PRIVATE DEBT MARKETS
USPPs, Schuldscheine, Euro PPs, Unitranche, Direct Lending, Unrated Bonds, MTNs, Regulation
April 2018
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The most active player in EUR Bonds
EMEA Bookrunner Ranking, 2012 – 2017

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1Source: Dealogic; cumulative data (2012 – 17 ranking) 1 Jan 2012 – 31 Dec 2017; annual rankings 1 Jan – 31 Dec

2Source: http://www.ifr.com


4Source: http://www.gfmaj.com/awards-rankings

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PRIVATE DEBT MARKETS

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PRIVATE DEBT is a growth market. The asset class has been expanding ever since the financial crisis, and participants expect that to continue.

In the past decade, it has enjoyed a near-perfect set of following winds: banks contracting; companies seeking new sources of funding; and low interest rates driving investors to seek yield, while making it as easy as possible for borrowers to repay.

All good things come to an end. The US Federal Reserve is tightening monetary policy, while the European Central Bank is gradually easing its foot off the accelerator. All big economies are expanding at once, but the bull run in equities is nine years old and benign periods rarely last longer than that. The US stockmarket has fallen 9% since its January peak.

The question for specialists in private debt is: what will happen to their brave, big new market when the financial cycle turns?

“The big test will be, when rates are going up, is the market stable?” says Jürgen Michels, chief economist at BayernLB in Munich. “If it holds, it will be a very popular tool in future as well. The acid test is: does this whole structure hold, and don’t we get a huge amount of defaults?”

The D-word is much used in private debt circles at the moment, because of Carillion, the UK construction group that went into liquidation in January, and Steinhoff, the South African retail empire fighting to stay solvent after its share price collapsed in December amid accounting irregularities.

But so far, the market shows no sign of slowing down. Preqin, the research group, counts $638bn of private debt assets under management globally in June 2017, up from $205bn in December 2007. The asset class is now nearly a quarter as large as private equity, having been only a seventh as large on the eve of the crisis.

The money is accumulating fast: private debt funds raised $107bn in 2017, and more than a third of all the capital has not yet been invested.

But private debt is not one market: it is many. Preqin tracks five types: direct lending, mezzanine, distressed debt, special situations and venture debt. But these do not include swathes of other lending. The US private placement market and Germany’s Schuld­schein, traditionally investment grade markets, both scored record issuance in 2017, of $75bn and €27bn.

“This is not a homogeneous market,” says Richard Waddington, head of loan sales and private debt at Commerzbank in London. “There are different elements of the private debt ecosystem. The Schuld­schein and US PP are skirmishing in investment grade territory. The Schuld­schein dips into crossover, then at double-B the Euro PP is active and in the single-B space you’ve got unitranche and direct lending.”

Fresh pastures

Beyond those, European insurance companies and asset managers are exploring many other new niches in search of attractive assets.

“The world has always divided into what banks will do and what they won’t,” says Andrew McCullagh, head of origination at Hayfin Capital Management, one of the early movers into the direct lending market that sprang up after the crisis in 2009.

When banks are eager to do a particular kind of lending, their capital structures and economies of scale often mean they can beat institutional lenders. But the combination of Basel II, the crisis and then Basel III meant banks pulled back from many kinds of financing they had dominated before 2008.

When it came to smaller and more leveraged corporate loans, says McCullagh, in 2009 “banks were being very cookie-cutter. Anything north of 3.5 times leveraged, or outside their geographical target area, or wanting flexibility around documents, they were not interested. So you could be thoughtful and have a competitive advantage.”

M&G Investments, which had been the first European investor to join the US PP market in 1997, expanded into direct lending at the same point.

“I don’t think money is going to disappear. The demand will remain but there will be a repricing of risk”

Richard Waddington, Commerzbank

But, fortunately for the European economy, banks — at different speeds in different countries and asset classes — have been recovering their appetite for credit.

Straightforward corporate loans, especially investment grade ones, were the first asset they took back. That meant the swelling direct lending market became what William Nicoll, co-head of alternative credit at M&G in London, calls “very much a high yield market, with no particular norms of documentation.”

Direct lending now typically refers to deals of £20m–£300m at leverage of three to five times Ebitda, to companies with Ebitda of £15m to £60m.

Specialist funds have raised so much money that the competition has become intense. Banks are fighting to get into deals, too, especially in Germany, the Benelux and France.

McCullagh dates to around 2013 the time when “most banks across Europe began to stop worrying about whether they had enough regulatory capital to...
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survive and more about making money”.

M&G and Hayfin are still interested in vanilla direct lending, but both have cast their nets wider.

“I never want to be in a fashionable market, because that’s an awful thing,” says Nicoll. M&G has cut back on seeking new money to invest in direct lending and instead is originating deals in less crowded areas, such as leasing and trade receivables factoring, usually partnering with independent finance companies. Nicoll says banks can no longer be bothered to spend months structuring complex deals, opening a space for the skilled and patient investor.

Hayfin has diversified into shipping loans, non-performing consumer debt, niche real estate portfolios, some tranches of securitizations and financing companies’ inventory. It even has a strategy focused on the healthcare industry.

**Change is coming**

When the interest rate and economic cycles turn, these many kinds of private debt are not all going to perform in the same way. The first challenge will be the withdrawal of ECB stimulus, expected by the end of this year, and likely to affect all credit markets.

“It will change to a buyer’s market,” says Thomas Leicher, head of capital markets at Helaba in Frankfurt. “Credit spreads will widen and issuers may be more reluctant to borrow money.”

Could investors that began exploring private debt when yield drained from public bonds turn away again?

“No one is quite sure how institutional demand is going to play out,” says Waddington. “I don’t think money is going to disappear. Clearly some will, but the products are embedded — people like them. It’s likely that as one of the biggest buyers is removed, there’ll be a normalisation of credit spreads and rates. The demand will remain but there will be a repricing of risk.”

The pain is likely to come later, when the economy slows and higher rates become hard for weaker firms to bear.

Parts of the market, notably the US PP and Schuldschein, have borrowers of mostly high credit quality and have been through many recessions before. Specialists in these markets are quite calm about the prospect of the next downturn. “We try to do everything to make sure we have high quality issuers, with the same quality as in the past,” says Jörg Senger, global head of sales and origination at BayernLB in Munich.

“So we are focusing on midsize and big companies. When SMEs try to tap the market we have to do due diligence. My feeling is the clients we reject usually don’t come to the market with another bank.”

Because of their confidence about the credit cycle, the US PP and Schuldschein markets are more focused on the processes that could make them more efficient and enable them to attract even more deals.

In the US PP market, recalibrated risk charges from insurance regulator the NAIC could improve the incentives for lending to companies of slightly lower credit quality.

Meanwhile, a clutch of second tier investors are starting to ape the biggest buyers by learning to engage in currency swaps, meaning that even though they only manage dollars, they can lend to European companies in euros or sterling.

The Schuldschein market is wrestling with how to bring itself up to date, without losing its old-fashioned virtues: very light, flexible documentation, a large number of small investors and careful gate-keeping of credit quality by the arranging banks.

“The number of companies that will use the Schuldschein will increase, because they are moving from bilateral credit to the capital markets,” says Leicher. “What you need to accommodate this is platforms, digitalisation of the process, so that you can reduce the cost and therefore place Schuldscheine for smaller sizes, like €20m.”

Helaba has launched a new platform, open to all dealers, investors and issuers, so that all documents can be shared and signed online, and the book can be built there.

Rudolf Bayer, head of private placements at UniCredit in Munich, says: “In the bond market we have seen a lot of technological development, especially on the administrative side, which has had a positive impact on speed and costs for banks and issuers. It would be a positive development if the Schuldschein also became faster at handling deals for issuers and investors.”

**Down is not out**

For issuers and investors in the more leveraged parts of private debt — including direct lending, which has never been through a credit downcycle — the next recession, when it comes, is bound to cause casualties.

Direct lending borrowers are usually smaller than classical leveraged high yield bonds, which tend to make workouts harder. Direct lenders will often have to negotiate workouts on their own, and may have to bail companies out with more cash.

Direct lending and other kinds of private debt will take some knocks, but they are likely to survive — just as high yield bonds have now weathered two recessions in Europe.

Four things have changed in the debt landscape since 2008 — all fundamental reasons for private debt to exist, which are unlikely to be removed by the next crisis.

Savings allocated to credit continue to rise. Meanwhile, liquidity has declined in public markets, so the sacrifice made by investors switching to illiquid credit is less.

The sophistication and knowledge of corporate treasurers has greatly increased. “We have just done a marketing roadshow to Asia where we spoke to potential issuers,” says Senger. “I was really surprised how deep the knowledge was already and how eager they were to tap the market.”

Finally, the stricter regulation and more conservative balance sheets for banks are not going away, so there is likely to be room for institutions to lend for a long time to come.

“In the long term,” says McCullagh, “this is an asset class that will deliver good premium, low volatility, sensible cash yield to investors and is here to stay.”

**Table:** Investors want more private debt

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<th>Investors’ allocation plans (%) of investors</th>
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Source: Preqin
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For further information please contact
Paul Kuhn, Head of DCM Origination Corporates  
Phone: +49 89 2171-25756, paul.kuhn@bayernlb.de  
BayernLB, Brienner Strasse 18, 80333 Muenchen
» www.bayernlb.com
Schuldschein tries to keep old virtues but embrace the future

The Schuldschein market has broken into unknown territory, welcoming borrowers and lenders from far-flung lands, while establishing itself as a hotbed for technological advancement. Can the miracle last? Silas Brown reports.

THE SCHULDSCHEIN is shedding its old skin. Once an austere and staid German market, it has shown a remarkable ability to adapt to borrowers’ needs. It has grabbed the attention of European corporate finance and racked up over €27bn of issuance in 2017, from 150 borrowers.

Participants believe the enticing mix of tight margins, lean documentation and tenor variety the Schuldschein can offer has worldwide appeal.

Technology can help the instrument clean up inefficiencies of process, which will help it expand to issuers across Europe, Asia and North America.

Seeking tech breakthroughs
Almost all see technology as one of the keys to the growth of the Schuldschein market, but some believe it is the paramount factor.

“There are many efficiencies to work on in the Schuldschein market, which could drive down costs for arrangers, issuers and investors and open up the market much further,” says Paul Kuhn, head of debt capital markets origination at BayernLB in Munich.

In June last year the market hosted its first Schuldschein using blockchain technology, issued by Daimler for €100m via Landesbank Baden-Württemberg. Origination, distribution, allocation and execution were conducted electronically through software provided by Targens and TSS, LBBW and Daimler’s IT systems.

The deal was sold to German savings banks Kreissparkasse Esslingen-Nürtingen, Kreissparkasse Ludwigsburg and Kreissparkasse Ostalb. This was a surprise to some, who felt this sort of bank might be too traditional to be receptive to technological developments in the instrument.

But the lender base has been receptive to new ideas, and arrangers are energised by this.

“Blockchain technology will change the role of banks as intermediaries in the economic process. We don’t want to merely observe this development; we want to proactively shape this field,” said Joachim Erdle, head of corporate finance at LBBW, in a statement.

Telefonica Deutschland followed in January, launching a €200m Schuldschein, which included a €50m one year tranche using blockchain technology, also led by LBBW.

“I compare the situation around blockchain with the internet when it started,” says Albert Graf, Telefonica Deutschland’s director of corporate finance.

“It [blockchain] will disrupt this world — and instead of reading about it, or thinking about it, we’re acting on it.”

Blockchain might cut costs for distribution, but there are more prominent inefficiencies that a distributed ledger could not solve. So some question whether introducing blockchain goes far enough.

“LBBW’s attempt was a pioneering effort, but it was very much the first step,” says one arranger from a rival bank. “There is still a long way to go — and actually, the real cost and time is in the process of the Schuldschein, not in merely the distribution.”

Although the marketing period for a Schuldschein is lengthy, between four and six weeks typically, there is some sense to this. As three quarters of the borrowers entering the market are unrated, serious credit work is required to determine whether the issuer is a worthwhile investment. So the market could not function effectively if it did not give investors adequate time.

