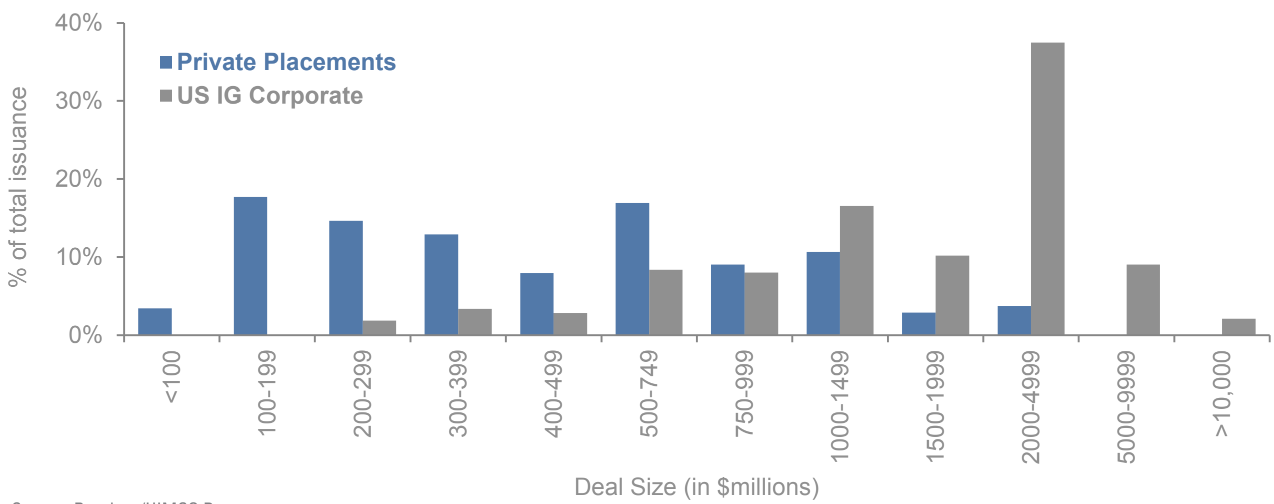
The private placement market is well established and dates back to the "birth" of the corporate bond market – the 1860s, when rapidly growing railroad, mining and canal companies needed significant financing and issued notes to investors. Historically, all U.S. corporate debt was de facto private because there was no Securities and Exchange Commission (SEC) or similar regulatory body and no requirement to register or make disclosures for new issuance. In those days, investment success was completely dependent on the ability to properly and completely analyze a bond offering. That analytical strength remains the cornerstone of successful private placement investing today.

A new and distinct public debt market was created following the crash of 1929, when financial market reforms created the SEC and established significant disclosure rules for selling securities to the general public. Public bonds from that point on had to be registered, while private bonds could remain exempt from registration provided they followed certain guidelines **(see "Keeping An Offer Private," page 2)**.

Today the U.S. Private Placement (USPP) market (defined as all Reg D investment grade bonds) is roughly $400 billion, making it smaller but not insignificant compared to the $3.3 trillion investment grade (IG) bond public market. Average annual private placement issuance is between $40 billion and $50 billion, according to HIMCO data.

USPP transactions are generally smaller than those in the public market, as the typical USPP issuance is about $250 million versus a typical public deal of $800 million to $1 billion **(see Figure 1)**.

Figure 1 – Deal Size: Private vs. Public, 2012



Source: Barclays/HIMCO Data
*Note: Public Issues less than $250 million are not index eligible and thus not represented in the data.

Keeping An Offer Private

The vast majority of private placement issuers follow Rule 506 of Regulation D of the Securities Act of 1933, considered the "safe harbor" provision, which allows a private-offering exemption from registration under § 4(2) of the Act.

