KEY POINTS

- Private placements are on the rise and lend themselves well as an alternative source of funding.
- Institutional investors like private placements because they tend to be longer-dated than bank loans and quicker to issue than publicly traded bonds.
- In Europe, diverging standards across different European regimes can add complexity and significant costs for cross-border placements. Coordination amongst key market participants is already under way in order to bring about a robust pan-European private placement market.
- Banks still have a role to play in private placements as clients prefer to have them coordinating the placements with the investors.

Authors Ranajoy Basu and Monica Dupont-Barton

The rise of private placements as an alternative source of funding: a time for innovation and growth

This article considers the rise of a pan-European private placement market and key considerations when structuring private placement transactions in Europe.

The recent financial crisis, the regulatory restrictions imposed by the Basel III regulations and the associated widespread de-leveraging by European banks have created a funding gap for European small and mid-sized companies and have caused them to seek access to alternative sources of capital. As a result, the European market in 2013-2014 has seen the lines between loans and bonds blur into hybrid products as companies look to a broader range of finance options to meet their varying needs.

The resulting funding mix is driven by a host of external factors, from governments pushing for local sources of capital, to the consequences of regulatory change as well as the increasing mix of capital providers.

One source of funding which has prompted a high level of interest in 2014 (both from corporates and institutional investors) is private placements. Traditionally a form of US financing provided by US insurance companies and pension funds for decades in the States, this is increasingly being used in Europe, in particular in Germany (in the form of *Schuldschein* loans) and France (in the form of Euro PPs). Importantly, the private placement market has remained open throughout the recent financial crisis. 2014 was a strong year for private placements in Europe with volumes exceeding US$40bn.

Consequently, 2014 has seen a high level of interest in Europe to drive forward the creation of national as well as a pan-European private placement market. An ongoing dialogue has ensued between the issuer, investor and adviser/arranger communities across Europe, with industry bodies including the International Capital Markets Association, the Loan Markets Association, the Association of Financial Markets in Europe and the Association of Corporate Treasurers actively promoting the need for a functioning and accessible European Private Placement market. Therefore, it is looking increasingly likely that a pan-European private placement market will join the mainstream of corporate finance in 2015.

SO WHAT ARE PRIVATE PLACEMENTS?

In the absence of a formalised definition, there has been some debate in the market as to what constitutes a private placement. Ordinarily, a private placement (PP) as the name suggests involves a placement of debt (often in the form of bonds or notes) with a small group of selected investors, often non-banking institutions. These transactions offer a number of real advantages, not least that they are cheaper and quicker to structure than bond market issues and they offer good medium to long-term yields, which are attractive to pension funds and insurance companies.

The US has long benefited from an active private placement market, where companies can raise finance by offering a small group of investors (typically pension funds and insurers) a chance to invest in debt, which does not involve the cumbersome process of public transactions as the securities are not offered to the public. The deals are placed directly with the investors or, in some cases, placed with a single investor, therefore the agents involved are not underwriters and they do not purchase the bonds themselves.

The securities are not publicly offered or listed (Regulation D) (although there are some recent exceptions to this rule) and are not registered with the US Securities and Exchange Commission (SEC). Issuers do not require a public rating for the debt. However, the US private placement notes are given a private rating by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC).

SO IS EUROPE PLAYING CATCH-UP?

In the European market, private placements are debt products that are not required to be listed on public markets or rated and can be structured either as securities or loans. The European market is fragmented, with each jurisdiction having its own form of private placement financing. While the UK was the first market to really grow in size, issuers from across Europe quickly came into the market, in particular in France, Germany and Italy.

WHO ARE THE PRIVATE PLACEMENT DEBT PROVIDERS?

The categories of investors that provide this type of financing are institutional investors in the form of pension funds and insurance companies and, in some cases, high net worth individuals and other significant large corporate investors. In the aftermath of the financial crisis, European insurance funds that in the past invested in government bonds are increasingly looking to spread their risk across a new asset class while earning more yield. Institutional investors like private placements because they tend to be longer-dated than bank loans and quicker to issue than publicly traded bonds, and they usually carry a slightly higher coupon than either. The longer tenors match the investors' long-term liabilities in pensions and savings.

