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US private placements find broadening appeal

Alexander Alston
Co-Head of Private Placements
Macquarie Investment Management, Americas

Frank G. LaTorraca
Co-Head of Private Placements
Macquarie Investment Management, Americas

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Large life insurers have a long history of accessing the US private placement market, as these securities have characteristics well suited to insurers' investment programs — characteristics including incremental yield, diversification benefits, capital efficiency, and structural protections that enhance recoveries. A stubbornly low yield environment and increased regulatory demands have compounded the challenges of insurance investment firms, and prudent investors are increasingly cautious nearly a decade after the global financial crisis.

Life insurers grappling with these challenges have found it increasingly difficult to effectively manage assets to meet the future funding requirements of their liabilities. In light of the current economic environment, larger insurers have been increasing their allocations to private placement debt. Private placements currently average 30% of US life insurers' bond allocations, while offshore and other types of insurers have also been considering adding privately placed debt (classified as all nonpublic debt) to complement traditional investment grade public debt in their fixed income allocations.

2017 through the rearview mirror

The US private placement market had a record year in 2017, with volume reaching $US66.2 billion, up 29% from 2016. Despite strong supply growth, demand continued to outpace supply, making "oversubscriptions" a reverberating theme. This was largely driven by an increased allocation to private debt by the traditional US life insurer investor base and by increased interest from offshore insurers and pension managers willing to sell liquidity in search of yield and structural protections (given the age of the current credit cycle). Strong demand growth compressed spreads a bit, with new investors typically accessing the market through the incumbent life insurance companies. This helped maintain the general homogeneity of the investor base, and resulted in ongoing covenant and structure discipline, despite erosion in the high yield and leveraged lending (private) markets.

Approximately 28% of issuance was rated A- or higher in credit quality, with spreads that ranged from 80 to 155 basis points, and 71% of issuance was the equivalent of some form of BBB, with spreads ranging from 100 to 335 basis points. Less than 1% of issuance was below investment grade. While US-domiciled companies were responsible for 38% of 2017 volume issuance, US dollar-denominated issuance comprised 75% of the market volume. Euro and pound sterling issuance each accounted for 10%.

Borrowers continued to capitalize on the flexibility afforded by the market, with $US19 billion of issuance subject to delayed funding, ranging from three months to a full year in some instances. Issuance was spread broadly across sectors, and infrastructure transactions accounted for 10% of market volume. The bid for infrastructure deals outpaced supply at a greater pace than corporate deals, due to slightly higher yields, the perceived safety of real assets, and more nontraditional US private placement investors tapping the market for infrastructure exposure. There was also a strong bid for utilities, social housing, and education deals, all of which typically offer significant duration.

A look ahead

Despite strong growth in the asset class, the supply of transactions has been no match for the growth in demand for US private placement assets. The technical imbalance has resulted in frequent market oversubscription, with some deals three to four times oversubscribed. Against this backdrop, the reduction of the US corporate tax rate is expected to dampen domestic issuance in both the public and private bond markets, further exacerbating the supply-demand imbalance. In this environment of already oversubscribed deals, strong agent relationships matter more than ever in building an allocation to private placements. Agents don't need to show most deals to the entire market in order to garner sufficient bids and fill out their books. And for broadly syndicated deals, the differences between favorable and unfavorable allocations can be meaningful.

Finally, if it truly is becoming less of a "Goldilocks" environment (as some members of our global fixed income team suggested in their commentary, Has Goldilocks left the building?), then central banks' removal of accommodative policy may spur rate increases. In the near term, we would expect an acceleration in issuance in response, as companies race to lock in lower funding costs, which should in turn dampen the technical imbalance. In the medium term, increased borrowing costs could be a precursor to negative migration in credit markets, given that investment grade corporate issuers in general finished 2017 with nearly three times leverage on their balance sheets, having borrowed extensively in the low rate environment. In response, we would expect to see a widening of credit spreads and a rash of ancillary fee income from the structural protections inherent to the US private placement market that allow investors to reprice risk.

Ultimately, we expect the US private placement market to continue its controlled growth on the supply side, moderated by the structural discipline of industry incumbents. Spreads will continue to ebb and flow with the credit cycle, similar to the experience of public credit markets. Interest from nontraditional investors that have not yet accessed the market may wane if a "Goldilocks exit" increases global yields, but we expect strong demand to continue from the incumbent investor base, as well as from new investors that have gotten a taste of the benefits afforded by the US private placement market.

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Contact us by region

Americas

Market Street
Philadelphia
215 255 1200
mim.americas@macquarie.com

Australia

Martin Place
Sydney
1800 814523
mim@macquarie.com

Europe/Middle East/Africa

Ropemaker Place
London
44 020 303 72049
mim.emea@macquarie.com

Asia

Harbor View
Hong Kong
852 3922 1256
macquarie.funds.hk@macquarie.com

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