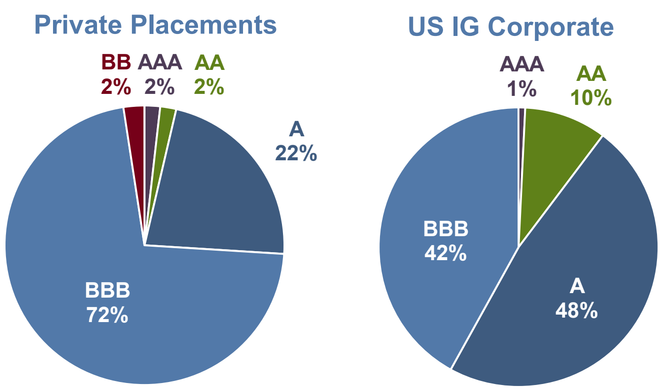
Issuers may avoid registering their securities and raise an unlimited amount of money if they:

- » Give any unaccredited investors disclosure documents that are generally the same as registration documents
- » Are available to answer questions by prospective purchasers
- » Provide financial statements certified by an independent public accountant.

By following these steps, issuers are allowed to sell their private securities to an unlimited number of "accredited investors," which are mainly institutional investors but can also be individuals with sufficient net worth or income. In addition, issuers may sell these securities to as many as 35 unaccredited investors.

The purchasers in turn receive "restricted" securities, meaning that they cannot be sold for at least one year without registering them (save for various exceptions).

Figure 2 – Credit Quality: Private vs. Public



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"Life" Makes the Rules

In the USPP market, life insurers are the dominant investors with an estimated share exceeding 90 percent. And private placements are on average about 15 percent of a life company's general account assets. Other investors have included non-life insurance companies, asset managers, pension funds, banks and hedge funds.

Understanding the constraints and behaviors of the life insurance industry is an important factor in managing the USPP supply, demand and pricing considerations. The life insurance business model is to match assets and liabilities within tight tolerance limits, and long-term fixed-rate credit products are typically the vehicle of choice. As the liabilities are well understood and stable, life insurers rarely require near-term liquidity and thus prefer not to pay a premium for the assumed liquidity in the public market. Life insurers also want their credit products to exhibit a favorable risk-adjusted return on regulatory capital. So life insurers are generally willing, for some of their credit exposure, to trade liquidity for yield.

Life insurers must meet – and prefer to surpass – the liability and return-on-capital requirements established by the National Association of Insurance Commissioners (NAIC). Private placements help them accomplish this because they are typically lower in quality than the public investment grade market. This creates a different quality and sector profile: the average USPP market quality rating is generally lower – Baa1/Baa2 versus A3/Baa1 – than the public index **(see Figure 2)**. About 94% of the USPP market is rated A1 to Baa3, with 3.5% higher quality and the remaining 2.5% below investment grade (BIG).[1]

Changes in regulation can impact the market, as we witnessed in the late 1980s to early 1990s. Prior to the fall of the high yield market, coincident with the savings and loan crisis, the USPP market had a more robust level of high yield issuers. After the crisis, the NAIC's proxy for underlying issuer credit risk changed from a binary Yes\No rating, indicating performing\non-performing, to a broader 1-6 designation (1 being strongest) to better reflect the relative credit quality of issuers **(see Figure 3)**. This resulted in more granular, transparent and refined risk-based capital charges by credit quality. For BIG issuers, it meant an increase in required capital – it became as much as four times greater for BIG than IG. Further, the credit cycle for public BIG issuers created greater focus on high yield weights as a percentage of total life assets from both rating agencies as well as internal enterprise risk departments, who created more refined limits. Although the credit results in USPP BIG were favorable relative to public bonds, the change resulted in lowered demand for USPP BIG issues.

Public vs. Private: Sector Concentrations, Maturities and Geography

Although the underlying risk in the USPP market is corporate credit risk, it differs from the public bond market in terms of sector concentrations, maturities and geography. Again the demands of the USPP market's largest buyer – life insurance companies – are the main reason.

Figure 3 – NAIC Ratings of Issue Credit Quality

Rating Agency Equivalent	SVO Designation	NAIC After Tax Capital Charge (unlevered)
AAA – A3	NAIC 1	0.30%
Baa1 – Baa3	NAIC 2	1.00%
Ba1 – Ba3	NAIC 3	3.40%
B1 – B3	NAIC 4	7.40%
Caa1 – Caa3	NAIC 5	17.0%
D	NAIC 6	17.0%

Source: Moody's and S&P, based on 10-year life

A Secondary Market

Private placements are thought by many to be illiquid and held to maturity, but 5-10 percent of the primary annual issuance volume trades on the secondary private placement market.