Costs in the Schuldschein market are largely beyond what blockchain technology can undercut. There are legal costs and bank fees for issuers, and for investors and arrangers there is a lot of time spent negotiating pricing over phones and emails. This is where proper efficiency gains can be made, and there are other schemes attempting to provide answers to those.

Putting everyone together
Helaba and VC Trade launched a digital platform for Schuldschein issuance in mid-March, designed to cut costs for arrangers, issuers and investors alike, while making the market more transparent.

“This software will oversee the whole process between issuers and investors, and will make the Schuldschein market much more efficient and transparent,” says Andreas Petrie, head of primary markets at Helaba in Frankfurt.

The software is open to all Schuldschein participants. It is meant to carry a Schuldschein transaction from negotiation through pricing and allocation all the way to settlement.

This could reduce the labour and cost of issuance for participants by up to 40%, says one banker involved in the launch, and perhaps provide some compensation for arrangers’ falling fees.

This in turn could make the mar-
SCHULDSCHEIN: OVERVIEW

ket more accessible to smaller issuers, which either cannot afford the fees, or struggle to find an arranger willing to put in the effort to bring them to market.

“No one wants to bring smaller issues of €10m-€20m to the market, as there’s not enough money in it,” says one Schuldschein banker in Frankfurt. “But if the software could dramatically cut the costs of issuance, and arranging that issuance, the market could open for smaller issuers.”

Helaba is in close contact with issuers and investors, which are set to begin using the platform shortly. “I had a quick look in my inbox [an hour after the launch] and there is already substantial interest from institutional investors looking for access,” says Stefan Fromme, co-founder of VC Trade.

Of course, the platform becomes more interesting the more widespread its use, but the participants seem highly confident of its success. “We expect the system might have 80%-90% of the market using it by the end of 2019,” says one banker involved in the platform. He believes progress towards a comprehensive software is useful for every market participant, and particularly if the Schuldschein market has ambitions to grow across the world.

Asian blueprints
Advances in technology could ease the understanding of the product in Asia, which is where the more ambitious Schuldschein arrangers are looking for new opportunities.

“Is it possible to truly take the instrument to Shanghai, or Tokyo?” asks Helaba’s Andreas Petrie.

“We are in the process of examining taking the product across Asia. We had roadshows in China, Japan and Taiwan for Lufthansa and Trelleborg and over 50 insurance companies and regional banks came.”

The interest in that region was sparked by the influx over the last few years of Asian commercial banks entering the market to diversify and increase their lending in Europe.

Forklift truck maker Kion Group sold nearly €1bn of Schuldschein notes at the beginning of 2017, benefitting from that increasing Asian interest. Commerzbank, HSBC and LBBW offered investors tenors of five, seven and 10 years, at fixed and floating rates, and Asian commercial banks’ European offices pushed the transaction to €958m. But the real growth lies in Asian lenders without such worldwide presences.

“What we are trying to do is not just sell to Asian offices in Paris or London, but selling in different non-European jurisdictions across the world,” says Petrie.

“This raises different questions around tax and legal documentation that have not been fully explored yet. That could be the next big growth for the market.”

If these investors are found to be good candidates to buy Schuldscheines, this could be the next long term milestone for the instrument, and draw it that much further from its German roots.

In the meantime, however, the German arranging banks are looking north for growth.

Can you see the Northern lights?
Nordic issuers are ahead in this respect. The region is proving fertile ground to find new borrowers for the Schuldschein market, as originators notice that local bank lenders are not providing tight margins to local borrowers, and Schuldschein investors are becoming more interested in diversifying their portfolios to that region.

“There is room for arbitrage in the Nordics, and we can compete with the local banks on price,” says Kuhn. But the test will be whether arrangers can entice the broadest range of Schuldschein lenders to invest in Nordic borrowers.

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The Schuldschein’s growing internationalism

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Source: Helaba
Schuldschein: no country for old men

The Schuldschein market attracts a diverse mix of investors, with different tastes and needs. Amid the push and pull of a burgeoning market, the burning question is whether each of these differing characters will remain content — or whether some may get pushed out, as the market develops and changes shape. Silas Brown reports.

SOME SCHULDSCHEIN investors still remember the good old days, when only German borrowers from the industrial heartlands would find a way to their desks. It was a local market for local companies, supported exclusively by local investors.

But that is changing — fast. Last year, for example, borrowers from as far afield as the US and Russia flocked to the market. “Last year was a new record in terms of volume, but it was less dominated by benchmark sizes,” says Rudolf Bayer, head of institutional investor reports.

“Average volume was down but the number of deals was significantly up”. Some are finding it hard to adjust to this racier pace of life. There was a moment in June last year when 26 borrowers were courting investors — a staggering figure for an older generation of investors, more used to dealing with that number over the course of a year.

Some smaller savings and co-operative banks are struggling to cope with the dealflow to the extent that they are asking arrangers to slow down.

“We don’t want to be forced to choose between one issuer or another because we don’t have the time to look at both,” says one investor from a co-operative bank.

But new types of investors are arriving, including European and Asian commercial banks, more used to the cut and thrust of capital markets. They are multiplying in number and appetite to the extent that they rival the Sparkassen for market dominance. They are bringing with them customs not seen in the Schuldschein market before. Deals can be oversubscribed in a matter of days, as investors place soft orders before analysing a borrower’s credit quality, to be sure of a stake in the final placement.

Process machinery firm Andritz launched a €200m Schuldschein in May that was oversubscribed in four days. It doubled to €400m, with the seven and 10 year tranches priced at the tight ends of margin ranges of 100bp-120bp and 120bp-140bp over Euribor. It took a mere day for car parts maker Hirschvogel’s €100m deal to be fully subscribed. Seven and 10 year tenors were sold at the tight ends of the 90bp-110bp and 110bp-130bp ranges.

Institutions squeezed
Borrowers hold the whip hand in the Schuldschein market. Any investor prepared to relax covenants or make concessions on margins is instantly popular, while the stricter lenders are quickly directed to the back of the queue.

This is particularly true for institutional investors, which are feeling the strain more than banks. Sticklers for financial covenants and minimum margin floors, they used to have one selling point above all else — a willingness to lend at tenors banks would not touch.

But this is changing. Commercial banks, as well as German savings and co-operative banks, are now prepared to buy Schuldscheine with comparable tenors to the institutional investors, at seven, eight or even nine years.

“The maturity advantage that an institutional lender had has gone,” says Thomas Schneider, head of European corporate loans at Allianz Global Investors in Munich.

Bank lenders are also prepared to cede ground on covenants.

“I sympathise with institutional investors that would like financial covenants if they lend for longer tenors,” says Richard Waddington, head of loan sales and private debt at Commerzbank in London. “The institutional lenders must offer something that other investors can’t.” They are at least trying to.

Some large institutional investors including AllianzGI, Talanx and VKB have set up a working group to carve out a niche for themselves in the Schuldschein market. They want to lend to premium, or unquestionably investment grade, borrowers. Their offer to issuers will be similar to the pitch investors in Euro private placements make; fewer investors, offering larger tickets and confidentiality, in exchange for higher yields and financial covenants.

“We know there’s corporate appetite for this sort of arrangement,” says one institutional lender. “And the other institutions are on the same page, too.”

No favours
Others have yet to be convinced borrowers will be interested in an institutional premium Schuldschein market.

“Ultimately, it’s a seller’s market, and most of those sellers are interested in lower margins and few covenants — it’s as simple as that,” says one Schuldschein banker.

But this seller’s market could
change if covenants and margins fall too far. Eventually, resistance will be felt. And there are signs, albeit tentative, that investors are beginning to dig their heels in.

Telefonica Deutschland was forced in late January to issue a second round of price guidance on its €150m Schuldschein issue, after investors’ appetite turned out weaker than expected.

The arrangers, DZ Bank and LBBW, launched it with margin ranges of 55bp-65bp, 70bp-80bp, 80bp-90bp and 90bp-100bp over Euribor, for seven, 10, 12 and 15 year tranches.

One German investor said: “I saw Telefonica offering 55bp for a seven year tranche and I thought, ‘Forget it.’” This was a view widely held by investors and rival arrangers alike.

“Our jaws dropped when that pricing came out — we certainly weren’t [pricing Telefonica] at that level,” said an arranger at a rival bank. After feeling the coolness of the reception, the leads published new guidance at the wide ends of the ranges: 65bp, 80bp, 90bp and 100bp.

But pricing wasn’t the only reason why the deal initially struggled. Porsche and Rewe, considered quite similar to Telefonica Deutschland among Schuldschein lenders, despite their very different industries, were marketing at the same time, and some felt investors already had enough on their plate.

“‘It’s hard to say whether we’ve reached a pricing floor, but the market is certainly a little overheated,” says one Schuldschein banker.

Some investors even say ultra-tight pricing is a bigger reason for downsizing their activities than credit problems such as those at Steinhoff and Carillion, both recent Schuldschein issuers.

**Default response**

Just six months after BayernLB and HSBC had brought Carillion to the Schuldschein market for the first time, the UK construction and support services group lost 70% of its stockmarket value in July last year, after declaring an £845m provision against bad contracts.

By January 15 it had gone into liquidation after running out of cash, despite being the UK’s second largest construction firm and listed on the London Stock Exchange.

Shares in Steinhoff, the acquisitive South African retail group, plunged in early December and roughly 100 lenders were stuck with about €630m of Schuldschein debt sold in June 2015.

The question in hushed conversations around Frankfurt was, would Schuldschein investors freeze up after the Steinhoff and Carillion debacles? Many felt investors might call for more financial covenants and higher yields for the risks.

And yet, the optimists in those discussions have so far been proved right. There is little sign of a retreat and last year’s issuance was a record €27bn, by a record 153 borrowers.

There is little sign of a retreat and last year’s issuance was a record €27bn, by a record 153 borrowers.

It seems the shocks of Steinhoff and Carillion were muffled because of the nature of the Schuldschein investors themselves.

Traditional Schuldschein lenders, like German savings and co-operative banks, go through a painstaking analysis of credit quality.

“You can’t do much if the audited financial statements turn out to be questionable,” says Paul Kuhn, head of debt capital markets origination at BayernLB in Munich. “Steinhoff was rated investment grade by Moody’s when it got into trouble.”

Steinhoff, as it affected more Schuldschein investors, caused more concern than Carillion, which was a niche credit in the market. But the vast majority of Schuldschein participants believe that the problem lies with the issuer, not the market itself.

However, 10-15 lenders to Carillion and around 100 lenders to Steinhoff still came up against the product’s illiquidity.

As the issuers stumbled, the investors struggled to work out how to proceed, as there were few previous cases to guide them, and little secondary market activity.

Investors usually have scant appetite for selling Schuldscheine, as they have traditionally had a buy-and-hold culture. But that culture might change if more borrowers get into difficulty — a real possibility after the credit cycle turns.

Hoping to answer that need, Debitos, a fintech company based in Frankfurt, has launched a secondary debt trading platform with a specific focus on non-performing assets.

Debitos says it has 298 investors prepared to buy non-performing loans, including Steinhoff’s Schuldschein debt.

“We have a bid out there from an investor looking for Steinhoff tickets up to €10m at 70, which is the best bid out there,” said Timur Peters, managing director of Debitos in mid-March.

“It’s not a surprise that with the growth of the market come more similarities with capital markets more generally,” says one commercial bank lender.

“Everyone needs to adapt to the new normal, or else move on.”

The relevance of credit defaults in the Schuldschein market is often overstated, and the same can be said for trading platforms.

But in the rare case of credit difficulty the Schuldschein investor’s characteristic stance as a buyer and holder might be shown to be merely skin deep.
Can the Schuldschein stay on top when rate climate changes?

The Schuldschein market attracted a record number of international issuers last year, and swept aside other forms of European private debt in the process. Now it must confront a bigger beast — a credit-hungry unrated public bond market — while simultaneously absorbing the impact of the European Central Bank winding down its bond purchasing programme. **Silas Brown** reports.

AT FIRST glance, the Schuldschein markets of 2016 and 2017 might not appear very different. After all, total issuance ticked up only €1bn to roughly €27bn. But each figure was rustled up using a different recipe.

