AFP® Annual Conference

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OCTOBER 27–30, 2013 | LAS VEGAS

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The Private Placement Market: Pros & Cons of Direct Issuance vs. Issuance Through an Agent Bank

October 28, 2013

Speaker Introductions

- Bob Kelderhouse, Vice President and Treasurer, United Stationers, Inc.
- Rick Fischer, Director, MetLife Investments
- Mike McCarihan, Director, Debt Placements, Wells Fargo Securities, LLC

What are Debt Private Placements?

- **"Privately-placed" fixed income securities, exempt from registration with the SEC**
- **Section 4(2) of the Securities Act of 1933 exempts from registration "transactions by an issuer <u>not involving any public offering</u>"**
- **Purchasers of these securities must be "sophisticated" investors**

What is the "Traditional" Debt Private Placement Market?

- **A corporate bond asset class that has existed in its current form for many years (does not include Rule 144a transactions)**
- **Bonds are sold directly or via an agent to institutional investors**
- **Represents an important financing channel for issuers that do not have access to or choose not to access the public debt markets, due to:**
  - Minimum size* and ratings requirements
  - Costs (associated with registration process, public offering and ratings maintenance)
  - Confidentiality concerns

**Inclusion into Barclay's (former Lehman) U.S. Aggregate or Corporate bond indices requires a $250 million issue size.*

Comparison of Senior Debt Markets

	Bank Debt	Private Placements	IG Public Bonds
Tenor	• Short term (3 to 5 yrs) • Revolving or term loans	• Long term (5 to 30 yrs+) • Bullets or amortizing structures	• Long term (3 to 30 yrs+) • Bullets w/standard maturities
Uses	• Working capital • Funding bridge	• Acquisitions, growth capex • Long-term asset matching	• Acquisitions, growth capex • Long-term asset matching
Issue Size	• Wide ranging availability	• \$25-\$50 million min to \$1B+	• \$250 million min to multibillion
Rate	• Floating	• Fixed or floating	• Generally fixed
Callability	• Par	• Fixed: Make-whole (T+50 bps) • Floating: reducing schedule	• Make-whole (T+20 to 50 bps; ~15% of credit spread)
Ratings	• None required	• None required (post-close NAIC designation)	• At least two (Moody's, S&P or Fitch BBB- or higher)
Fees	• Placement/syndication • Commitment	• None, if directly placed • Placement (agented issues)	• Registration/ratings • Placement
Investors	• Banks • Single or clubs	• Life insurance companies • Single, clubs or larger groups • Buy-and-hold nature	• Institutional investors • Sizable groups • Can be active traders
Covenants	• Most restrictive	• Similar/slightly looser to banks	• No financial covenants

Key Benefits/Considerations of Senior Debt Markets

	Bank Debt	Private Placements	IG Public Bonds
Benefits	• Ease of execution • Fully prepayable at par • No agency ratings required • Relationship-focused investors	• Structuring flexibility • Smaller issue sizes acceptable • No agency ratings required • Ratings arbitrage • Delayed funding and foreign currencies available • Relationship-focused investors	• No financial covenants • Depth of market – largest and most liquid • Quickest marketing period
Considerations	• Limited tenor • Financial covenants • Limited ancillary business may impact capacity	• Financial covenants • Amending terms w/large investor group • Potential prepayment premium	• Public ratings required • $250 million minimum issue size • Potential prepayment premium

Private Placement Issuers

- **Public or privately-held corporations (or similar entities*)**
  - A big misconception is that the market is just for privately-held companies
  - Roughly half of the issuers in the market are publicly-held and generally these credits (many with household names) issue in larger sizes
- **U.S. or foreign-based (large volumes come from abroad)**
- **Wide sector diversification (excluding the obvious more "equity-attractive" industries)**
- **Primarily "investment grade" credit qualities**

**For example, special purpose vehicles that issue credit tenant leases (CTLs) or project finance related notes.*

Investment Grade Private Placement Issuer Profile

- **Revenue: $300 million to several billion**
- **EBITDA: $50 million to $1B**
- **Debt to EBITDA leverage:**
  - Generally < 3.5x
  - Typically in the 1x to 2.75x range (during a normal operating environment)
- **Book net worth: > $100 million**
- **Operates in niche end markets with defensible positions**
- **Management maintains conservative view on leverage**