As with traditional public bonds, there are many reasons portfolio managers may want to trade a private placement position:

» M&A activity within the life industry

» Manage portfolio exposure or risk positions

» Shorten or lengthen duration to meet changing ALM considerations

» Income, capital or tax considerations

» Analysts change in the view of original investment thesis.

Critical to success in the secondary market is a dedicated secondary trading effort and operations area. As the information flow is restricted with private bonds, there must be delicate management of material non-public information and confidentiality agreements between sellers and buyers before initiating a trade.

While public bonds settle electronically through the Depository Trading Clearinghouse (DTC), private placement bonds settle delivery-versus-payment requiring notes to be delivered via courier and validated by custodian banks, prior to funds being wired electronically. The process requires legal and back-office resources to coordinate with counterparties and custodian banks ahead of settlement. The additional processing typically increases trade settlement from T+3 for IG Corporate to T+10 – a week longer – for private placement bonds.

Any sales between companies require the notes to be reregistered in the new owner's name. All these important steps require a team fully focused on the activities for successful execution.

In matching assets and liabilities, life insurers want credit vehicles with a long-term investment focus that they can invest in under a "buy and manage" mentality, versus a total-return orientation. (We say "buy and manage" versus "buy and hold" as there is a developed USPP secondary market – see "A Secondary Market" sidebar.)

As such, life companies – and therefore the USPP market – tend to favor more stable, asset-intensive industries. Utility issuers account for approximately 27 percent of the USPP market, whereas they are only 11 percent of the IG public bond market. Financial issuers in the private placement market, on the other hand, are relatively rare, representing only 8 percent of total issuance, compared to 33 percent of public issuance **(see Figure 4)**.

The maturity profile is also different in the two markets. According to Barclays U.S. Corporate Investment Grade Index, between 2008 and 2012, 80 percent of public market issuance was 5-, 10-, or 30-year maturities. In the USPP market, however, insurers sought a variety of maturities – 3-, 7-, 12- and 15-year and longer – to match their varied liabilities **(see Figure 5)**. The average new-issue maturity during this period for USPP was 10.9 years, while for public bonds it was longer at 12.4 years.[2]

And as the USPP market does not require registration of its securities, issuers from outside the U.S. are more prevalent, providing a more geographically diverse issuer profile than the public IG market **(see Figure 6)**.

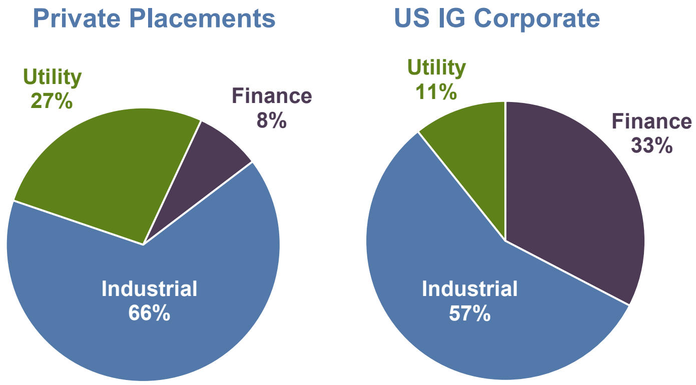
Why Issuers Go Private

There are many misperceptions regarding the profile of USPP issuers. One is that they are primarily small- and middle-market companies with limited access to alternative sources of capital. In fact, many issuers are large and mid-cap companies with sizable financing needs.

All issuers generally come to the USPP market the same way: they review their financing needs with a banker, and upon determination that a private placement is the best solution, the bank acts as agent, providing guidance on structure, pricing and negotiating with investors, and the timeline. Mandate to pricing is usually about 12 weeks.

But there are a variety of reasons as to why financial officers choose to issue private placements.

Figure 4 – Sector Distribution: Private vs. Public



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Diversify capital sources: CFOs and treasurers have a fiduciary obligation to assure they have access to capital in all market conditions. In today's post-financial-crisis environment, banks have stricter credit criteria, greater risk aversion and reduced lending capacity. Companies are encouraged to diversify their sources of capital across banks, public and private markets.

Confidentiality: When needing to maintain information discretion, issuers tend to favor the private market.

