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Private Placements: Aiming for Greater Yields, Downside Protection and Customized Cash Flows

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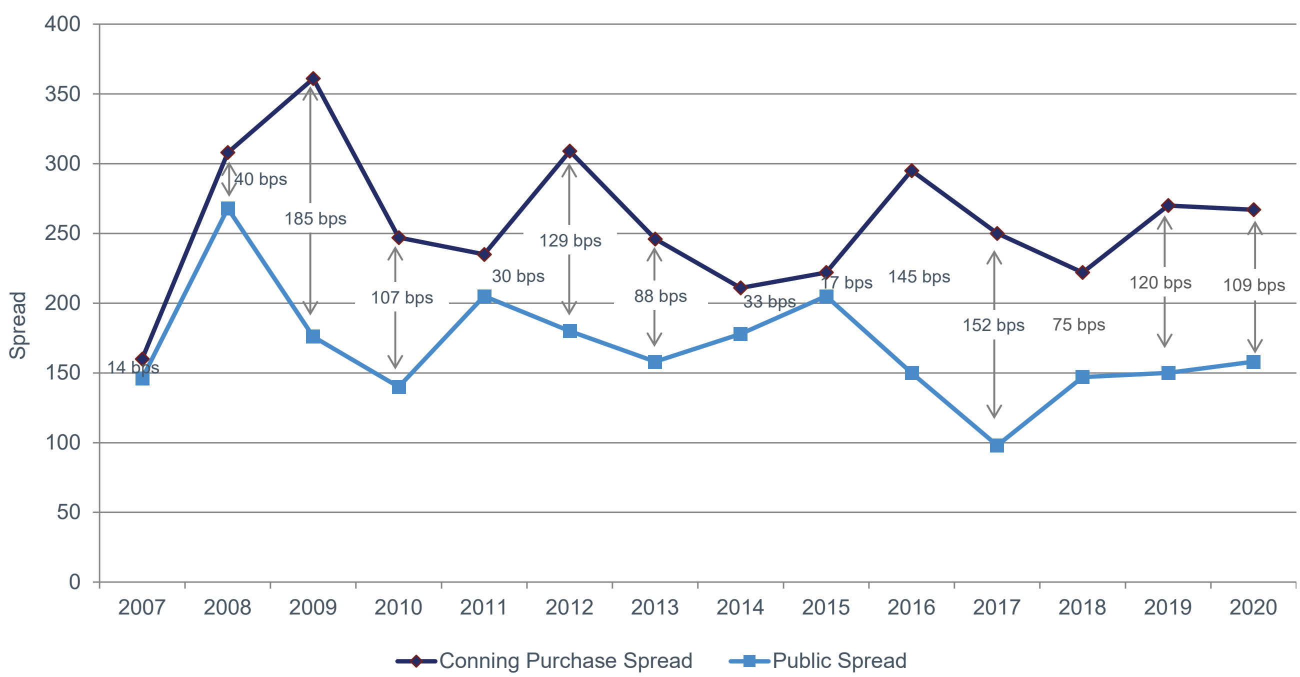
Private placement securities may provide attractive opportunities for insurance companies to enhance portfolio income in a continued low-rate environment.[1] They are typically rated investment grade and may provide higher yields and stronger investor protections than are available on public securities with similar ratings and maturities.

Private placements are typically illiquid, but many insurers may be able to trade some of their current portfolio liquidity to potentially capture additional yield. Larger insurers generally have greater exposure to this sector and have effectively addressed liquidity issues. Small- to mid-sized insurers may be able to leverage opportunities in private placements by working with investment managers that can help them assess their liquidity needs and have the requisite experience, capabilities and access to deal flow.

Private placements offer a much broader range of maturities than are normally available in public debt, which may enable insurers to customize maturities to match their liabilities. In addition, this sector may be able to provide portfolio diversification, as it includes both U.S. and non-domestic issuers who generally are not active in U.S. public debt markets.

Figure 1 Private Placement Yield Premium vs Corporate Bond, 2007-2020

Difference in yields of private placement securities versus similarly rated corporate bonds at Conning's time of purchase.