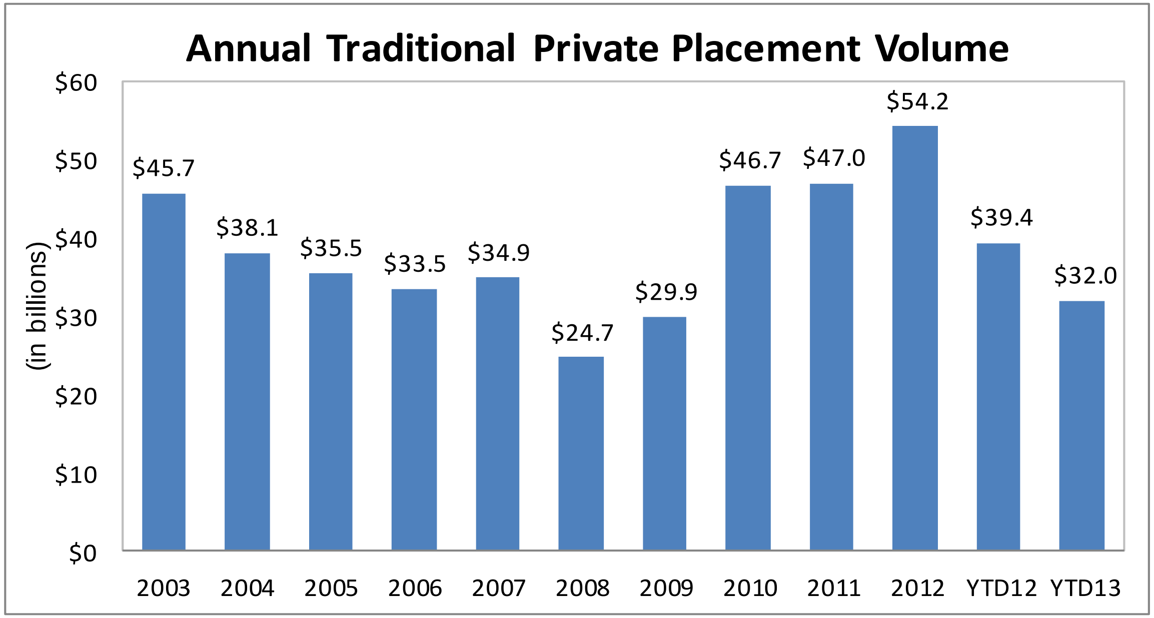
Issuers Use Private Placement Proceeds for a Variety of Needs

- **Proceeds raised through private placement issues are used for:**
  - Mergers and acquisitions
  - Growth capital
  - The refinancing of existing bank debt and/or maturing long-term bonds, and
  - Special dividends, share repurchases and/or recapitalizations (assuming credit quality remains reasonable)

In general, issuers are seeking to fund longer-term assets and/or add or maintain a more permanent layer of debt capital

Market Size and Stability

- **Approximately $40 to $50 billion of new issuance annually**
- **~ 10% of the size of the U.S. IG bond market (ex. Financials)**
- **Generally more stable than the public bond markets**