In the small to medium enterprise (SME) space, while banks remain the primary lenders due to the size of transactions and the local nature of the commercial relationship, PPs have grown as a private form of debt. Particularly in countries such as Greece, where corporates have been traditionally dependent on bank financing and where bank lending has significantly contracted over the last few years, the Athens Exchange Group (Athex) has been very proactive to boost SME lending by allowing companies to issue €5m of bonds through its ENA STEP (support the entrepreneur) part of its alternative market listings.

Similarly, funding long term infrastructure investments has become significantly more expensive for banks, as a result of the Basel III reforms and changes to bank funding costs. Last year in particular, witnessed a greater acceptance of capital markets instruments and PP transactions as an alternative source of funding in the infrastructure market.

WHO CAN INVEST

Traditionally, private placements were a form of financing geared at mid-cap companies who could not access the public markets where the minimum size of the transaction is around US$300m. The private placement market allows for significant flexibility in issue size, with issuances ranging for as little as US$20m to as much as US$1bn for strong issuers. In Europe, as the private placement market developed, the profile of the issuers in this market tends to range from mid-cap to larger corporates. 2014 saw large public issuers and companies in FTSE 100 accessing the market because of its expeditious time frame and much lower cost structure than any public transactions. In addition, with the growth of cross border transactions in recent years, US insurance companies were afforded much broader regulatory discretion to make private placement investments in companies not located in the US. Therefore, European corporates (in particular those with US operations) sought funding by tapping transatlantic investors and raised US dollar denominated debt.

THE ADVANTAGES OF A PRIVATE PLACEMENT

The principal advantages ascribed to private placements are lower transaction costs and shorter time-to-market timeframes because there is no requirement to produce a prospectus or comply with other investor protection rules. Without this, transaction costs are greatly reduced and private placements can be carried out in a much shorter time frame. This makes them particularly attractive to companies who wish to raise funds quickly or sophisticated capital markets issuers wishing to transact in short timeframes. Direct contact between the issuer and the investors allows for the tailoring of products to the requirements of a specific investor or group of investors.

In contrast with the long held view that private placements are less liquid than public offerings, recent months demonstrated a much greater liquidity in the US and more private placement trades than at any other time in the market.

From a borrower perspective, private placements are a good product for companies with steady revenue streams or assets they need to finance. There is typically no commitment fee and the coupon is usually fixed. Recent private placements contain a delayed drawdown feature that allows borrowers to have six weeks to two months settlement periods or to have several closings. This can be advantageous for treasurers if they do not require debt straight away but they want to have funding commitment and lock down the interest. It also removes the need for hedging arrangements.

Private placements are less regulated as there is general acceptance among financial regulators and capital markets participants that they require less regulatory protection since they are offered to sophisticated investors without the need for the prospectus requirements and regulatory authority approvals put in place to safeguard retail investors.

A FEW KEY CONSIDERATIONS WHEN STRUCTURING PRIVATE PLACEMENT TRANSACTIONS IN EUROPE

Tax structuring

Tax structuring is often an important consideration for both issuers and investors. This is particularly relevant when structuring transactions in jurisdictions such as Greece. There are still hurdles to overcome in this regard before the pan-European market functions properly. The regulatory backdrop is being finalised, and no agreement has been reached so far on tax harmonisation and common insolvency rules.

The role of banks

Investors will need to build up resources, allowing them to assess risk in lesser-known companies (or for which information is not publicly or readily available). Also, banks still have an active role to play in the development of the PP market as companies prefer to have their banks intermediate the access to the private placement market rather than dealing direct with investors. Playing an active intermediary role would help prepare banks for the time when cheap central bank liquidity is finally turned off and new regulations start to bite, encouraging them to help customers access alternative funding options. At that point, the pan-European private placement could move beyond its niche to become a more central player in corporate funding.

DOCUMENTATION

Traditionally a private placement is intended to be offered to a small syndicate of investors and therefore the issuer is required to prepare a private offering memorandum. This is more akin to an information memorandum prepared in relation to the syndication of a loan facility rather than a high yield bond offering and it contains a term sheet setting out the main terms of the financing. Public issuers for whom existing public disclosure is available may waive the requirement to provide a detailed memorandum, however they will be required to respond to due diligence questions.