As of December 31, 2020.*Past performance is not a guarantee of future results Chart represents average data for all private placement bonds Conning purchased from 2007 through September 2020, including two 144A securities purchased in 2010. Prepared by Conning, Inc. Source: Bloomberg Index Services Limited. Used with permission. Bloomberg is a trademark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Barclays is a trademark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Neither Bloomberg nor Barclays approves this material, guarantees the accuracy of any information herein, or makes any warranty as to the results to be obtained therefrom, and neither shall have any liability for injury or damages arising in connection therewith.

Factors Driving Greater Yield

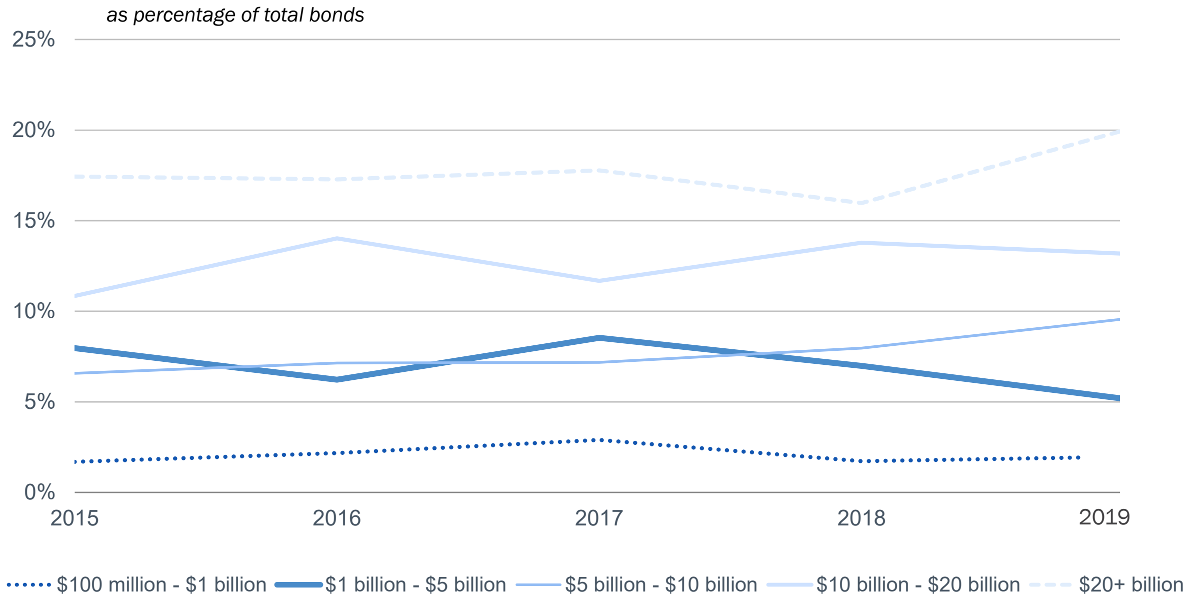
The potential yield advantage for private placements versus public issues of similar quality and duration is often between 10 and 40 basis points for more traditional issues and even higher for more complex securities (see Figure 1). The vast majority of issuance is investment grade and tends to come from traditional groups such as industrials, financials and utilities, making the sector more palatable to many insurers.

The yield premium compensates investors for several factors. One is liquidity, as private placements trade infrequently. While each insurer must consider its own liquidity needs, an experienced risk management team can help insurers analyze, model and stress-test their liquidity position to see if their balance sheet can sustain an allocation to less liquid securities.

Another factor is the greater complexity in private placement issues, which generally require more sophisticated analysis than is necessary to invest in public securities. Private placement securities are not SEC-registered and therefore do not require standard SEC-required disclosures. Some private issuance may also involve off-balance-sheet transactions such as special purpose vehicles (SPVs), which cannot be issued in public markets.

Issuers may turn to the private market for a variety of reasons, including a desire to avoid SEC registration. Marketing SEC-registered securities can slow an issuer's time to market. Issuers may also prefer to keep details of their business private rather than release information as required in SEC registration. As one example, professional sports leagues that may want to protect their financial and business strategy details from athletes and fans often issue through private placements. Issuer information is protected during the marketing phase as non-disclosure agreements are de rigueur.