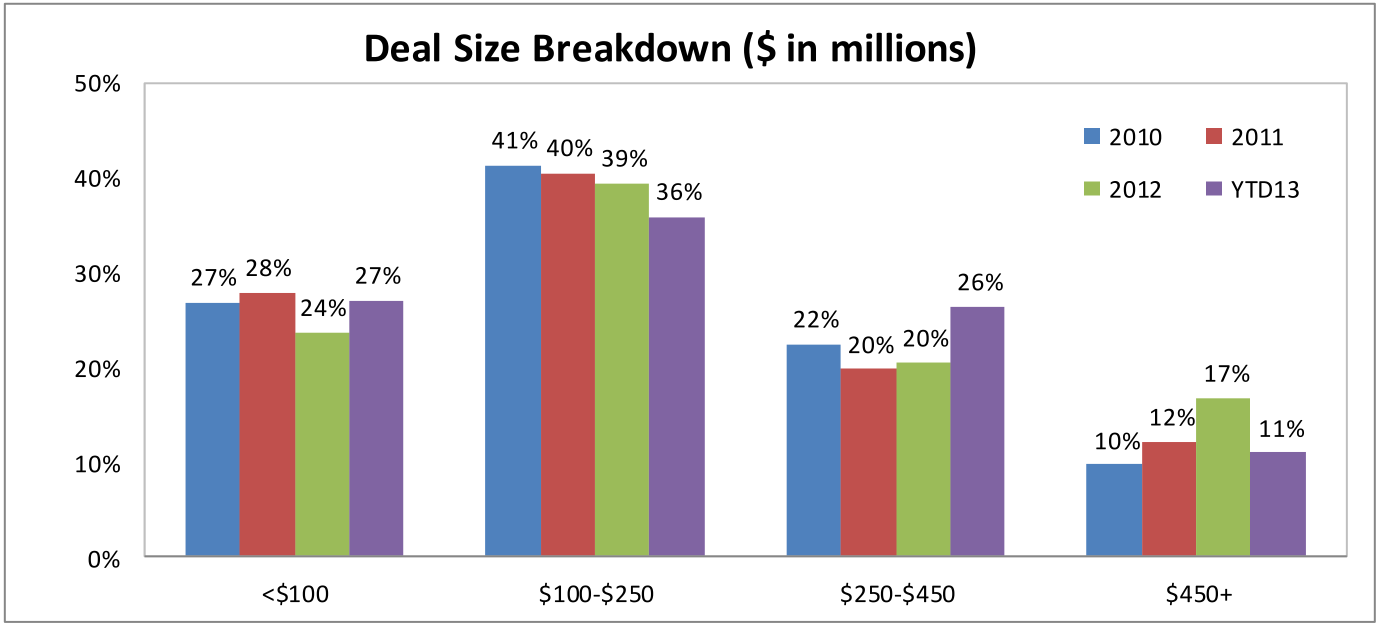


Even during the height of the financial crisis, private placements were being executed

Source: Thomson Reuters, The Private Placement Monitor and Wells Fargo Securities.

Deal Size and Number of Issues

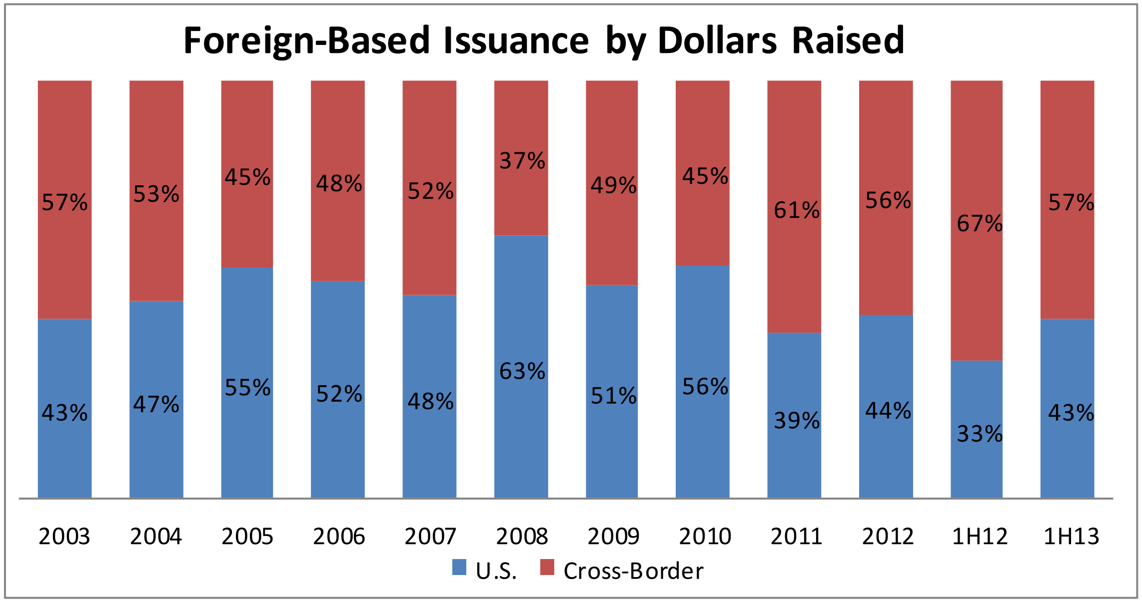
- **Average issue size of approximately \$200 to \$250 million, with issue sizes ranging from \$25 million to over \$1 billion**
- **Roughly 200 issues per year**



Source: Thomson Reuters, The Private Placement Monitor and Wells Fargo Securities.