The main document in a private placement is a note purchase form under which the initial investors agree to subscribe for the notes. This document contains the typical representations, warranties and undertakings in favour of the investors that are found in a debt financing. In the US, Model Form Note Purchase Agreements have become a standard form for the institutional private placement market. For non-US borrowers, the standard form to be used is called Model Form X with two variations – one for issues with a credit rating of A- or higher and one from issues with a credit rating of BBB- or higher. French European Private Placement documentation is loosely tailored on the Model Form X.

The issuer is required to enter into a separate subscription agreement or Note Purchase Agreement (NPA) with each private placement investor on a bilateral basis.

European corporates will ordinarily use the Model Form X and adapt it to conform it to the terms of a standard bank facility agreement. It is generally acceptable to US private placement investors that the representations and covenant package in an issuer's NPA should be substantially the same as the representations and covenant package in a bank facility agreement. If the issuer is English, the NPA can be governed by English law as US investors generally view England as a creditor friendly jurisdiction.

STANDARDISING EUROPEAN DOCUMENTATION

In the European context, there is a high level of interest to drive forward the creation of a pan-European private placement market by establishing a guide of best practice and facilitating the emergence of standard documentation. One of the reasons the US market has grown so strongly is precisely because it is a unified market, with common standards and common approaches to documentation. In Europe, diverging standards across different European regimes can add complexity to the process and significant costs for cross-border placements.

On 6 January 2015, the Loan Market Association (LMA) launched template documents to be used in European private placement transactions in the form of a loan agreement that is also capable of being evidenced as a note. It is based on the existing LMA term facility agreement for use in investment grade transactions. While the template is governed by English law, unsecured and aimed primarily at investment grade borrowers, the documents are drafted so that they can be easily adapted to other governing laws and market sectors, and can be tailored for a whole range of borrowers. The template documents also include a precedent subscription agreement, a term sheet and a confidentiality agreement.

THE MAIN FEATURES OF A TYPICAL PRIVATE PLACEMENT FINANCING

Ordinarily, the notes are issued with a fixed coupon and denominated in US dollars with maturities as long as 30 years. The most common tenors in Europe are five, seven or 10 years and it is not uncommon to have tranches of notes with different maturities.

The NAIC rating is a pre-requisite for US private placement investors that are US insurance companies as the NAIC requires that the financial assets of these investors be rated by it for regulatory purposes. The rating depends on the credit quality of the issuer. NAIC 1 and 2, given to investment grade companies carry less reserve requirements. For NAIC 3 (below investment grade) the reserve requirements increase dramatically. There is a NAIC exemption for border line credits.

The representations, warranties and undertakings in a Model Form X are significantly more extensive than would ordinarily be found in a Eurobond and more akin to a bank facility based on the LMA precedent for investment grade borrowers. As a guiding principle, it is generally acceptable to US investors that the covenants in the Model Form X are aligned to those in a bank facility agreement. There will generally be two financial covenants although stronger credits may negotiate one or no financial covenants. Investors strongly prefer maintenance covenants so that basket levels are maintained at all times but may accept incurrence covenants for higher NAIC rated companies. Model Form X contains several provisions in addition to those ordinarily contained in a bank loan agreement, for example covenants restricting subsidiary borrowings and restrictions on transactions with affiliates other than in the ordinary course of business.

In terms of covenant reporting, the private placement covenants will typically be aligned to any bank financing of the issuer so that it delivers the same reporting information across all debt facilities.

Similarly to a bond, Model Form X contains a call protection for early redemption by way of a make-whole payment for the life of the notes calculated by reference to a gilt or government bond plus a margin. The make-whole provisions would ordinarily (but not always) apply to the change of control provisions.