» Public companies that are experiencing a transformation (acquisition, divestiture, major capital expenditure, etc.) and want to control the timing of public disclosure often find value in discussing their specific situation and financing needs with a limited group of sophisticated lenders. Further, financial officers may not want competitors, suppliers or customers to have the financial and operational disclosures during these events, which is required of public disclosures.

» Financial officers may be able to capture favorable execution through a specific, more comprehensive discussion of a company or industry situation – e.g., information on market share, favorable supply arrangements, status of litigation, major capital programs – versus the sanitization and/or restrictions of public disclosure.

» Infrequent debt issuers may not want an off-the-run public issue to create a credit-spread pricing benchmark to influence their cost of debt capital. Bank officers and other suppliers of capital look at comparables when pricing a company's securities, and off-the-run public bond pricing is based on the marginal trade which may not be reflective of company fundamentals. An illiquid public proxy can influence a firm's credit spread, whereas private bond pricing is not widely available.

» Private companies can find relatively fair pricing without the requirement for a public credit rating in the USPP market. Additionally, issuing public bonds involves an extensive registration process and required disclosures that an issuer may prefer to keep private, such as financial statements and credit spreads.

Hedging, Tax and Operational Efficiencies: Private placements, which do not require registration, can provide financial officers more flexibility to customize their issuance to accomplish various strategic objectives within their capital structure. A common practice, especially among multinationals based outside the U.S., is to issue debt through their U.S. subsidiaries to manage and optimize tax efficiency. This practice also allows them to issue the debt in U.S. dollars to better match their revenue stream. In addition, the private market allows greater flexibility to issue from these subsidiaries either on a direct basis or with parent guarantees.