In 2016 total volume was carried by larger companies like Lufthansa, Hofer and Porsche issuing €1bn-plus loans, alongside M&A-inspired activity from companies like Groupe SEB and Mann+Hummel.

This was not the case in 2017, when fewer large transactions took place. Rated and unrated public bond markets were more competitive on price, so the argument for the use of the Schuldschein became less persuasive.

Kion was the only borrower to break the €1bn mark last year. But as Schuldschein investors grew more comfortable lending to smaller international borrowers, the procession of companies entering the market grew longer.

Average deal size fell a third to €166m as roughly 150 firms raised Schuldscheine. More than two fifths were non-German.

The formula for success in 2018 will be to pluck the successful elements of both years and maintain the flow of new arrivals, while drawing the larger borrowers back.

Tangle with bonds

But the unrated public bond market is proving a game competitor. For some issuers, the pricing it offers is more attractive than what they could get in the Schuldschein market.

French video game developer Ubisoft, which had issued €200m of five year Schuldschein notes in March 2015, sold its first corporate bond in January — a €500m five year note, priced at 85bp over mid-swaps.

This was tighter pricing than its Schuldschein, one banker in Frankfurt noted.

Orpea, the French care homes group that is another prized convert to Schuldscheine, followed in early March, selling €400m of bonds at 200bp over mid-swaps.

Both issuers obtained substantial order books — in Ubisoft’s case over €1bn — which drove the price down to inside what they could have achieved in the Schuldschein market, one banker noted.

“Ubisoft could quite easily have issued further Schuldscheine at benchmark size,” says Richard Waddington, head of loan sales and private debt at Commerzbank in London, but accepted the product’s pricing advantage had diminished due to a hot bond market. This started to unwind in the first quarter of 2018, however.

“The unrated market is much more volatile so perhaps it makes sense for borrowers to place bonds over Schuldscheine when the conditions are strong,” says one Schuldschein banker in Frankfurt. “But we’re hoping for less strength and stability [in public bonds] over the course of the year, so we can convince corporates that there is less execution risk in private debt.”

There is evidence that this position might hold some weight.

Over 20 issuers have sold Schuldscheine so far this year and super-market chain Rewe became the first to raise €1bn, pricing three, five, seven and 10 year fixed and floating rate notes at the tight ends of margin ranges: 50bp, 65bp, 80bp and 100bp.

“Throughout 2017 markets were very stable,” says Kai Seeger, deputy head of UniCredit’s global syndicate.

“But with more volatility you might see larger issuers using the private debt markets more frequently again.”

Telefonica Deutschland and Volkswagen Financial Services both raised over €500m in the first quarter. The former offered tenors of seven, 10, 12 and 15 years, while the latter sold a two year Schuldschein to a single investor.

“There are many European corporates with the capacity to place Schuldschein loans above €500m, with no execution risk whatsoever,” says Andreas Petrie, head of primary markets at Helaba in Frankfurt.

“These issuers can treat the Schuldschein as a useful source of [investor] diversification, and can help their debt maturity profiles.”

Some fear that if the larger borrowers return en masse, there will be less

The rise of unrated Schuldschein credits

![Graph showing the rise of unrated Schuldschein credits](source: Helaba)
Space for smaller issuers, as arrangers and investors will be drawn to the easier credit work and larger ticket sizes that go with bigger companies. “Who wants to go through the stress of analysing some tiny German corporate debut Schuldschein when there are blue chips on offer?” asks an international investor at a commercial bank. “It’s much more work, the smaller the company is, and there is no necessary pick-up on spread — so it is more of a strain on resources, and from our perspective larger borrowers are more cost and time-effective.”

Bankers also grumble about having to do the same work for a smaller fee when a smaller borrower comes to the market, and argue that credit analysis is harder. Some sceptical analysts believe an over-reliance on smaller, unrated companies could spell trouble further along the credit cycle.

**Can small be strong?**

With more unrated issuers entering the market than ever — three quarters of last year’s borrowers and four fifths of volume, according to Helaba — a fierce debate has boiled up between analysts over whether they will bring credit deterioration to the market.

Scope Ratings, a rating agency in Berlin, urged caution in January. “Investors need to be careful in assuming the high credit quality of the Schuldschein market in the past will automatically apply in the future,” it warned in a report.

Scopes believes the credit difficulties of two Schuldschein issuers in particular, Carillon and Steinhoff, illustrate a broader decline in the market.

“It takes time for patterns to become visible,” said a director at Scope, when the report was published. “Our prediction is it will become more visible over the coming months.”

These sorts of conclusions, however, are largely met with derision across the market.

“There may be a few niche issuers that access the market with poor quality, but it will never be the norm, as the lenders are too interested in credit quality and analysis to buy much sub-investment grade debt,” says Paul Kuhn, head of BayernLB’s debt capital markets corporate origination team in Munich.

Ulrich Kirschner, a senior credit analyst at Helaba, came to the opposite conclusion to Scope’s in a report also published in January.

“In our opinion, the sound credit metrics of unrated issuers indicate that the Schuldschein market continues to offer investors a broad range of companies with a good investment quality,” said Kirschner.

The report goes further, noting that the credit metrics of unrated borrowers are often more attractive than those of the rarer rated issuers.

“The average earnings-based leverage ratio for the group of unrated issuers was yet again below that of companies with agency ratings in 2017,” Helaba said.

“In addition, the median ratio of net debt to Ebitda of 2.0 times, or mean ratio of 2.2 times, saw a further improvement compared to the year before.”

Perhaps it is reassuring that analysts, when confronted with the same data, can disagree on it so fundamentally.

But, whichever conclusions are correct, there would be less concern if investors felt better compensated for the risk. Even if there was no fall in credit quality, spreads fell some 20bp–30bp on average last year.

This downward cycle of spreads should change as quantitative easing subsides. There will be less pressure on margins, and risk is likely to match reward more evenly-handedly.

**So long, ECB**

The broader conversation across private debt is turning to the effects of the European Central Bank withdrawing its monthly slug of stimulus from the public bond markets. The Schuldschein market is trying to work out how the pieces of the debt puzzle will shift as a consequence.

Some lenders, in particular European commercial banks, have been forced to enter the Schuldschein market looking for yield. As margins rise again, there is concern that bank lenders in particular might move as a block back to loan or public bond markets, which would affect the margins an international issuer could achieve.

One banker said commercial banks’ original incentive to enter the Schuldschein market had been spread, but he hoped they had become accustomed to the product.

Alongside the traditional qualities of the Schuldschein, like low costs, lean documentation and no external rating requirements, competitive margins have drawn international borrowers to the market.

There is a clear correlation. When ECB president Mario Draghi’s bond buying programme began in 2015 and margins fell for both private debt and the bank loan market, the Schuldschein broke its yearly issuance record, reaching €20bn. Yearly volume continued to rise as average spreads fell, as bank lenders strove to put their money to work.

This tightening trend might be reversed this year, and some banks have noticed that treasurers are aware of this.

As NordLB concludes in its outlook for 2018: “Fears of a negative trend in the currently favourable refinancing environment have, however, entered the heads of issuers since the ECB’s announcement of the implementation of its exit strategy. We assume that the necessary funding will continue to be brought forward in 2018, to secure the currently favourable conditions.”

When the ECB withdraws, and provided margins rise as a consequence, this could affect private debt markets across Europe more broadly.

So far, the markets have largely divided along lender lines, with banks gravitating towards the Schuldschein market and institutional investors using the Euro PP and US PP instruments.

Once central banks retire from active duty and institutional lenders feel less squeezed, they could migrate more into Schuldscheine and talk of the harmonisation of European private debt markets could return.
SCHULDSCHEIN: US ISSUERS

A new German export: the Schuldschein’s American dream

The Schuldschein market has a grand ambition — to make it big in the US. Its reputation is growing internationally but it will not be easy to take on the more established private debt instrument, the US private placement note. Silas Brown asks: just how realistic is the Schuldschein’s American ambition?

IF SOMEONE SAID a few years back that Schuldschein desks would have outposts in New York, they would have been met with rolling eyes. And yet, this is what is happening.

Schuldschein originators from the German Landesbanks are stationed in the US to hunt for clients, hoping to take business from the US private placement market, in particular.

“There are two clear ways we can eat into US private placements so far in terms of price,” says the head of Schuldschein at a German bank. “Either with European issuers looking to raise dollars, or US issuers on the hunt for euros.”

The two markets have different types of lenders. The US PP is dominated by large insurance companies, prepared to offer big tickets at long tenors, in exchange for stricter covenants and illiquidity premiums.

In Schuldscheine, over three quarters of last year’s volume was bought by bank lenders, tending to prefer shorter tenors, three to seven years, and more comfortable with lighter documentation. So the SSD market will have to play to its strengths to attract clients from the US PP market. There are signs of this occurring.

Yankee goldrush
If the market spreads to the US, it will expand its borrower universe, not its investor pool. US institutional investors are better served by the stricter covenant packages in US PP notes, and US bank lenders have not made overtures to Schuldscheine (although Citi is beginning to arrange some SSD deals off its London MTN desk).

“The market has grown more attractive to US borrowers, but not because of an influx of US investors,” says Paul Kuhn, head of DCM origination at BayernLB in Munich. “It is due to international investors from Europe and Asia driving down pricing margins for international corporates.”

These international lenders are more comfortable investing in US borrowers than more traditional German savings and co-operative banks, and they have dollars to lend.

The market has started to offer dollar tranches. Last year 13 issuers — Carillion, Ecom Agroindustrial, HTM Sport, Huhtamaki, Lonza, NAC Aviation, Neopost, Oiltanking, Phoenix Mecano, Porsche Salzberg, Qiagen, Tarkett and Volkswagen Financial Services — took advantage of that.

The number of instances in which a US issuer can raise dollars with a Schuldschein more cheaply than with a US PP is rare, but growing. The US affiliate of the German Wacker Neu- son issued $100m of five year dollar Schuldscheine in March, for example. The after-swap pricing was similar to Wacker Neuson’s previous Schuldschein issue, a €125m five year sold in 2017 at a spread of 55bp.

“What is becomingly increasingly popular is a US borrower raising Schuldscheine through a European subsidiary,” says Petrie.

More US issuers
There are an increasing number of deals either issued or guaranteed by US firms. Wabco Europe BVBA, an industrial equipment supplier with headquarters in Brussels, launched a €200m inaugural Schuldschein in February. It was guaranteed by Wabco Holdings, listed in New York.

The reverse is also happening. Fresenius US Finance II, the US arm of the German medical services company Fresenius SE, raised $400m in March 2016, with a Schuldschein issued by Helaba and HSH. Before that, Arcadis issued $275m through a US subsidiary.

“More of this cross-pollination is expected, and will hopefully provide purer US issuers good examples of successful transactions, as well as getting the international investors used to the borrowers from overseas,” says one Schuldschein banker.

But the likelihood of a big spike in issuance from pure US borrowers remains somewhat limited, as long as they have access to cheap (and long-dated) funds elsewhere in their native markets.
Private debt markets have made inroads into European funding strategies over the past few years, taking transactions from syndicated loan markets, as well as public bonds. The Schuldschein market has been particularly vibrant, racking up €27bn of issuance in 2017 from more than 150 transactions.

Advocates argue its unique selling proposition is its ability to combine attractive pricing, lean documentation and unparalleled flexibility. But the outlook is not all rosy, as doomsayers warn that pride may come before a fall through the market’s next credit cycle.

GlobalCapital invited some of the Schuldschein market’s leading participants, including bankers, investors, issuers and lawyers, to a roundtable in Frankfurt in mid-March to discuss the state of European private debt markets, and what the future might hold for them.

Participants in the roundtable were:
- Klaus Distler, executive director of origination, Helaba
- Oliver Dreher, head of debt capital markets practice, CMS
- Michael Lamla, head of corporate banking, Agricultural Bank of China
- Patrick Mannl, director, UniCredit
- Johannes Mayr, economist, BayernLB
- Stefan Scherff, head of corporate Schuldschein origination for Germany, Switzerland and Austria, Commerzbank
- Thomas Schneider, head of European corporate loans, Allianz Global Investors
- Felix Warmuth, group treasurer, RHI Magnesita
- Zsófia Zséger, head of group funding, MOL
- Silas Brown and Toby Fildes, moderators, GlobalCapital

GlobalCapital: Private debt has made some very good ground over the last four or five years in Europe. Is it continuing to rise up the agenda for corporate treasurers? And if so, where are we in its evolution?