Issuers by Geography

- **Issuance from foreign-based credits is significant, representing roughly 50% of dollar volume raised over the last decade**
- **Western European, Australian and Canadian issuers consistently tap the market**

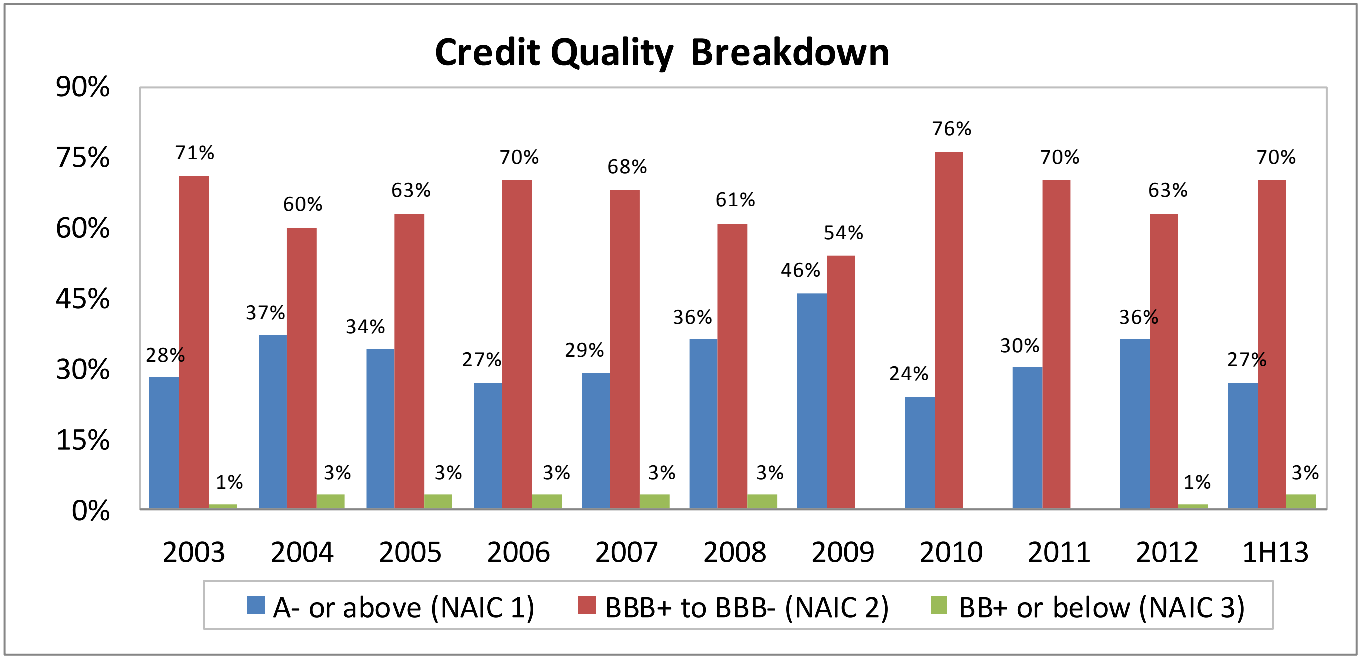


Looming bank constraints have driven recent elevated issuance from high-quality European credits

Source: Thomson Reuters.

Issuer Credit Quality

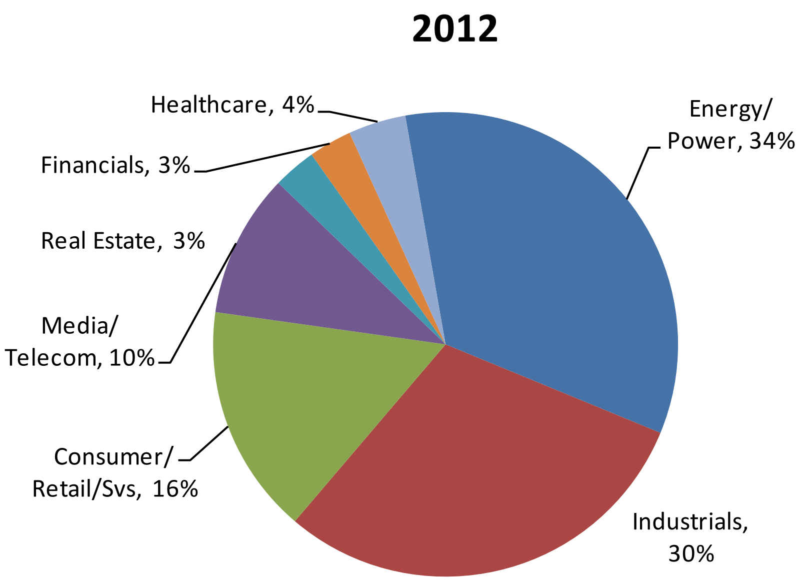
- **Principally, an investment grade market (per investor credit evaluations, as most issuers are not rated by the agencies)**
- **Below investment grade issuance is generally very light**