Figure 5 – Maturity Profile: Private vs. Public, 2008-2012

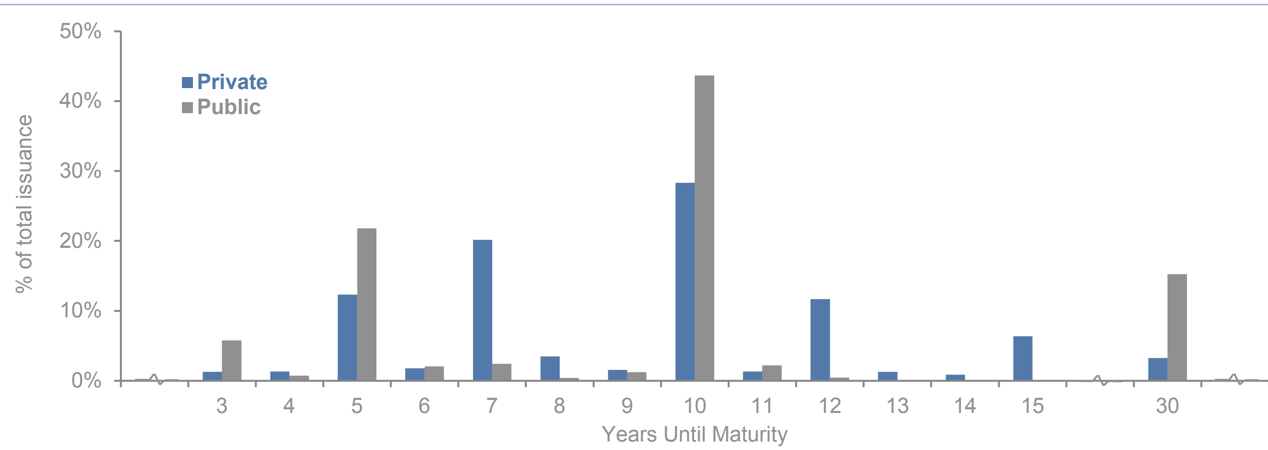

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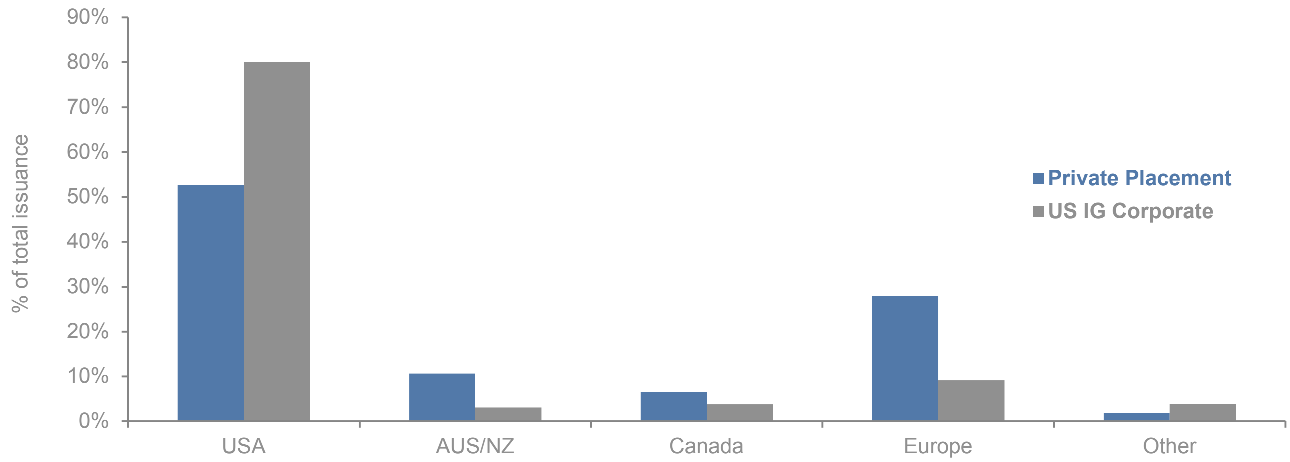
Figure 6 – Average Geographic Issuance: Private vs. Public, 2008-2012



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Manage financing risk: Private placements help companies better manage their refinancing risk or finance a specific capital project. Treasurers can issue a greater range of maturities through the USPP market to help avoid outsized refinancing requirements.

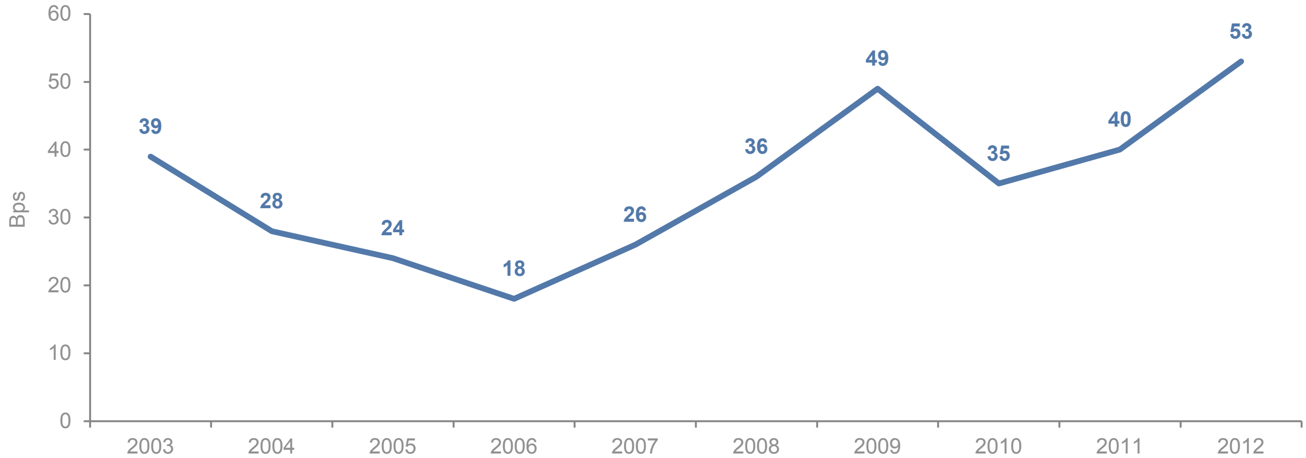
Pre-fund maturities and capital needs: A less common but nonetheless valued aspect of the USPP market, investors can commit to transactions for future delivery, often 3-12 months in advance. Issuers pay a premium for this delayed funding feature but value the ease of execution, certainty of funding and accounting friendliness. Utilities and industrial companies with near-term maturities rely on this feature to help lower market risks and more effectively manage bank and hedging capacity. Utilities can lock in current rates which assist in capturing regulatory approval.