Stefan Scherff, Commerzbank: Where we are going to be in a couple of years is a tough question. The rise in volume has been for good reasons, though. We have flexible products and I think that’s not only true for Schuldscheine but many private debt instruments. You can tailor them to your needs, in a way not possible with other instruments. Syndicated loans are fixed in that structure to a certain extent, and even more so corporate bonds.

Patrick Mannl, UniCredit: The prominence of the Schuldschein product in Germany is incredible. Ten years back there was a market size of €5bn and now you have some €25bn-€27bn — that rise gets it on to the agenda of every treasurer. One of the big lessons learned from the crisis was to diversify your funding base.

Klaus Distler, Helaba: Maybe one additional point is the policy agenda, right? There’s an additional push for these market segments, and especially smaller companies, as a result of the Capital Markets Union. We have to think more broadly about where the additional Schuldschein volume is coming from. Private debt has eaten into the loan market, and in particular the German loan market has declined, while the Schuldschein has gone up significantly.

Thomas Schneider, AllianzGI: When I started at Allianz, the Schuldschein was a product in the bottom drawer of investment bankers’ desks. But as it’s grown, institutional investors like us still play a very limited role, and we still have the Schuldschein market in the hands of banks. We still don’t have a real alternative lending market and this is something we should change, to make the product even more attractive.
Johannes Mayr, BayernLB: I agree it is still in the hands of banks, but it is different banks. It is not the traditional banks that you find in the syndicated loan — it’s rather smaller, regional banks like savings banks, or foreign banks who invest in the Schuldschein instrument. So from that point of view, yes it’s banks — but it’s still a diversification.

Schneider, AllianzGI: It is going to be very interesting to see how things work when things become difficult. Currently refinancing is not a problem because there is plenty of liquidity, but this could change once the credit cycle turns.

Oliver Dreher, CMS: Coming from the lawyer’s perspective, that is indeed what investors from other jurisdictions come and ask us. How can you make light documentation work? Then indeed the lawyer has to admit that it is not magic, but because there is still a certain hygiene in the market. Leading arranging banks are looking to keep this high level of credit quality. But you can never foresee what happens. We also remember the days of credit-linked notes. Bankers were saying: ‘Oh, the secret is you just pick the right ones’, but of course things can change.

GlobalCapital: It’s interesting that we have highlighted the negatives so early on in this discussion — let’s not forget the last three or four years have been very successful ones for this product. Maybe not for everyone, like an investor who has seen their yields being squeezed or failed to get into a deal, but from a corporate perspective it’s been good news.

Felix Warmuth, RHI Magnesita: Absolutely. The point about diversifying your funding sources definitely makes sense. The Schuldschein should not be the only instrument you have in your debt structure, but it is an additional and non-traditional funding source.

Of course there are positives and negatives to each product — not only the Schuldschein. But definitely one topic that could be an advantage or improvement going forward is to get institutional investors more on board, to have the optionality of longer tenors.

Zsófia Zséger, MOL: I very much agree with your point. Earlier in our portfolio, we mainly had syndicated loans, and we were present on the debt capital markets. We heard a lot about this product and our banks kept coming to us and saying: ‘you should try this, it’s more international’.

We were sure there was not that much to lose. Worst case, we would have ended up with a deal which we hadn’t been able to close.

We definitely wanted to diversify our portfolio, and we also very much liked the repayment option on floating terms. Another advantage is that you get access to longer maturities than your usual syndicated facilities.

GlobalCapital: So you now have Schuldschein bank lenders as well as your syndicated loan banks. How different are they? Are there more Asian banks in your Schuldschein, for example?

Zséger, MOL: Well, the Schuldschein lenders didn’t ask for ancillary business, most importantly. We don’t really have a relationship with them. And in terms of geographical location, it’s a different set-up. We do have Asian banks in our bank portfolio, but there is more focus on Asian lenders in our Schuldschein. Also, it was surprising on the documentation side that the banks who came into our Schuldschein deal were not demanding regarding contractual terms.

Scherff, Commerzbank: In a syndicated loan each bank provides maybe hundreds of millions of euros. That’s quite different to an average commitment of maybe €5m in a Schuldschein loan. So your level of protection is lower.

But if you look at the Schuldschein it is, by its very nature, not a native instrument for institutional investors. There are some things in a Schuldschein that do not cater to institutional investors’ needs. If you don’t have an investor that’s in a position to do the credit analysis, it’s not the product for that investor. On the institutional side there are only a limited number of investors who actually have that capability.

Also, the Schuldschein market doesn’t have a huge secondary market, because investors are usually buy and hold investors. And that’s another thing institutional lenders don’t really like. They want to be able to trade out if they want to.

So can we bring the two things together? Are there ways to bridge that gap?

Warmuth, RHI: But the question here is why is there no secondary market? Because actually the Schuldschein should be something that is common for a secondary market, right? Because any investor can sell it all the time.

GlobalCapital: Is it because the traditional
Schuldschein investors are smaller banks that are typically buy and hold investors?

Mayr, BayernLB: You have a mark to market in the bond markets, and this drives buying and selling. We don’t have this in the Schuldschein, and this is one of the major reasons we don’t need to have an active secondary market.

Distler, Helaba: It’s part of the charm of the Schuldschein that you don’t have the mark to market, at least that’s our impression from many of these investors. Our strong impression is that part of the driving force behind the Schuldschein market is this quality. That it is illiquid for certain purposes but liquid for regulatory purposes. But as you say, it is buy and hold investors and what they need, in terms of, let’s call it, regulatory liquidity, is just to have the possibility to transfer it.

Mannl, UniCredit: But this could also be affected by the current low interest rate environment, right? When the cycle turns, I’m not so sure if we will be in the same setting or if the secondary market might develop a bit further.

GlobalCapital: You raise an interesting point. The Schuldschein market raised €25bn-€27bn last year, and I think the US PP market $70bn. Even the Euro PP market had a good end of the year. But I wonder what will be the impact of the retirement of special central bank measures such as quantitative easing and financing operations on private debt markets. Would it be true to say that the private debt markets have benefited greatly from central bank liquidity and therefore once that central bank liquidity recedes, Schuldscheine and other private debt will begin to reduce in volumes?

Mayr, BayernLB: Not necessarily with the volume, but certainly it has an effect on the price. I would dare say there is a pricing effect of maybe 20bp or 30bp, whether the Schuldschein is ECB-eligible or not.

On the other hand, I think the effects those measures had on the related corporate bond market were much higher. So it’s really hard to say what we’ll see in the volumes. Our view is that we will have a strong year in 2018 again, so comparable to 2017 — but the forecast beyond this is a bit uncertain.

GlobalCapital: But do you think that the main reason why these private debt markets have had such a good two or three years is because of the ECB?

Distler, Helaba: No. We have to look back, beginning in 2016 without the Corporate Sector Purchase Programme. We had an excellent start to the year, also coming from 2015. New issuers. New investors. It also was, from my point of view, to a certain extent M&A-driven. And then we also had an interest rate environment, particularly in 2017, where some corporates decided to go ahead and pre-fund themselves, since the view was that interest rates as well as debts were going up the curve. I’m not sure if I would agree that 2018 will see the same volumes as 2017.

Scherff, Commerzbank: I agree — I would sign that statement if it was written down. A lot of last year’s demand was clearly due to the fact that issuers were expecting higher interest rates this year, and refinanced a lot of their funding needs early for 2018. And I think that is proved by the fact that right now the market is pretty much slowing down.

Mayr, BayernLB: Does that make a difference? Because in my view it doesn’t make a difference if the market is €20bn or €27bn — the most important thing is that we have a stable market, and we’ve had this stable market for the last five to seven years.

For you as a journalist, yes of course you want to write stories about the market’s overall volume. In early 2016 nobody knew what volumes we would have at the end of the year and I think the same is true also for this year. Because there might be different motivations at the multinational level, which make either the Schuldschein more attractive — or perhaps the only product to go for — or a bond.

Warmuth, RHI: I think one of the main motivations was diversification. As you already mentioned, Schuldschein investors are totally different from your traditional corporate banks or relationship banks. So you just diversify your funding base, you diversify your banks, and you don’t have banks that want additional business here and there.

Zséger, MOL: That’s true for us as well. Of course we read about the Schuldschein in the news a lot and our banks kept approaching us. We’re focused all the time on finding new opportunities to diversify and to innovate. To do something new which is completely unknown for the country, as one of the major firms in Hungary, definitely it’s a challenge.
In our case it was driven by the fact that we had a very strong liquidity position and we are an issuer in the bond market, but we are not a very regular issuer. We’re not out every year. We are issuing in every, say, second or third year. And we just didn’t need the benchmark size. That’s also a big advantage for the Schuldschein, that you can do €50m or €100m. You don’t need to shoot for €500m.

**GlobalCapital:** Did you contemplate doing other forms of private debt? A US private placement, for example, or Euro PP even or even something bilateral by nature?

**Zséger, MOL:** Not really, because we have quite a substantial syndicated loan portfolio thus enough liquidity. So far, the Schuldschein is a product which we like, but of course we are considering different alternatives as well, but when I ask my partner banks: ‘Would it be cheaper than a Schuldschein?’, if they say no, then basically, I’m sorry, but I lose interest.

**GlobalCapital:** So having done one Schuldschein, would you now say it’s probably going to be a permanent feature of your funding toolbox?

**Zséger, MOL:** It’s probably too early to tell. But we liked it and we believe it’s a good product. We need to consider, as mentioned, the pricing. At the time when we issued, the pricing was closer to loan pricing, but definitely lower than bond pricing.

However, during the year, pricing has really come down, and if we take a look now at the current yield for a potential bond issuance, then it’s probably now below the potential Schuldschein pricing, because Schuldschein investors do not react that quickly.

**Warmuth, RHI:** Similar from our side. We have issued three Schuldscheine already, and they were also driven by pricing. We did not have access to the rated bond market as we weren’t rated, so it was more a choice between an unrated bond and a Schuldschein.

As you mentioned, the pricing difference between unrated bonds and Schuldscheine has tightened. So looking into the future there’s a question on how the pricing will develop — in both the Schuldschein market and the bond market.

**GlobalCapital:** Just going back to my question about the ECB. Thomas, are you looking forward to the ECB getting out of your market?

**Schneider, AllianzGI:** We know from discussions with issuers that many of them are interested in diversification. They are not only going for cheap prices. The issuers who are only looking for tight margins are not the target group of institutional investors. We actually look for the companies seeking to diversify.

**GlobalCapital:** But do you think your time is coming, though? When central banks disappear from the markets, that will mean that syndicated loans should become more expensive and perhaps go to levels that we thought they were going to after the crisis, but didn’t. So that might be the opportunity finally for institutional investors to start taking market share?

**Schneider, AllianzGI:** Once liquidity dries up in the markets, then times might get better. That might take a while, and for the foreseeable future we have to take the product as it is. My idea is to introduce a kind of institutional Schuldschein, which can really help to diversify the lending base for companies interested in broadening their funding bases. But, coming back to the point that insurers are not really interested in the product — I would disagree. We have a €4.2bn portfolio in Schuldscheindarlehen. And we are looking to expand our business every year. So the interest is there and we are opening our Schuldschein business for third party clients and they are also interested in that product.

I don’t know what happens with the Schuldschein once you have more issuers like Carillion, Steinhoff and other companies getting into trouble. The loans we are making today have terms up to 10 years and there will certainly be defaults in that lifetime. So I think we have to anticipate what the future brings. One point is to maintain a kind of market discipline and another is to develop the market towards a separated issuing for institutional lenders, who can provide a lot of advantages.

Diversification is one aspect. And institutionalists like long terms. And you have the advantage that you don’t need too many lenders because institutionalists can take big ticket sizes. In the way you can reduce the number of banks involved in a loan and the number of things you have to manage, cross-sell for example.