Although the notes are subscribed by each investor individually, the consents that may be required to waive or amend the terms of the NPA will be determined by a specified majority of the investors. As there is no agent appointed to act for the investors, it is important that the issuer maintains on-going relationships with individual investors to

Feature

Biog box

Ranajoy Basu is a partner in the structured finance team at Reed Smith in London. He has extensive experience in debt capital markets, structured finance and private placement transactions. Email: RBasu@ReedSmith.com. Monica Dupont-Barton is counsel in the banking practice at Reed Smith in London, advising on leverage finance transactions, term loan Bs in the European market and distressed debt. Email: MDupont-Barton@ReedSmith.com.

TABLE 1: EUROPEAN PRIVATE PLACEMENT MARKETS: KEY FEATURES

French private placements	German private placements	English private placements
Euro PP has raised more than €7bn in the past two years, almost exclusively for French companies, arranged by French banks and funded by French insurers. This was partly due to assistance from the French government and the Banque de France keen to ease the process with a standardised system of documentation and disclosure. Pursuant to the French Monetary and Financial Code, only an institution that is licensed as a credit institution in France or recognised as such in France through the EU mutual recognition can conduct banking transactions in France on a regular basis. Therefore private debt funds cannot make loans to borrowers incorporated in France (or French branches of foreign companies) and private debt lending must take the form of a bond instrument. The obligations under a French bond are governed by a set of mandatory provisions enshrined in the French Code de Commerce which differs in several respects from the provisions of a standard loan agreement (eg in relation to debt buy backs). With respect to secured bonds, security may not be granted in favour of each bondholder. Instead the bondholders form a group with legal personality and security is granted for the benefit of the group.	The German Schuldschein sector, twice the size of the French market and far longer established, is a key part of the country's thriving midsized business sector. Schuldschein issuance is invariably in the form of a private and unlisted bilateral loan agreement. Its benefits are similar to a US private placement: longer tenures, diversification of lender base and no formal rating requirement. Where there are multiple lenders, there are no loss sharing or majority lender provisions or consent mechanics and each lender has individual claims against the borrower. It is therefore difficult to restructure the loans in the absence of creditor consent. The loan agreement contains a shorter list of events of default and the material adverse effect concept is not built-in expressly as there is an equivalent concept in the German civil code. Schuldschein loans were traditionally issued by German companies. However the market has recently attracted international borrowers such as Clariant (Switzerland), Sonepar (France) and Sainsbury's (UK). The majority of investors in this market are still German banks and insurance companies but European banks (such as Société Générale) are teaming up with German banks to arrange Schudlschein for borrowers in their jurisdiction.	In addition, last year, more than 40% of the total invested in traditional private placements by US investors went primarily to UK and European issuers, with French companies making up the second largest portion of investments after the UK. Britain has less in the way of a recognisable private-placement market than Germany or France, although it has a number of insurance companies and pension funds. British firms hare off to America to issue privately placed securities and most domestic activity consists of private loan agreements. The British Chancellor of the Exchequer, George Osborne, announced in December that interest accrued on private placement investments would be exempt from withholding tax, giving a significant boost to the development of the UK private placement market.

ensure they are familiar with the financial position of the company and can react quickly to a consent request.

PROCESS

Following the circulation of the private offering memorandum, placement agents will arrange a road show where the chief financial officer of the issuer will meet with investors to talk through the business. Following the road show, investors will submit further questions to the issuer. The level of due diligence is not as extensive as for a high yield bond offering but more extensive than for a loan because the investors will hold the debt for longer.

It is worth keeping in touch with investors once a year with an update call so that they can get any amendments when needed notwithstanding that noteholders do not ordinarily wish to be in regular contact with the relevant borrower.

IN CONCLUSION: THE ROAD AHEAD

As alternative credit providers make their presence felt in this market and the market develops as expected, European companies could soon have a thriving and credible source of new finance on their doorstep, rather than looking across the Atlantic as they have increasingly done in recent years. Market participants, particularly new issuers in this market and investors need to be kept updated with the developments and innovation to realise the opportunities that lie ahead. Our experience in recent years shows that this is already happening. 2015 may yet be the year of the private placement market. ■

Further reading

- Schuldscheine and N bonds in demand [2014] 9 JIBFL 592
- Dutch debt capital markets: a funding solution for SMEs? [2013] 9 JIBFL 589
- Lexisnexis Loan Ranger blog: Non-bank lending options for UK corporates – 2 years after Breedon