Foreign "aids": As many multinational companies receive significant revenues in U.S. dollars, borrowing through the USPP market helps them efficiently hedge exchange-rate risk while avoiding the rigors, delays and expense of SEC registration. Further, foreign issuers historically relied on floating-rate bank financing, and the fixed interest rate of private placement financing can help mitigate interest-rate risk. Many companies believe these benefits are worth the USPP market's higher interest rates and restrictive covenants given the amount and volume of non-U.S. issuers.

The Private Placement Advantage

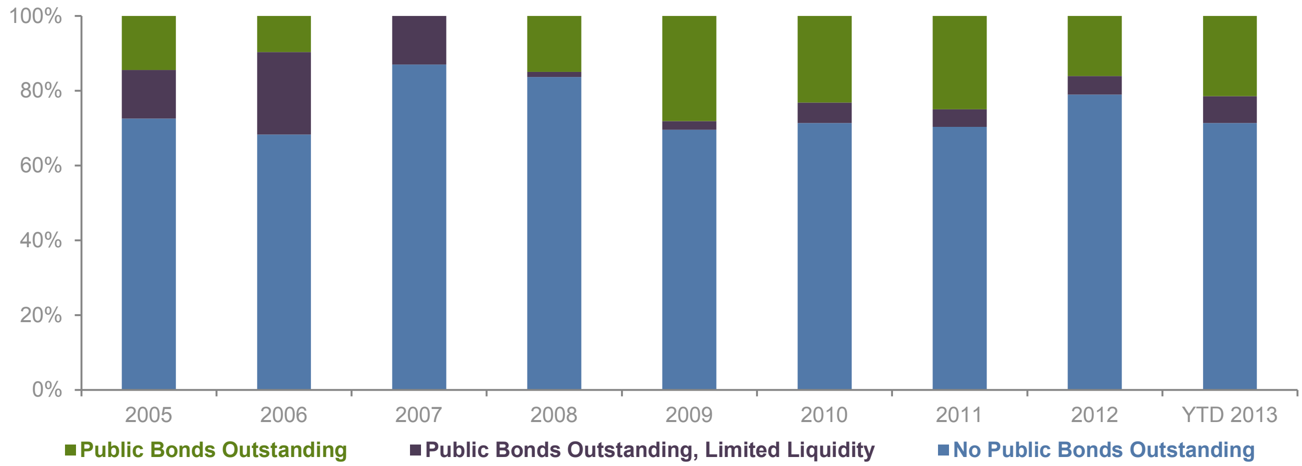
Private placements offer investors a number of potential advantages over public issues, including incremental spread, structural protections, diversification, favorable credit-loss experience and valued relationships.

Figure 7 – Net Private Placement Spreads to Publics, 2003-2012



Source: HIMCO data

Figure 8 – USPP Issuers With Public Debt: Private Placement Purchases



Source: HIMCO data, as of June 30, 2013

Incremental Spread

Private placement investors require additional yield relative to comparable public bond issues, as lenders demand greater yield to compensate for increased liquidity risk as well as the underwriting and monitoring costs. This premium is variable over time and is a function of technical, supply and demand characteristics, credit fundamentals and insurance liability requirements. The typical liquidity premium historically ranges between 25 – 45 basis points **(see Figure 7)**.

Investors must consider many factors to ensure they capture the appropriate relative value, such as selecting the appropriate comparables, calculating the cost of delayed funding, Z-spreads for amortizing bonds and the impact of new-issue premiums in the public market.

Diversification

As indicated earlier, adding a sleeve of USPP may add diversification benefits to a credit portfolio, as the public and private markets are notably different in both sector and issuer weights. The USPP market also provides a broader geographic opportunity set for IG U.S.-dollar-denominated debt. Issuers are evenly split between domestic and foreign domains. And although market data is limited, our experience is that borrowers rarely issue U.S. dollar-denominated debt in both public and private markets simultaneously **(see Figure 8)**. So portfolio managers can find issuers in the USPP market that may not be available in the public market, or capture risk exposures in issuers where they cannot capture critical mass.