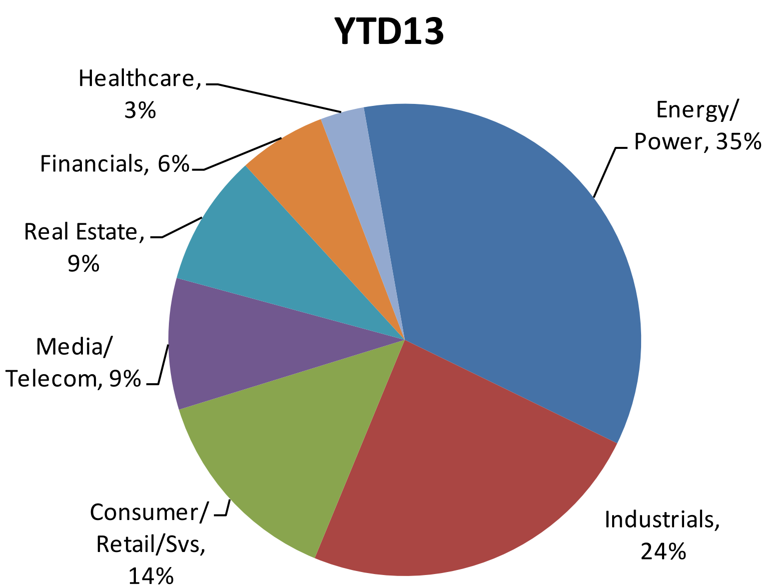


Source: The Private Placement Monitor.

Issuance by Industry Sector

- **Not surprisingly, Energy and Power (utilities) has consistently been the largest issuing sector in the market**
- **Following widely-defined (general) Industrials, there is broad diversification of issuance by industry**



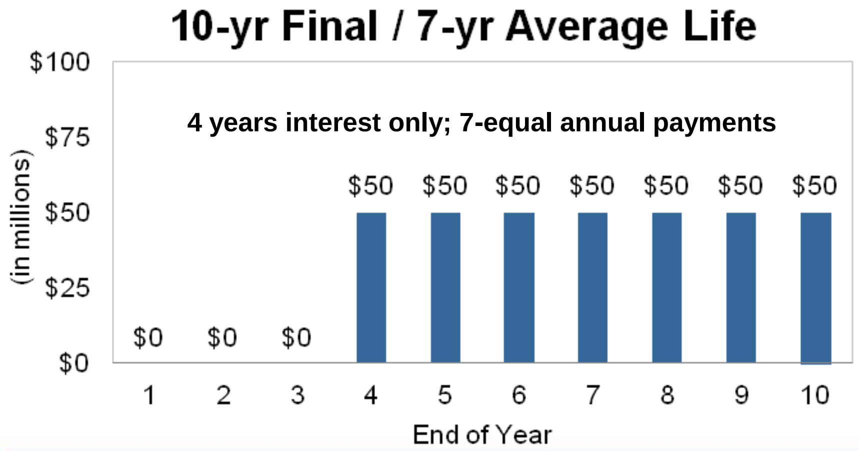


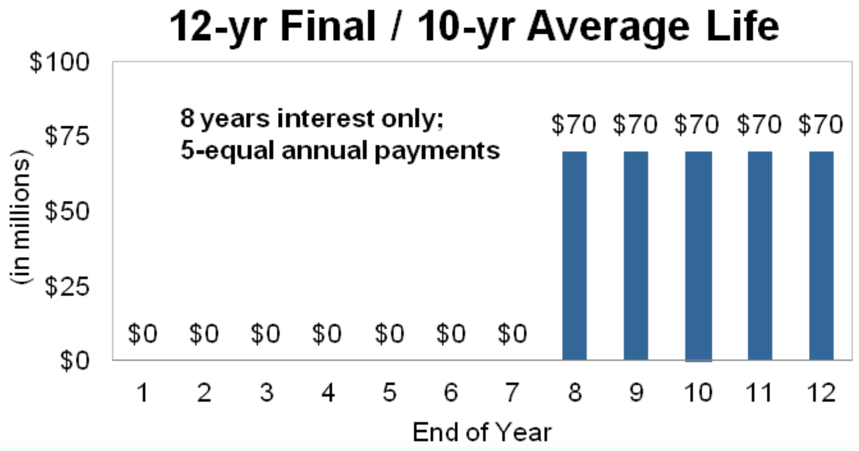
Source: Wells Fargo Securities.