**Scherff, Commerzbank:** Firstly, I think I was misunderstood. I didn’t say there was no interest from institutional investors, I just said that most institutionalists or potential institutionalists did not have the analysts, the knowledge, inside to actually participate.

There are a couple of names, like Allianz and maybe Axa and Generali that actually have private debt teams, who can perform credit analysis.

Unless the issuer has a rating, where the institutional investors can come in on the basis of the rating, like we know from bonds — then it’s a different story.

But as soon as you have an unrated credit, the institutional investors do need to perform that analysis, and a lot of them just can’t do it. That’s my point. And I think the story with, ‘Oh, there will be a time when the institutional investors come in’ is as old as the M&A story in loans.

I have not experienced in almost 20 years a situation where institutional investors had a larger share of the Schuldschein market than they have today. It has always been around 1% or 2% of the total volume. It’s pretty stable, actually.

We have seen times when the documentation was
much stricter. We have had times in Germany where almost all Schuldscheine issued had financial covenants and still no institutional investors were participating.

GlobalCapital: So what are you saying? We’re going to get that?

Scherff, Commerzbank: I don’t know. It is like we’re standing somewhere in the forest and shouting for a rating system and no one’s listening. Mr Schneider maybe can comment on that. We cannot force that — it has to come from the group of investors. We had roundtables and regular meetings with banks and institutional investors but the conversations all dried up over the years.

Michael Lamla, Agricultural Bank of China: If I understand Thomas’s point correctly, Allianz has the capacity to analyse the credit, and it’s increasing its exposure to the Schuldschein market, as well as stepping up its direct lending.

That is exactly what we are doing as well. In direct lending, we can provide the borrowers with more tailor-made solutions. We can focus on our capacity to do credit analysis, decide locally and draft the contracts. And we can be quick to react to specific situations; for example, mergers and acquisitions. Then you really need to be quick, and review a case, for example, a carve-out where you don’t have a full annual report, with a 700-page English LMA documentation and full credit approval in three weeks. That’s what we target.

Scherff, Commerzbank: And there’s a place for that, right? You are quite successful in doing that, and treasury departments also need that part of the financing. It is part of the mix.

Mahr, BayernLB: And on the other side, we have heard it from the horse’s mouth; your motivation to go for a Schuldschein as issuers, I understood, was the pricing, the leaner documentation, much more flexibility than in your syndicated loans, and diversification — but not necessarily the institutional investors. Would you have been willing, as a first time issuer or a third time issuer, to accept tougher documentation?

Zségér, MOL: In our case, of course it depends on the specific targets at that time. From the diversification point of view, it’s not necessarily important to have institutional investors. It’s important to have different banks and different investors from the ones in our syndicated loan portfolio.

The biggest advantage on the institutional investor side is probably the maturity, because usually those are the ones aiming for longer maturities.

If I may add one comment regarding defaults — defaults are natural and the risk premium is there because there is a risk of default.

Warmuth, RHI: But also, coming to your question regarding tougher documentation — tougher documentation would have to drive down the margins. And the second thing, which is difficult in terms of tougher documentation and Schuldschein in combination, is that you don’t have a majority lender clause. So that is really difficult on the fixed rate Schuldschein notes.

On the floating rate loans, it doesn’t matter, because you can cancel them at any time. But on the fixed Schuldschein terms, it’s really difficult because if you want to change something or you have to amend certain clauses, you have to seek the approval of each and every lender. And it can happen: there could always be something you have to amend.

Dreher, CMS: What we do from the lawyers’ side is effectively what you say. We translate syndicated loans into Schuldschein loans, which means we actually shorten the documentation.

On one hand, we make the clauses more flexible for the borrower, while on the other hand, we make them less complex. The reason is: you cannot ask for a waiver in the Schuldschein market every week, so the terms need to be fairly flexible.

In a syndicated loan a breach in covenants is a means to renegotiate conditions. That doesn’t work in the Schuldschein world. One result is that Schuldschein terms need to give the borrower more leeway, so that breaches do not occur as part of daily business.

At the same time, clauses in a Schuldschein must not foresee a constant exchange of declarations or actions between the parties, which would be similarly impractical. And that is what we see, at least at the moment, being clearly accepted by the majority of investors, wherever they come from. They understand that they cannot bind the borrower to something which could practically mean a hard default occurring for simple technical reasons.

If you wanted to change the current approach, a real paradigm change would be necessary. On one hand, you could of course introduce tougher documentation. However, without other changes, this would simply not work, as I mentioned. Hence, investors would also have to get used to the idea of majority clauses and related measures, to handle new necessities like frequent waivers and the like.

The question remains: will there be sufficient market pressure for such changes, and where would this market pressure come from?

Schneider, AllianzGI: Just to be clear, what I didn’t say is that financial covenants should be tougher — they should be in line with the syndicated loan documentation.

Warmuth, RHI: But if that’s the case, what is the difference from a syndicated loan?

Schneider, AllianzGI: Short term and long term — this is exactly the point here. With German issuers we currently see almost no financial covenants, though in syndicated loans there are still covenants in place.
We go for long terms, and the disadvantage that you get in the short term from not having covenants, it’s just huge. We invest money for insurers and are further away from the issuers compared to banks. Banks have more comprehensive information sources like current account information.

Distler, Helaba: I think this brings us back to one of the initial points, because the Schuldschein market is basically an investment grade market, and I think that is where we should continue to be. Because the advantage of the Schuldschein is that it has a lean documentation, proven documentation, and having a covenant only makes life more complicated for the issuers and investors involved. This brings me back to the other point: where does the market go? Historically, the market was driven by the Landesbanks, because these banks tend to have investment grade clients. Now, seeing other arrangers in the market, I see the risk that there are other issuers coming, with lower-rated profiles. I’m, however, not too sure if this changes the market going forward, and if this would increase the default rates, which are non-existent pretty much, historically.

Mannl, UniCredit: Absolutely. A sanity check is so important. The last year has seen not only the two mentioned companies, Carillion and Steinhoff, but there have been other transactions with less success than expected. Sanity checks are very important, though of course I don’t see all private bank lenders going for the lower rated credits.

GlobalCapital: Can we stop the market evolving? I understand why you’re saying it and why you want to stop, perhaps, lower-rated issuers doing Schuldschein deals; but can we actually prevent it?

Mannl, UniCredit: No, there are too many people in the market, and of course too many investors not being able to accept the current price.

GlobalCapital: Do you expect the market to calm down a bit?

Lamla, Agricultural Bank of China: Hopefully. This is something where you have to be very near the market to know about smaller transactions and special situations.

I think there might be a bit of reluctance for some investors to continue to go with lower margins and credit quality.

Mayr, BayernLB: Just one point regarding Landesbanks and their strong market position — when we think about how the market will develop, we should not forget that the investor base mainly buys these Schuldscheine to diversify their credit portfolios. So if we think about if it should be a market for institutional investors, we should not forget what the rationale behind a large part of the investor side is.

GlobalCapital: There is possibly a danger that the Schuldschein product is having too much of a good time, and that the development needs to be checked slightly to maintain its reputation for high quality and reliability. I think we all agree with that. But how do we do that?

Schneider, AllianzGI: Don’t you think that once there are too many defaults in the market, then nobody will want to be associated with the market any longer?

Scherff, Commerzbank: That’s a very important point, and that’s why I do not agree when we say we can do nothing about issuers, and particularly investors, moving down the credit spectrum; because we are in the driver’s seat. All of us as arrangers and all of the investors.

We need to step up and tell the clients: this is not a risk you want to see. We can’t play this with the market, and investors need to push back if they don’t like the risk.

Lamla, Agricultural Bank of China: To be honest with you, from an investor’s point of view, one of the first things we look at is which bank is arranging the transaction. There are one or two arrangers in the market today which have a yellow flag with us.

Clearly I can only tell an issuer to watch for the reputation of its arranger. You have new borrowers coming to the market, which posed a significant loss in the last year, without any special explanation by the research or by the bank.

I would understand if there was some restructuring, but sometimes they just tell you there is a restructuring without really giving details of the case. So that’s where I totally agree with the point that the arrangers have to do this sanity check.

Thus, we prefer bilateral or syndicated club deals where we have a better communication with clients.

Warmuth, RHI: Probably some of the guys sitting here would not be happy if I say this, but it definitely makes sense for a corporate to have one of the Landesbanks as an arranger for a Schuldschein, right? Because you get the diversity and access to those banks and Sparkassen that you normally don’t have access to.

The second topic, which is also important for investors, is that the arranger should have a close relationship with the company. Like, for example, doing other bilateral business, being invested in the Schuldschein or term loans and so on.

That also means the investor can be sure the arranger has sufficient information on the company, has knowledge about the company and its business model, and can also present and market its Schuldscheine the right way.

So the arranger should have a good relationship and ongoing business with the corporate, and then also be able to market the Schuldscheine to the investor base.
Distler, Helaba: Yes, whether it’s a Landesbank or not, the arranger has to have this relationship with the borrower, and we are also telling international banks who try to get more into this market as arrangers, that they need to take on quite an active role with issuers. Not only in potential restructurings, which hopefully won’t be there, but investors rely on this implied active strong role of the arranger.

Warmuth, RHI: Although historically, the bank doesn’t have to be invested in our loans, but it could also just be a history of working together. Also taking tickets.

GlobalCapital: Does the Schuldschein market need to evolve? Can it take on features such as collective action clauses that you see in the public bond markets so that it becomes safer to use?

Scherff, Commerzbank: That’s interesting, because looking at the default rates, I wonder how safe it should be. I don’t think we need to talk about how we can make it safer right now — I think the question is: can we keep it that way?

And of course, that is maybe not possible, because once we have been through an entire cycle, we will see some sort of default rate established in the market.

Hopefully, we will have a low default rate; if not, the market will disappear.

But I don’t think it’s the right time to think whether we can make it safer — I think the important question is: can we keep it as safe and attractive as it is? Of course the product needs to evolve. I think we need to come to a more standardised documentation.

I don’t think it is possible to have majority clauses as a standard if you want to keep it a Schuldschein; I think that’s legally impossible. You would end up having an instrument that is almost like a Schuldschein but with majority wording.

Michael Lamla
Agricultural Bank of China

Lamla, Agricultural Bank of China: There are issuers who have the majority clause with a Schuldschein, therefore want between five and 10 lenders and that’s it. Because this way they can keep the relationship with their lenders and if there is need they can talk to someone.

Dreher, CMS: I think technically you can still have it as a Schuldschein with majority voting, but you’re very right that the Schuldschein as we know it would be over if we brought in majority voting clauses.

We’re seeing a bit of a counter-tendency, interestingly. We see very big and strong borrowers that are very active in the bond markets, which are trying to introduce the opposite: they are trying to introduce quotas, for instance, for termination rights. This means a certain proportion of the issuers would have to ask for a termination.

In other words, the issuers are not making it easier for the investors to handle stricter covenants. On the other hand, they are reducing the risk of sole investors triggering terminations.

So I think we have got various tendencies in the market, which come from it expanding and becoming interesting for different types of borrowers, big and small — which is a positive thing.

GlobalCapital: But from an investor’s point of view, do we have enough clarification regarding potential spillovers between the bond market and the Schuldschein market in difficult times? Let’s say a company has both instruments out there and gets into trouble; how does an investor look at this?

Dreher, CMS: The Schuldschein has always been a mix between the two worlds. A typical negotiation scenario when a deal is being documented is where one side, it might be the borrower or the banks, will pick up on something and say ‘this is something I know from the syndicated loan market. I like it, and so I want to put it in’.

Or if an issuer has got bonds out there on an MTN programme, you will have people wanting features from the bond side.

Frankly, a Schuldschein is a bit of a mix. I think many technical clauses like tax gross-up and so on might even be closer to the bond market than to clauses in the syndicated loan market.

Although clauses may be very similar, there are some big practical differences from bond documentation, including on topics like cross-defaults.