Figure 2 Private Placement Bond Allocation by Size of Life Insurer



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Investor Protections via Covenants

When public bond investors are unhappy with a poorly performing security, their main recourse is to sell. However, private placement issuance includes covenants, which usually place investors as first-lien creditors on equal footing (i.e., "pari passu") with the issuer's banks.

Covenants provide investors safeguards when private placement securities underperform or are at risk of default, preventing issuers from taking steps that may dilute company assets such as adding additional leverage, stripping company assets and buying back stock. Investors have access (if not established relationships) with the issuer's management team which may shed additional light on performance issues and help facilitate additional negotiations regarding investor protections if needed.

Covenants are designed to:

- Protect against future actions by borrowers that introduce significant additional risk
- Afford a “seat at the table” for lenders if the borrower’s performance deteriorates substantially
- Provide potentially better default experience and recovery performance
- Protect against event risk through change-in-control puts or restrictions on leverage.

Customizing Cash Flows to Liabilities

A common misperception of private placements is that they mainly feature long maturities and they are assets better suited to the needs of life insurance companies than those with shorter-dated liabilities.

However, the private placement market is very active in a wide variety of maturities, including shorter maturities. The range of available maturities is also much broader than the five-, 10-, 15-year maturities commonly found in public issuance. Insurers can often find specific maturities to match their unique liability needs (e.g., an eight-year maturity issuance for an eight-year liability).

Investing Like a Large Insurer

The largest U.S. insurers tend to be more active in private placement investing than smaller firms. Insurers with $20 billion or more in assets had 20% of their total bond allocation in private placement securities as of year-end 2019; every other size category had less than 15% of their portfolio invested in private placements and their exposure generally declined as insurers’ investable asset size became smaller (see Figure 2).

While larger insurers may have the necessary resources and liquidity appetite to successfully invest in private placements directly, smaller insurers may find the help they need by working with an experienced asset manager. Not all managers are equal, though. Insurers may wish to consider these factors when considering candidates:

- **Access to Deal Flow:** The private placement market is heavily relationship-driven and some managers may have long, deep relationships with issuers and dealers. While the market is small compared to the public bond market, there is still a great deal of private issuance and insurers will want access to as many deals as possible to find the appropriate securities to meet their needs.

- **Disciplined Investment Process:** The lack of SEC-required disclosures highlights the value of a disciplined investment process in helping private placement managers assess issuance. Analysis of fundamentals as well as relative value, legal review of securities, investment committee review and ongoing monitoring are among the critical factors investors may wish to ensure are part of a manager’s process.

- **Experienced Team:** On top of relationships and a disciplined process, there is no substitute for experience. Private placement investing offers many challenges and experience in the market can be essential to help properly assess securities and the management of issuers.

- **A Manager Focused on Your Needs:** Private placement investing should start with a careful understanding of an investor’s needs. Knowing investor needs and risk tolerance helps drive a manager’s initial assessment of where to look for the proper fit by industry, issuer, structure, pricing and geography. Investors should be able to count on a manager to sift through all private issuance and deliver a solution that, regardless of size or duration, can work as a core asset in an investor’s portfolio until maturity.

Incremental income from assets like private placements can offer meaningful value to insurers’ portfolios. With their potentially greater downside protection and flexibility that enables insurers to customize cash flows to match liabilities, private placements may be a good choice for consideration in insurers’ bond portfolios.

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About Conning

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

Disclosures:

Past performance is not a guarantee, predictor or indication of future results. Similar investments likely would produce different results under different economic and market conditions.

Footnote:

[1] Insurers must be qualified institutional buyers with at least $100 million in assets under management to invest in private placements.

Additional Source Information:

Risks:

Market Risk – Market, or systematic, risk is the risk that individual securities may be correlated with general market downturns regardless of the particular business conditions and outlook for the individual companies

Credit Risk – Eroding fiscal health in issuing companies resulting in inability to meet debt obligations

Inflation Risk – Inflation erodes the purchasing power of future cash flows from investments. In times of high inflation the value of securities may be reduced

Liquidity Risk – Liquidity risk can occur when market conditions do not allow transactions to be made in a quick and orderly fashion in relation to indicative market prices

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