Traditional Debt Private Placement Structure

- **Ranking**
  - Generally unsecured; can be secured as well (by blanket lien or specific assets)
  - Pari passu with bank debt (Inter-creditor arrangement if secured)

- **Tenor**
  - Maturities range from 5 to 30 years+ (typically 7 to 12)
  - Bullet and/or amortizing structures ($350 million amortizing issue example below)





Traditional Debt Private Placement Structure (cont'd)

- **Coupon**
  - Primarily fixed rate, priced at a credit spread over U.S. Treasuries
  - Floating rate notes also exist and are priced at a credit spread over LIBOR; spread over LIBOR is generally fixed for the life of the issue (i.e., it does not float with a leverage grid, etc.)

- **Callability**
  - Fixed rate: make-whole at a Treasuries + 50 bps discount rate
  - Floating rate: NC1/2 with gradually reducing schedule thereafter

- **Currencies**
  - Predominantly a U.S. dollar market
  - Issuance can be in all major currencies (€, £, C$, A$, ¥, etc.)
  - Swap breakage language generally included for non USD-denominated issues

Legal Documentation and Financial Covenants

- **Model Form Note Purchase Agreement**
  - Legal documentation template developed by lenders, agents and legal counsel
  - Speeds execution process (no need to “re-create wheel” for every new issue)
  - Similar to bank loan agreement documentation

- **Financial Covenants**
  - Generally structured to match those of the issuer’s primary credit facility
  - Typically one to three depending on credit quality (maintenance-based)
    - **Leverage ceiling** (Debt/EBITDA or Debt/Capitalization)
    - **Interest or Fixed Charge Coverage floor** (EBITDA/Interest Expense, EBITDAR/Interest + Rents, etc.)
    - **Net Worth minimum**
  - Other standard provisions include “priority” debt and sale of assets limitations

Issuer Motivations for Accessing the Private Placement Market

- **Diversification of Financing Sources**
  - Complement to shorter-term bank borrowings
  - Broadening of lender base (frees up bank capacity)
  - Source of liquidity when other markets dry-up or become dislocated
  - Reduce dependency on bank financing

- **Structuring Flexibility**
  - Tailored maturities; acceptance of amortizing notes
  - Deferred funding availability ("locking-in" current interest rates)

- **No Ratings Requirement**
  - Elimination of size-bias
  - No need for annual ratings confirmations from the agencies

Issuer Motivations for Accessing the Private Placement Market (cont'd)

- **Low-Cost Execution**
  - No registration or rating agency fees
  - Competitive issuance costs* vs. public bond/bank markets
  - Modest legal fees for lenders' outside counsel

- **Competitive Pricing**
  - Credit spreads close to the levels of applicable publicly-traded comparables
  - Credits in out-of-favor or less "understood" industries could actually price tighter then in public markets

- **Familiarity with Lenders**
  - Manageably-size investor groups
  - Maintenance of confidentiality (controlled distribution of issuer information)
  - Relationship-focused, patient lenders (buy-and-hold mentality)

**Zero or nominal placement fees if directly executed.*

Investor Motivations for Lending into the Private Placement Market

- **Portfolio Diversification**
  - An alternative to public bonds; adding granularity to overall portfolios
  - Access to a unique set of issues/issuers that could not otherwise be sourced
    - Structured deals for public bond issuers (e.g., CTLs, project finance, etc.)
    - Niche business sector and foreign-based opportunities

- **Structuring Flexibility**
  - Permits best asset-liability portfolio management
  - Multi-tranched tenors or amortizing bonds for better duration matching
  - Primarily fixed rate with valuable call protection

- **Covenant Protections**
  - Provide early warning signs of declining performance; guard against event risk
  - Key aspect of long-term lending and relative illiquidity of asset class