If you look at the cross-default clause on a liquid bond from a big, frequent issuer, you tend to forget that there is usually no information obligation in the bond terms. The reason is that, in the case of such issuers, the market expects that really bad things will be in the public domain anyway, whether for reasons of regulatory disclosure, market pressure or as a result of derivative transactions, like credit default swaps documented under ISDA.

By contrast, in a Schuldschein you usually find an information obligation, where the borrower has an obligation to disclose information on events that could constitute an event of default, or cross-default. Nevertheless, many Schuldschein investors have got this constant question about whether they are subject to a kind of systematic subordination.

In practice, many Schuldschein investors rely on the information obligation that they expect will be in public markets. Of course, this works better with issuers that have public securities and hence have to disclose more information.

The bottom line is, in many situations the Schuldschein investors nowadays are piggybacking on the other instruments, the loan or the bonds, using their cross-default clauses and information obligations, which apparently the investors think will help them sufficiently. But of course there may come situations when people say, look, this has happened, and now we clearly see that this is a problem for us.

Schneider, AllianzGI: Yes, but the regulatory require-
ments for Schuldscheindarlehen are lower because they are not traded on regulated markets.

**Oliver Dreher, CMS:** Absolutely. Due to the legal and technical nature of the Schuldschein loans and the practical parameters of typical Schuldschein deals, a number of securities-related regulations do not apply to the Schuldschein as we currently know it.

And we can probably have extensive debates about whether these markets would work better with more regulation.

Even the regulators — you mentioned the Capital Markets Union — actually said the Schuldschein market works very well. And they recognise that partly it might work well because it’s not regulated in a similar way to other markets.

At the same time, of course, the regulators become more interested in the market, the bigger it gets. But I have to admit, from a lawyer’s point of view, that a lot of the regulation put in place over the last decade has not made the capital markets much safer. And therefore, I’m not terribly pessimistic about the Schuldschein market.

At the same time, the discussion about the regulation of the Schuldschein market is something that has not been carried out very loudly on public platforms. But the Schuldschein market is often dubbed a soft path to the capital markets. I don’t mean it’s soft in terms of ‘oh, it’s actually a bit bad and it’s shady’ — no, it is actually a very good way for companies to approach the capital markets, without triggering a number of otherwise typical capital markets requirements, such as a prospectus or the requirement for international accounting standards or frequent formal reporting.

I think we should be very careful that we do not destroy it or weaken it by adding formal regulation.

We are telling the arranging banks anyway, when it comes to contract liability and reputation, you should practically treat a Schuldschein issue as seriously as you would a private bond placement. You shouldn’t do less, but it’s still a practical and not so formal process as for a bond.

**GlobalCapital:** But does the market need to consider what happens in the next credit cycle, and whether it could make it easier for investors in any way to work through distress situations?

**Mayr, BayernLB:** One point: if it’s difficult to work out a deal in the Schuldschein market, then this truly only an argument against the Schuldschein, or might this even become a more problematic issue for the bond market?

If I’m invested in a bond and the issuer has a Schuldschein outstanding which is a larger part of its external financing, what does that mean for the bond investor? The question of potential spillovers between the markets in case of defaults has yet to be answered.

**Schneider, AllianzGI:** A consequence should be that the market remains restricted to the upper end of mid-cap or large cap companies. We have to be really careful with the market. For example, to obtain better risk charges for Schuldscheine, because of the very low historic defaults in the market. If this is sustainable, then I think there could be lower risk charges for this instrument and this will further increase the interest of the institutional investors further.

**GlobalCapital:** So you wouldn’t have let Carillion into the market? It’s quite a big company.

**Schneider, AllianzGI:** Yes. We are already invested in many non-German issuers. For example, from Austria, the Benelux, Switzerland, France. Actually, we have only about 60% German issuers, the rest are issuers from abroad. So it is absolutely possible to widen the market further to issuers abroad.

**GlobalCapital:** One thing we have seen in the last 12 months is a few US issuers start to access the Schuldschein market. Are we in favour of that? Do you think US issuers should be issuing Schuldscheine?

**Mannl, UniCredit:** We are currently in a marketing role, so my answer is yes, of course. Why not?

**GlobalCapital:** You could argue that US issuers are very well served by their home market, which of course includes the US PP.

**Distler, Helaba:** Well, it depends on the company’s situation, but there is interest building up on both the issuer and investor sides. It depends on the link to Europe the issuer has. I can imagine that we could see more of these kinds of transactions, with US issuers with European parents, or vice versa, coming to the market. However, if there is no link at all, I think there might be one or two issues, but not that much more.

**Mannl, UniCredit:** Let’s not forget that the spread in financing costs is huge, currently, between the US and Europe. We have record low rates in Europe and US rates are rising. That might be an additional argument to think about.
US private placements
stake out their future

As more cash is directed into the US private placement market, its attractiveness as a venue for more and larger deals will continue to increase. But even as it sets new issuance records, the question facing investors remains the same as ever — where can more deals be found? Richard Metcalf reports.

IN 2017, THE US private placement market’s busiest year ever, issuance totaled somewhere between $64bn and $66bn, of which about 41% came from borrowers outside of the US, a split roughly in line with the last three years. Indeed, participants in the market often complain that “US” private placement is a misnomer, citing the international borrower base and range of currencies on offer.

Yet investors are far from satisfied. With capital flows into the market outpacing the increase in supply, competition for deals remains intense.

“Last year was a record year and that was fantastic, but the imbalance between demand chasing supply continues to plague the industry,” says Amy Judd, senior vice president and director of private placements at AllianceBernstein in New York, who notes that pension funds and Canadian investors are among the accounts taking a closer look at US private placements.

The additional capital flowing in can be difficult to trace back to its source, because some of it is managed by US life insurance companies, the quintessential private placement investors, on behalf of third parties. Occasionally, however, it is obvious, as when UK insurer Legal & General staffed up in Chicago last year and started to source private credit deals from there last March.

L&G had been running a US private placement operation from London for some time, but the additional resources in Chicago enabled it to branch out of its comfort zone — primarily the Australian market and infrastructure — and focus more on US dollar denominated transactions for corporate borrowers.

“As a relatively new US investor, we’ve been very successful in getting access to dealflow,” says Ed Wood, the former private placement banker L&G hired from Bank of America Merrill Lynch to lead the new team in Chicago. “There’s always the issue of deals that only go to existing holders, but we’ve benefited from our global portfolio of legacy investments across L&G Group and our ability to write large individual tickets.”

Deeper pockets
As investors allocate more funds to the asset class and new names enter the fray, either directly or through the big established players, the market has grown deeper, able to absorb bigger deals, and more of them.

“We have had more billion dollar plus transactions last year than I’ve seen before and the sizes of the transactions continued to get larger on average,” says Virginia O’Kelley, vice president at Voya Investment Management in Atlanta.

The record for the largest US private placement is said to be held by Mars, a household name but a secretive user of the capital markets. The confectioner raised about $2.5bn in a single offering last year.

“For high quality, well structured transactions you can certainly think about the private market as multiple-billions in one go,” says Richard Thompson, head of private placements at Mizuho in New York.

“We have had more billion dollar plus transactions than I’ve seen before.”

Virginia O’Kelley, Voya Investment Management

“The market could very easily have absorbed $100bn, maybe even $125bn or more,” adds Wood. “The really good credits are three, four, five times oversubscribed. I’ve seen deals 10 times oversubscribed.”

Against this backdrop, investors are looking out for the next pockets of potential issuance.

Areas of growth
One area of growth is the real estate investment trust sector. Here, as with small, regional regulated utilities, a change to index eligibility criteria for public debt may have contributed, on the margins, to a shift from the public to the private debt market.

The index criteria update means that a single bond tranche now needs to be at least $300m in size, rather than $250m as before, to be listed in the Bloomberg Barclays US Aggregate Bond Index.

“For the regulated utility opcos or medium size Reits, that made it much more challenging for a CFO to say, ‘I’m going to take that lump in my maturity schedule, where I have $300m due in one year,’” says AllianceBernstein’s Judd.

“If the company was on the edge in terms of their ability to do that benchmark transaction, it made more sense to come to the private placement market and take advantage of the flexibility to create a smoother maturity schedule.”

This is partly because the illiquidity premium that was traditionally considered to be baked into US private placement pricing has eroded (perhaps even completely, according to some) as a result of intense lender competition whereas in the public market the premium for a sub-benchmark size deal remains substantial.

This appears to have been demonstrated in March, when two simi-
Idaho Power came first, pricing a 30-year SEC registered bond at 110bp over Treasurys for a coupon of 4.2%.

The next day, ITC Transmission, a company that owns and operates power lines in Southern Michigan, paid 15bp less for an offering five years longer.

The company, a subsidiary of Canada’s Fortis Inc, priced a 35 year bullet private placement at 95bp over the same Treasury note, achieving a coupon of 4%.

It is worth noting, however, that ITC would have had the same rationale for tapping the private placement market before the change to the index criteria, since its deal was smaller than $250m. Some market participants downplay the impact that the raising of the threshold has had.

“That may be part of it but a bigger reason [for the record deal volume last year] is that it was communicated so clearly that interest rates were going to rise, we may have pre-funded some of the debt people were planning to issue this year,” says Voya’s O’Kelley.

Either way, preliminary figures for the first quarter of this year suggest that utilities, project finance and Reits will continue to be big areas of supply in 2018. Project finance in particular has grown as a proportion of the market as features such as delayed drawdown and committed financing for M&A and bid-style financings have become available at lower costs.

Swap language dropped
The illiquidity premium has not been the only casualty in the ultra-competitive investment environment. Some larger investors are also forgoing protections that were market standard until recently, such as swap breakage language in foreign currency transactions.

Foreign currencies such as Aussie dollars, sterling, euros and even Swedish kroner and yen are offered in two ways in the private placement market—either they are provided by investors that have foreign currency liabilities that they need to match, or they created synthetically through a swap that matches the tenor of the note.

Because the investors typically have higher credit ratings than the issuers, it is more efficient for the swap to be done by the former and the cost passed on to the borrower through the coupon.

In such deals, swap breakage language is usually included in the documentation to ensure that the investor is made whole should the borrower have to repay the debt early, for instance in the event of a covenant breach.

Recently, however, swap breakage language has disappeared from some deals as confident investors seek to offer borrowers the best possible terms. This occurred recently on a roughly A$900m transaction for a PPP highway project in Australia, the Outer Suburban Arterial Roads (OSARs) programme in the State of Victoria.

“It’s a real-time evolution of the market,” says Mizuho’s Thompson. “Not all investors are comfortable going without the swap indemnification protection.”

Those that are may reason that they don’t need the swap, perhaps because they intend to hold an asset denominated in the same currency as the swap come what may.

If an Aussie dollar private placement has to be repaid early, the investor could take a position in Australian government bonds or participate in another Aussie dollar issuance — it would not necessarily be a perfect match for the swap but it would not be a disaster either.

“Some investors are taking a commercial view that prepayment of this asset and default are very unlikely,” says Conrad Owen, managing director and head of private placements and project bonds in the capital markets group at MUFG, adding that the credit quality of the borrower is also factored into the decision to forgo this protection.

Regime change
Another change to the market that observers say could unlock a new source of deals is the revision of the NAIC’s capital charge regime.

The NAIC regulates the US private placement market by imposing risk-based capital requirements on the US insurers that make up the bulk of the investor base.

“Under the existing regime, there is a sheer cliff between the capital charges for NAIC 2 and 3, which relate to triple-B and double-B credits, respectively. This acts as a strong disincentive to invest in sub-investment grade credit (and a strong incentive to hold BBB-equivalent paper).”

Amy Judd, AllianceBernstein

New direction
The latest proposals would subdivide the five existing NAIC ratings into 19 bands, softening the cliff between triple-B and double-B and potentially opening up the market in a new direction.

“I think there is appetite on the part of the private placement investors for below investment grade debt that has a good credit story and is well-structured, and this may allow them the ability to price it more efficiently than they have been able to in the past,” says Mizuho’s Thompson.

“The product needs to continue to expand its geographic footprint if the US private placement market is to continue growing, but that is largely going to be investor driven as they expand their credit appetite,” adds MUFG’s Conrad.