Structural Protections

Covenant protections are terms, financial or otherwise, in the Note Purchase Agreement (NPA) that define certain issuer actions to protect the investor. The covenants act as an early warning system notifying investors when a credit is deteriorating or under stress, helping mitigate the severity of loss given default and protecting against shareholder-friendly activity and/or event risk.

Negative covenants prohibit an issuer from taking certain steps. One example is a limitation on indebtedness, which prohibits marginal borrowing above a defined level, typically tested by debt/EBITDA or debt/capital ratios. Affirmative covenants require an issuer to perform certain activities. A typical affirmative covenant is "interest coverage" which requires the issuer to maintain an adequate ratio of cash flow to fixed charges (e.g. EBITDA/Senior Interest Charges >2.0x).

More robust covenant packages are typically required for issuers of lower credit quality and perceived reduced liquidity. For very high quality issues investors may be willing to accept a lighter covenant package with a "most favored lender" (MFL) covenant. The MFL is constructed to assure that the notes will continue to rank *pari passu* with other major providers of capital including the issuer's bank debt.

When a company thinks it is about to breach or has breached a covenant, USPP lenders are likely to have a seat at the table. Lenders may choose to give the company a waiver, negotiate new terms or exercise their rights under the NPA including putting the bonds back to the company at par or with make-whole. This affords USPP lenders more responsive recovery opportunities not commonly seen in the public market.

Favorable Credit-Loss Experience

The covenant protections are the primary reason why private placement investors are likely to experience better recovery with a distressed private issuance than a comparable public bond. The 2006 Society of Actuaries Study "1986-2002 Credit Risk Loss Experience Study: Private Placement Bonds" showed the average recovery rate on distressed private placement bonds was 65% compared to the historical public bond average recovery rate of 40%.

The report said private placement issues are more likely to:

- » Trip covenant levels long before defaulting, giving investors a seat at the table to negotiate
- » Be secured by assets other than common stock of the issuer
- » Rank *pari passu* with bank debt, allowing investors to share first claim on the assets of the company.

Our experience is consistent with this report.

We should note that when a credit falls to BIG there is reduced liquidity and the bonds often trade initially at a sizable discount. Although this does create a pricing dislocation, it also creates a buying opportunity for those institutions who can invest in high yield issuers. The covenant protections and increased spread on certain BIG issuers may be worth the increased credit risk for those issuers with the capacity to repay their debt.

Building Relationships

Communication – and the relationships that result from it – is a key advantage in the USPP market. Unlike the public market, private placement analysts are speaking directly to senior company management. The direct conversation allows the issuers to potentially capture better execution and the investors to have a more informed credit decision. Further, direct and comprehensive discussions with industry participants can allow analysts to have more informed views within and across industry participants. Successful issuers, once in the market, often will stay and grow their participation in the private market. In the first half of 2013, 70% of issuers were repeats, according to HIMCO data. Issuers not only use the USPP market to refinance their existing bank debt, they may also use it to finance capital and acquisition growth.

The USPP market environment encourages lenders and issuers to develop long-term, trusted relationships, which can benefit both sides. Lenders can more fully understand issuers and have greater faith in their ability to meet obligations, and issuers tend to have a more understanding audience should they need an amendment or a waiver if a covenant is breached.

Not Without Risks

All financing markets have their risks, and the USPP market is no exception.

Credit Risk: Similar to the public market, the fundamental risk within the USPP market is credit risk. As the securities are largely A3 to Baa3 bonds, we expect a similar frequency of default. As noted above, while the USPP market has experienced more favorable recovery from a loss given default compared to the public market, the fundamental risk is clear.

Liquidity Risk: Private placement bonds are less liquid than public bonds for several reasons:

- » Annual turnover is limited
- » Their primary purchasers are life insurance companies, which tend to hold them to maturity
- » The bonds are primarily payment vs. delivery instead of the faster DTC.

(See "How Liquid Are Your Public Bonds?", page 8)

Life insurance regulatory risk: As life insurance companies are such a significant factor in the USPP market, changes in the life industry regulatory treatment of these assets could have a temporary but material impact on pricing and liquidity.

Transparency risk: A cornerstone of the USPP market is confidentiality. Although a good portion of the market consists of public companies, the level of public and rating agency disclosure does not match that of the public market. Managing the asset class requires a staff of qualified underwriters and does not lend itself to passive management.