Investor Motivations for Lending into the Private Placement Market (cont'd)

- **Favorable Loss Experience**
  - Priority debt restrictions reduce risk of structural subordination
  - Average recoveries have been favorable relative to public asset classes

- **Relationship Investing**
  - Enhanced assess to management leads to stronger credit knowledge
  - Efficient refinance and add-on opportunities

- **Yield Enhancement Versus Public Asset Classes**
  - Illiquidity premium
  - Added credit spread for structural complexities

Private Placement Transaction Timeline (Direct vs. Agented)

Week	Directly Placed	Agented*
1	• Perform initial diligence and credit work • Prepare summary term sheet	• Begin drafting offering memorandum (“OM”) • Start pre-documentation of Note Purchase Agreement (“NPA”)
2 - 3	• Receive credit approval • Agree on pricing and terms • **Set coupon** (“circle” a rate)	• Continue drafting of OM and NPA • Begin drafting roadshow presentation • Finalize OM, pre-documented NPA and roadshow presentation
4 - 5	• Conduct in-person due diligence • Review legal documentation	• Launch transaction • Field investor questions (while “in-market”) • Receive bids; allocate investors; **set coupon**
6	• **Close and fund**	• On-site group due diligence
7		• Finalize legal documentation • **Close and fund**
Post-Close	• **Single point of contact** for communication, e.g., compliance certificates, NPA modifications	• **Multiple points of contact**

**Repeat issuers and public filers can expedite timeline*.

Post-Close Issuer/Investor Relationship

- **Not "high-maintenance" – the issuer generally sets the tone**
  - Buy-and-hold investor philosophy
  - Typically less interaction than with bank group (private placement lenders not seeking ancillary business)

- **Examples of contact**
  - Delivery of quarterly and annual covenant compliance certificates and financials
  - Annual lenders' meetings or update calls (optional)
  - Event-driven updates
  - Amendments/modifications to the NPA
  - NAIC appeals participation

In general, issuers find that a greater level of contact leads to more efficient execution of add-on financings and/or amendments

The NAIC and its Ratings

- **NAIC (National Association of Insurance Commissioners)**
  - U.S. regulatory support organization
  - Governed by chief regulators from the 50 states
- **SVO (Securities Valuation Office)**
  - NAIC branch
  - Responsible for credit quality assessment of securities owned by state-regulated insurance companies
- **Ratings**
  - Govern insurance company capital reserve requirements
  - Material jump in capital charge from "2" to "3" rating

NAIC Rating	S&P Equivalent
1 (+/=/-)	A- or better
2 (+/=/-)	BBB+ to BBB-
3 (+/=/-)	BB+ to BB-
4 (+/=/-)	B+ to B-
5 (+/=/-)	CCC+ to CCC-
6	CC, C, D

The NAIC Ratings Process

- **Initial Rating**
  - Occurs post-close
  - Lead investor submits appropriate documentation (audits, NPA, etc.)
  - SVO analyst evaluates and submits credit quality recommendation to Committee
  - Could take up to 12 months
  - Pre-ratings are possible but rare
  - Issue can be filing exempt if rated by a rating agency (i.e. S&P, Moody's, Fitch)

- **Annual Updates**
  - Ratings updated/confirmed annually
  - Investors file issuer's audits

- **Ratings Appeals**
  - Investor-sponsored
  - Issuer participation

Private Placement Investors

- Primarily U.S. life insurance companies (roughly 40 active accounts) that require long-term assets to match their liabilities
- The five largest account for more than 50% of annual purchases, as buying power is heavily weighted at the top end
- Most invest through agented transactions. The top three, and a growing number of other buyers, also actively invest directly with issuers (as sole investors or via direct clubs)
- Almost exclusively buy and hold in nature; a small secondary market does exist, which is primarily utilized to add/reduce a single-name exposure or to adjust portfolio duration, mix, etc.