But market participants will have to wait a little longer to begin assessing the impact of the reform, as the NAIC has postponed implementation until the end of 2018 at the earliest. And there are some who support the cautious approach in what is, after all, a fundamentally conservative market.

“We live in a world of glaciers,” says O’Kelley. “It will eventually come to pass, but nothing moves quickly in the regulatory environment.”

“That’s not necessarily a bad thing,” she adds. “Because you don’t want glaciers moving quickly.”

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US PP foreign policy working despite Schuldschein’s land grab

The US private placement market is the largest, most established private debt market in the world. It has huge international appeal, attracting issuers from around the globe who enjoy the ever-evolving features the market offers and the fact that it seems to ride out any periods of weakness of other global markets. Nigel Owen reports.

The variety of geographies from which issuers come to access the US PP market continues to grow year on year, while the volumes of deals from the more established jurisdictions are maintained. Most participants do not see any reason for that to change.

“2017 was a typical year for the US private placement market,” says Geoffrey Schmidt, general manager, corporate finance, for North America at National Australia Bank in New York. “US issuers represented 59% of total issuance, hence cross-border issuers represented 41%.

“In 2018, the cross-border segment has outperformed. US issuer volume has dropped to 43%, i.e. cross-border is now 57%. This is a function of increased UK issuance due to a larger deal for Thames Water, and perhaps some issuers getting in before Brexit occurs.”

UK companies make up the largest proportion of cross-border issuers by country, and continue to grow their issuance volume by year. Other countries’ volumes vary (of these, the Netherlands, Ireland, Australian and New Zealand tend to dominate), but combined and supported by a number of issuers from new jurisdictions, the cross-border volumes keep growing.

“The use of the market varies by country,” says Ed Barker, vice president at Pricoa Capital Group in London. “The UK is totally established for issuers issuing US PPs and 2017 was another big year for UK issuers.”

The UK education sector was responsible for a number of US PP issues in 2017 as the market is continuing to become a mainstream market for UK borrowers.

“Companies have realised that the US PP market has more liquidity than the UK public market,” says Barker. “There are more buyers of size in the US PP market than in the UK loan market.”

“Europe is a slightly different beast,” he adds. “There has been a slower acceptance of US PP product. Whether that’s a documentation issue, a legal element, or rival domestic markets such as Schuldschein in Germany, it is difficult to say why European issuers have not gone to the market in as such a big way as UK issuers. The Netherlands has some occasion, but probably not taken the US PP market as a mainstream market yet.”

Barker also says that his firm is putting money to work in new territories — Latin America has been a big focus recently. It is this capability of the US PP market that attracts both investors and issuers. There are no structural hurdles for cross-border issuers to overcome. Issuers from any geography that want to access the US PP market just need to prove their quality, and this is the reason the level of issuance is seen as continuing to increase.

“From an investor perspective, the main benefit is access to issuers you wouldn’t have access to in other markets,” says Barker. “Some have public issuance, but most slightly smaller companies that choose to do US PPs instead wouldn’t otherwise have access to those investors.”

Strategic access

Slobhán Duffy, head of private placements at NatWest Markets in London, explains that pricing for European issuers has played its part in issuers from the region not using the US PP market, but that both can be used strategically.

“We’ve taken transactions from Germany and France, but they are still few and far between. In part, the challenge has been that QE has made euro markets very competitive. However, there have always been big European issuers that have used the US PP market strategically — when there has been lack of access to the euro market or a pricing arbitrage. We have seen strong markets in Europe, but we are starting to see a reversal of pricing advantages as QE starts to slow. That will offer opportunities.”

Duffy, however, also feels that the complementary nature of the maturities available in the US PP market is also an important factor in issuers’ plans. In December 2017, German motorway services operator Tank & Rast sold a pair of €300m public bonds with seven and 10 year maturities. Before that, however, the Baa3/BBB- rated company had sold €507m of US PPs, comprising a €225m 15 year bond and a €282m 19 year bond. A company with that rating would not have been able to raise such long dated tenors in the euro public market.

Aquasure, the company that runs the state desalination plant in Victoria, Australia, issued US PPs in 2013 and 2015. Matthew Onley, chief financial officer, says the three main factors that led to the decision to access the US PP market for funding were the tenors available, the
flexibility and the demand. “The domestic debt markets in Australia is generally a three to five year market, with some seven year issuance. Whereas the US PP markets offers those tenors but, more importantly from our perspective, also the ability to go longer. The only restriction going longer than 15 years is the ability to swap it back to Aussie dollars at the right price.”

“We have had Aussie dollars as part of deals, in addition to US dollar funding,” adds Onley. “Whilst we don’t have a real preference, the fact we don’t have to put in place cross-currency swaps makes the process a bit simpler on our side. That is the one change in the market we have seen in the last few years. When we did our first deal there were only a few investors who could place Aussie dollar funding. Now we’re seeing many more have that ability to place funds in currencies other than US dollars.”

The other characteristic the US PP market gives to issuers is the option to delay settlement. It is generally accepted that an issuer can delay the settlement of the deal for up to three months at no cost. Longer delays are possible, but issuers start to have to pay for the benefit beyond that. This effectively provides more time for an issuer to close out the deal and lock in pricing, even though the funds may not be required immediately.

Growing deal sizes
Onley continually monitors opportunities in the US PP market and believes that there is still plenty of capacity left for his company. “There was a common conception that you could cap out somewhere between $1.5bn and $2.5bn. But now we’re seeing some much larger transactions.”

Aquasure’s compatriot Transgrid, the power generation business in New South Wales, sold the largest debut deal by a non-US issuer when it sold $750m equivalent across four tranches in 2016. It then returned to the market to issue a similar volume in 2017.

Schmidt agrees that the larger ticket sizes are a key factor in the success of the US PP market. “Larger issuance volumes, longer foreign currency tenors and bigger bid sizes are the attractions. One transaction that NAB led recently, for example, had a $300m bid from a single investor.”

Not only is the investor base able to absorb larger issuance, Onley likes the stability he gets from investors. “The investor base is stable, and the representatives from those investors are also quite stable. You get the opportunity to develop a relationship with those investors.”

Duffy says this is not an unusual experience. “Issuers who like the US PP market tend to love it,” she says. “Because they feel there is an engagement with the investor base. MiFID reduces an issuer’s ability to communicate with public bond investors. A private placement enables them to still engage with investors. As such, they like the fact they know investors, are consistent and can they get a chance to get feedback on how investors feel about their name.”

Duffy is quick to point out, however, that the US PP market should not be seen as a way round these regulations. “We have had to navigate through MiFID, MAR etc, but most requirements, whether they apply to the US PP market or not, are all good practice. So they should be things we should adopting as good corporate citizens in these markets.”

Investors are also accepting of the direction of regulation, but are similarly unworried by it. “Regulation is only going one way,” says Barker. “Regulation always makes the job of investing a little more complicated and time-intensive, but investors are big operations with big back offices to deal with that.”

More global alignment of regulation may prove to be yet another factor which proves to increase volumes. “There is lots of talk in Europe around the ability to rationalise the PP market for the European investor base,” says Duffy. “But those large European investors are saying the US PP market is fast becoming a global market, and European issuers are pleased to see European investors taking part.”

Barker also doesn’t see Brexit having much impact on the market. “It may have an impact on some institutions, particularly for investing in the UK or for either US or UK investors investing in Ireland or the Netherlands. Maybe they will need some location in Europe. That may make it slightly harder, but even then, it doesn’t feel like to us or our peers that there is any regulation on the horizon that will make a material difference to investors’ appetite.”

The success story of the cross-border US private placement market looks set to continue for the foreseeable future, with all sides of the market in bullish mood.
Room for all in European private debt

European issuers are finding ever greater depths of liquidity in the private debt market with the Euro PP, Schuldschein and US PP markets all offering different options. GlobalCapital brought together a number of bankers, investors and issuers in London in mid-March to discuss the state of the markets and how they see them developing.

Participants in the roundtable were:

Ed Barker, vice-president, Pricoa Capital Group
Heiner Boehmer, head of international corporate clients, Helaba
Simon Fretwell, head of private placements, M&G Investments
Graham Keer, treasurer, Capital & Counties Properties
Paul Kuhn, head of DCM origination corporates, BayernLB
Martin Leighton, director of corporate finance, Great Portland Estates
Konrad Merkofer, MTN and PP syndicate, UniCredit
Jason Rothenberg, managing director, MetLife Private Capital Investors
Penny Smith, head of emerging markets corporate debt origination, Commerzbank
Nigel Owen, moderator, GlobalCapital

GlobalCapital: Is private debt rising up the agenda for corporate treasurers and what benefits do you see that it has for you, compared with loans or public bonds?

Graham Keer, Capital & Counties Properties: The attractiveness of the US PP market for us was being able to achieve longer tenors than we can via the traditional banking market, as well as opening up a diverse base of investors.

We’ve got a quite mature estate. Covent Garden is an estate that we own and, where we’ve got a long-term interest and we feel that that particular investment can attract and hold longer dated debt rather than the typical short-dated bank facility. So that’s why it’s attractive for us.

We accessed the market in 2014 and we’ve been back three times, very successfully, so it’s a market that we feel will continue to be important to us in our capital structure.

Martin Leighton, Great Portland Estates: It is high on the agenda for corporate treasurers. We’re obviously in uncertain times at the moment, but I think one of the advantages of the private market is it is very dependable. It gives you certainty in uncertain times. Some of the markets are not always there for you.

We actually took out some public debt and replaced it with private debt. We know the investors, the investors know us and they know lots of property companies.

GlobalCapital: Is that something the banking side are experiencing as well?

Konrad Merkofer, UniCredit: Yes and no. If you look at small and medium-sized companies, not a lot has changed compared to the last couple of years. There is still strong competition from bank financing and a lot of the smaller-sized companies decide to go for this option. But we see increased interest in private placements, mainly for longer maturities. Given the current environment we have, we will see more companies focusing on that funding channel this year.

Paul Kuhn, BayernLB: The benefit for many issuers is to remain private. They do not necessarily want to go
public, exposing themselves, having a prospectus written and everything explained. So the more private an issuer is, the more likely it will like private placements. It doesn’t matter if it’s a US PP, a Schuldschein or Euro PP.

**Heiner Boehmer, Helaba:** From an international point of view, the UK is more biased towards the US PP market. UK banks are pushing hard for that. They have their own desks and, therefore, access to the investors. On the European side, you find it less so. There’s some advantage about the maturities and the depth, but we experienced a lot of clients who found it too complex, so they stick with the European markets.

**GlobalCapital:** And from the investor side, what sort of benefits does it have for you?

**Jason Rothenberg, MetLife Private Capital Investors:** It helps us diversify our portfolios. Private placements give us access to issuers that typically aren’t rated and therefore not in the public bond markets. The covenant protection that we get from investment grade private placement issuers is very valuable.

We think that’s a critical factor in the lower historical loss rates that we’ve seen compared to the public bond markets over time. And because of the longer maturities we’re able to do and the menu of options that are available to issuers, there’s more flexibility, which works great for issuers but is also helpful to the investors from an ALM standpoint, matching these assets against our liabilities.

The last point to mention is from a pricing perspective. There’s a premium involved for the illiquidity relative to the public bond market, so that’s another positive feature.

**Penny Smith, Commerzbank:** As issuers, are you seeing that demand?

**Simon Fretwell, M&G Investments:** In terms of recent new investors in the UK, not really. You’ve got some specialist investors who are coming and taking the odd deal. But we at M&G have seen a number of illiquid mandates come to us.

I work in the alternative credit group, and there are about 80 people there. There are deal managers, fund managers, people to get the deals done. And then we have a separate credit analysis group. So, within the wider group we look at aircraft leases, receivables, ground rents, housing associations and US PPs. In terms of size of company, it goes all the way down to direct lending, so there’s a wide range of things we look at. We’ve got third-party mandates and they specifically want alternative credit, including private placements.

They want a premium.

One of the things that has, historically, been an accusation against private placements is that they’re illiquid. But, compared to the sterling public market, where there are a limited number of very big investors who couldn’t possibly offload their positions in any normal size without really affecting the market, the PP market is not that illiquid.