Conclusion

Today's low-yield environment presents challenges for all portfolio managers to drive performance. We believe the Reg D Private Placement Market exhibits superior characteristics to a traditional IG credit portfolio, and the USPP market has a long history, is well understood, and fundamentally is a credit portfolio. The private placement value proposition may include enhanced yields, diversification and structural protections to help manage credit and event risks, making it an asset class worthy of consideration by any portfolio manager. The asset class provides an additional tool to portfolio managers with a durable credit allocation. The manager must be willing, for a portion of that portfolio, to assume marginal liquidity risk for these superior performance attributes.

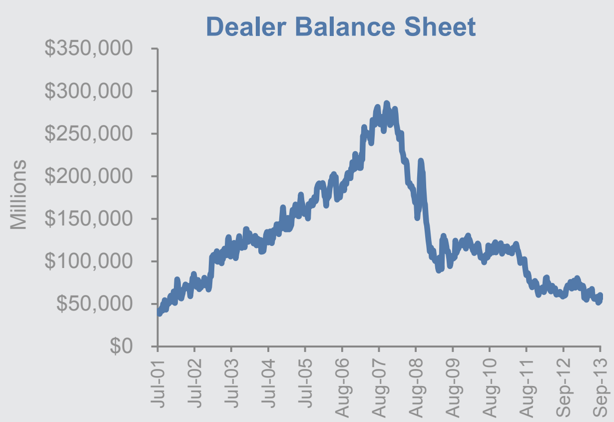
How Liquid Are Your Public Bonds?

Recent changes in the regulatory environment seem to have reduced the liquidity profile of public bonds.

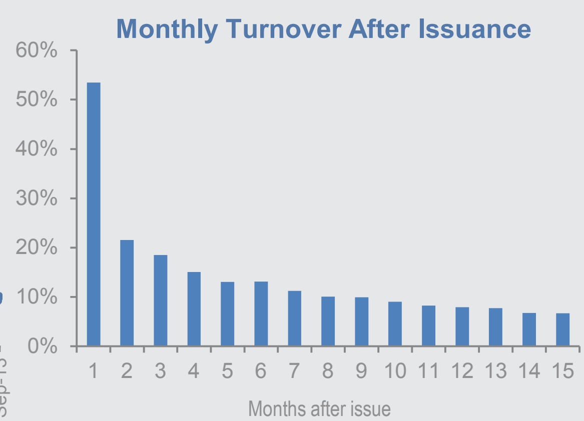
Enterprise risk management practices of investment banks and commercial banks with trading operations, responding to increased regulatory scrutiny, are less willing to take balance sheet risk by buying and holding public bonds. The chart below shows the decline in balance sheet inventories of primary dealers.

Further, a look at public bond portfolios shows how much liquidity they really enjoy. Trading largely takes place after a new issue comes to market. Market data displays the significant decline in trading as an issue ages.

With changes in the market environment, public investors are starting to question if the liquidity of the corporate bond market will be present during the next credit cycle. One perspective of the situation was provided in "Setting New Standards – The Liquidity Challenge II," issued by BlackRock Investment Institute in May: "It's not easy to buy and sell bonds in the secondary market. Liquidity is patchy, and many bonds have turned into museum pieces; nice to look at, but tough to take home."



Source: Federal Reserve Bank of New York, as of September 18, 2013



Source: Trace, JPMorgan, as of July 2013

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Hartford Investment Management has been managing private placement debt since 1996 and has $7.1 billion in private placements assets under management as of June 30, 2013. The Private Placements team has nine members with an average industry experience of 14 years (as of September 30, 2013).

Footnotes

1. Source: HIMCO issuance data, 2008-2012
2. Source: Barclays (US IG Corporate Issuance, 2008-2012), HIMCO Issuance (Private Placements 2008-2012), as of December 31, 2012

Definitions

The forecasts, opinions and estimates expressed in this report constitute the Firm's judgment as of September 30, 2013 and are subject to change without notice based on market, economic and other conditions. Diversification cannot assure against market loss. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. All data contained in this is from sources deemed to be reliable, but cannot be guaranteed as to accuracy or completeness.

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