Top Private Placement Investors

2010

	Investor	Total
1	MetLife	$9.92B
2	Prudential Capital	9.86
3	New York Life	4.39
4	Babson Capital	3.57
5	Sun Life	3.17
6	Northwestern Mutual	2.82
7	John Hancock	2.81
8	Aviva Investors	2.18
9	Delaware	2.09
10	Mutual of Omaha	1.20

2011

	Investor	Total
1	Prudential Capital	$9.60B
2	MetLife	8.70
3	Northwestern Mutual	4.51
4	New York Life	4.30
5	Sun Life	4.28
6	Babson Capital	3.10
7	ING	2.93
8	Aviva Investors	1.98
9	John Hancock	1.91
10	Delaware	1.29

2012

	Investor	Total
1	Prudential Capital	$9.54B
2	MetLife	8.14
3	New York Life	4.31
4	Sun Life	4.03
5	Northwestern Mutual	3.99
6	Delaware	2.82
7	Aviva Investors	2.03
8	ING	1.77
9	Mutual of Omaha	1.14
10	Hartford	0.99

Source: The Private Placement Letter.

Motivations for Issuing Direct

- **No agent fees/expenses**
- **Ancillary business not expected**
- **Speed and ease of process – preserving management's time**
  - No marketing phase
  - Offering materials not required
  - Due diligence with a single party
- **Execution risk negated – working one-on-one with a relationship focused investor**
- **Confidentiality maintained – for private as well as public issuers**

Motivations for Issuing Direct (cont'd)

- **Competitive pricing – ability to secure large investment amount ("bite size") may drive aggressive bids from potential lender(s)**
- **Access to significant capital (in excess of $500 million) through club-like transactions**
- **Single or club-like point of contact post-close**
- **Streamlined access to funds via Shelf facilities**
- **Knowing your capital provider(s)**
  - Direct lenders are active stakeholders, looking to build strong, long-term relationships with management over the course of multiple business cycles
  - Investors in agented transactions might be passive participants

Benefits of Direct Issuance for the Investor

- **Securing the preferred investment amount, as allocations associated with agented transactions can be a fraction of desired hold size**
- **Growing portfolio size in a favored asset class**
- **Enhancing issuer/lender relationship for future financing opportunities**

Shelf Note Facility

- **Uncommitted instrument that enables swift access to long-term debt capital**
- **Credit underwriting and legal docs finalized in advance of borrowing needs**
- **Interest rate can be set in 24 to 48 hours of pricing request and funds can be provided to issuer within five business days**
- **Multiple draws can be made over Shelf's life (with various tenors and structures)**

Establish
$150 million
3-year Shelf

- Make initial $50 million draw of 7-year notes to refinance maturing debt
- $100 million capacity remains

Future draw(s)

- 9 months following Shelf close
- Draw remaining $100 million in 10-year notes to fund bolt-on acquisition

Private Placement League Tables

2012 Traditional Domestic Debt Private Placements
Proportional Credit to each Agent ($ in millions)

	Institution	Volume	# Deals	Share
1	BAML	$6,356.6	37	27.3%
2	JPMorgan	4,549.1	28	19.5%
3	Wells Fargo	3,065.0	28	13.2%
4	Citi	1,634.5	12	7.0%
5	Morgan Stanley	1,602.0	9	6.9%
6	Barclays	1,014.5	7	4.4%
7	US Bank	846.2	13	3.6%
8	KeyBank	642.8	9	2.8%
9	Mitsubishi-UFJ	637.5	5	2.7%
10	RBS	559.2	5	2.4%

2012 Traditional Global Debt Private Placements
Proportional Credit to each Agent ($ in millions)

	Institution	Volume	# Deals	Share
1	BAML	$10,525.6	61	19.7%
2	JPMorgan	7,707.2	40	12.9%
3	RBS	5,375.7	35	11.3%
4	Wells Fargo	3,193.3	30	9.7%
5	Citi	5,303.6	25	8.1%
6	Barclays	3,477.6	23	7.4%
7	HSBC	2,418.6	15	4.9%
8	US Bank	879.2	15	4.9%
9	RBC	1,881.2	13	4.2%
10	Morgan Stanley	2,217.0	11	3.6%

Source: Thomson Reuters and Wells Fargo Securities.

Motivations for Issuing Through a Bank Intermediary

- **Competitive bid process should lead to lowest coupon and most issuer-friendly structure (i.e. fewer/looser covenants)**
- **Agent fees can be more than off-set through lower coupons when amortized over life of issue**
- **Opportunity to provide fee-based business to credit line bank to strengthen relationship**
- **Diversity of end investors: reduces refinancing risk from having dominant position with one institution**
- **Some direct investors require own document; could give investors overly strong influence in compliance breach or recapitalization**
- **Can set up "market shelf" allowing the issuer to quickly tap the market for additional issuance with multiple investors**

Q & A

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