We always talk about buy-and-hold in the PP market, but I would say a lot of public bond investors are now buy-and-hold. Ironically, public bonds trade least when things go wrong, whereas private placements trade most when things go wrong.

**Rothenberg, MetLife:** I agree. There’s more limited liquidity in the public bond market these days. From what we’ve seen, it feels like there has been greater participation by UK institutions in the US PP market. Perhaps not in the traditional 10 year corporate space, but we’ve seen more long-dated, maybe more esoteric asset classes issue in the UK market. And those long-dated sterling deals seem to match up well with some of the UK institutions in the space. So in recent years I’ve seen them come in more, especially in those deals.
filtering through to you? Are you getting new investors coming through with enquiries?

**Leighton, Great Portland Estates:** The appetite seems to be pretty insatiable and the banks have been talking to us about the private placement market stepping up for quite some years. Whenever you get updates from them the message is always supply is not as high as demand and it doesn’t seem to matter how much issuance there is, that always seems to be the case; and that benefits us.

Whether or not the total pool is higher or not, the investor group that is interested in the kind of credit we provide, a Central London property company, there’s huge demand for our paper.

In 2011 and 2012, we asked for dollar bids and sterling bids and we got one sterling bid. Everyone else was in dollars. In the 2017 and 2018 issues, we only asked for sterling because we knew there was the demand.

We liked the delayed draw. You can now delay for longer than you used to and so there seems to be much more flexibility there, due to that seemingly insatiable demand.

**Rothenberg, MetLife:** One of the biggest changes in the market over the last four or five years is the ability of investors to deliver euros or sterling directly. It used to be that companies would come to our market and take dollars and swap it themselves, but it’s really shifted such that they expect to be able to get euro or sterling directly from US investors in the US PP market, and from local investors, of course, as well. So that has helped drive dealflow in recent years because it has saved companies from having to use their swap lines.

**Smith, Commerzbank:** Is that partly because of the Schuldschein and the Euro PP expansion? Because five years ago they weren’t really options and now issuers have this new choice offering them currencies and floating rates as well, so has the US PP market had to adapt a bit to stay competitive?

**Fretwell, M&G:** Because the Schuldschein market has doubled to approximately €30bn, that has affected the issuance in US PP markets? Probably very little. Our big competition is conventional commercial bank lending, and both of those are the fleas on the backs of that hippopotamus. We always get asked if PP or Schuldschein is squeezing the other out. No, I don’t think so.

**Smith, Commerzbank:** We’ve done deals where there’s been a Schuldschein and a US PP done one after the other which is feasible because the issuer is tapping different investor bases and thus making the most of the longer tenors they get from the US side, and the attractions of the Schuldschein like the pre-payability.

**Merkofer, UniCredit:** Whilst both the Schuldschein and US PP are still predominantly for investment grade issuers, over the last two years the Euro PP market diverged a little bit and started to focus on the lower credit profiles which is a market that hadn’t really existed a couple of years ago.

Two years ago there was still competition between Euro PP and Schuldschein for the same issuer base, but now the classic Euro PP seems to be the domain of lower credit profiles. There are a lot of new European investors in that market and they established tailor-made funds for exactly those kinds of credits.

**Barker, Pricoa:** Low investment grade credits are realising there is appetite for them in different markets and certainly in the private placement market. Maybe not from all private placement investors, but from most of the big private placement investors.

**Rothenberg, MetLife:** Do you think that will continue as rates rise?

**Barker, Pricoa:** Certainly the appetite will stay there from an investor perspective. The appetite from issuers to issue at what will clearly be higher rates will be the limiting factor; most companies may not want to take the hit on a below-investment-grade coupon, but, from an investor standpoint, the appetite is going to remain.

**GlobalCapital:** Are swap rates giving US lenders an advantage over the UK-based ones when lending to European borrowers? And will debt markets cope when interest rates start to rise, as we’ve already seen in the US?

**Fretwell, M&G:** My observation is it’s currently an advantage when you go 10 years and beyond, but, at say five or seven years, local currencies are more competitive. Certainly when you go longer, there are some odd results, where recently the US investors have come in very tight.

**Barker, Pricoa:** Yes, there are some quirky parts of the curve where it’s advantageous, some where it’s the opposite. What we’re finding as an advantage is probably, more fundamentally, being able to offer different currencies and being able to be flexible to the companies’ requirements. Clearly, borrowing in sterling and euros at the minute is cheap and being able to offer that on a natural basis, without swap breakage, is really important.

**Kuhn, BayernLB:** There is a correlation between higher rates and higher pricing and that would definitely also benefit the private placement segment. It’s dependable and more stable in that regard, so the pricing didn’t go as low as it did in the public sector. That’s why, when the pricing is going up, some of the issuers might realise it was just not beneficial enough and inexpensive.
enough to go into the private placement market because they have to pay a premium for illiquidity. But, when the pricing is going up, they might be tempted to go to the more dependable, more reliable, more stable market and the pricing might be reasonable enough to go there. Right now, we do not see, in the private placement market, those blue chips anymore. They all go to the public market. Whenever you need €500m straight, you do a bond. Private placements cannot match that.

When ever they realise that, as we saw in 2008, that the bond market becomes illiquid, that’s the time of the private placement market and we will probably see more of those once the pricing and spreads are going up in the public or overall market, due to the fact that liquidity is reduced.

Rothenberg, MetLife: As a US investor, since the start of the year, the euro-dollar basis and the sterling basis have both become a bit less negative, so not as attractive as it was but still helpful. Optically, prices in euro terms are still very attractive.

As an example, we’re trying to price a 12 year euro denominated deal this week, and the coupon in euros is more than 200bp tighter than the coupon in dollars. So European companies are able to get an attractive coupon in euro terms, and we’re still able to get what we need on the dollar side when looking at a comparable public bond. So we’re still in a good spot in terms of what we’re able to offer. There’s a similar relationship on the sterling side as well.

Merkofe, UniCredit: The US PP market is the dominant private placement market which can offer the very long maturities, so the competition from the Schuldschein is less so in those kinds of maturities and the Euro PP is also much shorter. So yes, there is a price advantage, but also the advantage to offer long maturities for an issuer.

Leighton, Great Portland Estates: From an issuer’s perspective, US investors looking at US public comparables versus UK investors looking at UK public comparable spreads puts the US side at a big advantage in terms of the pricing that their institution expects them to be able to achieve.

From our perspective, when we had to issue in dollars and swap into sterling ourselves, the credit spreads we would pay would be at least 15bp. We’ve just done a 15 year issue and I’m not sure if we could have swapped that with any of our banks. I suspect some of these triple-A rated investors have a credit spread under 5bp and they charge us 10bp. Much cheaper than we could do it, so that’s great for us, and gives them a turn, as well, on the swap, so it’s a win-win structure.

Boehmer, Helaba: From what we see from a corporates level, they utilised the window of opportunity over the last few years quite a bit. They sit on a lot of liquidity already, and rising rates maybe puts them, at the moment, in the spotlight. So in terms of M&A activity, we expect it to be slightly slower than the last few years and therefore maybe less demand. So overall rising rates will not necessarily have an impact, but what we will see is gradually slowing down because there’s less demand.

GlobalCapital: UK companies have been less active in the Schuldschein market than French ones. Is that market attractive to UK companies?

Smith, Commerzbank: One of the reasons the US PP is so embedded in the UK is that the British banks here offer the product, as do the US banks, etc. So it has traditionally been the number one PP product available. The UK has thus effectively had its own PP product for years, just as Germany had the Schuldschein and France set up with the Euro PP.

This means in the UK you have issuers who have mostly done one or more US PP, who probably know the investors quite well, and in some cases probably could call them up and ask directly for a new investment without a bank intermediary. The US PP documentation and its requirements such as covenants are known and accepted. So to look at a different product brings in an unknown element of execution risk and uncertainty, because it’s different and you haven’t done it before, so it needs to be carefully considered.

Why have the French taken the Schuldschein to heart? One reason is because it was much more competitive than the Euro PP when it first moved into that market. That’s maybe why the Euro PP went down the curve a bit. We also see the French market has a lot of domestic investors there already; the UK less so.

Additionally, the UK is not an ECB eligible country, so banks can’t refinance themselves via the ECB. The
UK is not the only one that’s ineligible as some of the mainland European countries aren’t either, but that can be a bit of a handicap. Having talked to a lot of UK companies, you’re always up against the US PP, so it’s an interesting discussion and then it comes down to “I want 12 year dollars” and US PP is it. But we have seen some UK Schuldschein.

Keer, Capital & Counties Properties: We’ve always wanted sterling, so, when we went to the market in 2014, all of our investors lent us sterling and did the swap for us. So the US market was the path of least resistance. It was the easiest thing and that’s why we’ve gone back to the market.

When we’ve tried to look at direct lending, they still haven’t been able to get down to that pricing point where the US markets are just that much more competitive for us. So again, it was the path of least resistance.

Leighton, Great Portland Estates: It’s interesting but Schuldschein isn’t something any of our banks have ever presented to us. They’ve never pitched it and I’ve never seen anybody in the UK property market issue into that market either. It makes me question whether banks earn a different fee when they are agent on a Schuldschein versus a PP?

Smith, Commerzbank: The only real estate company Schuldscheine I could find were German and maybe a couple of Austrian and that was it.

Barker, Pricoa: Property companies have managed to get great tenor out of the PP market which the Schuldschein market just can’t offer. And the reticence towards the Schuldschein market is maybe because it’s quite an untested market and it’s not really been through a full default cycle.

There are a couple of examples where companies that have issued Schuldschein have got into problems, they’ve maybe found that who they thought were their lenders weren’t their lenders ultimately. Whereas, the US PP market has been through lots of cycles and has demonstrated a mature reaction to amendment and defaults.

Kuhn, BayernLB: The Schuldschein market is always senior unsecured and as a real estate corporation you tend to have some of your assets already being used for securitization and senior unsecured is really that segment which the vast majority of investors are looking for. Whenever there is structural subordination, that tends to go away.

Otherwise, you need a different set of documentation, looking into assets, and taking this into account would be beyond what the regular Schuldschein investors are used to.

Another reason why Schuldschein has not been that suitable for British corporations is whenever you have sterling requirement and provide that liquidity in sterling, you end up having British investors. So it’s not really diversification. The vast majority investing in Schuldschein are financing themselves in euros and that’s where they are competitive.

Boehmer, Helaba: One of the main reasons is the UK banks. If you go to the corporates, 80% of the time British banks will never talk about the Schuldschein product. So if you do not get that offering, why should it change?

Fretwell, M&G: Carillion was sterling, wasn’t it? If we were approached to do a Schuldschein on a credit that we knew and they’d got bank loans and they’d more than likely have a private placement, at that point, how would we view it? Bearing in mind what’s been in the newspapers recently, we would view it with a degree of suspicion because there would be the feeling that they’ve gone over and above, made real efforts to do a Schuldschein. So you have to ask why. Have they tapped out other sources of liquidity?

Boehmer, Helaba: There’s a lot of noise around the Carillion Schuldschein placement and it’s going to be interesting to see how the market, or investors, are coping with that. But on the other side, Carillion didn’t finance just by Schuldschein, it was only 5% of their outstanding debt.

Fretwell, M&G: There was a comment in last year’s roundtable where one of the participants spoke about an international non-German deal, for an aircraft lessor. They had fewer than three years of accounts and the comment was along the lines of “we were very pleased it got away and it was largely placed with Far Eastern investors”. Now, that’s the kind of deal that we would feel uncomfortable with.

Smith, Commerzbank: Interestingly, the issuer that Simon mentioned had executed a highly successful US PP before they came to the Schuldschein market, which had all US investors in it. And also the ownership was Asian, so there were underlying reasons why there was Far Eastern emphasis on it from the investor perspective.

International Schuldscheine differ a bit from the true German ones. Our loan document is never 15 pages, and it’s perhaps more of a hybrid loan than the true Schuldschein that you’re used to in Germany. It will have covenants in it — not every single time, depending on the borrower’s credit and standing, but most of the time we still have covenants. So the document isn’t this flimsy piece of paper that sometimes the press seem to mention.

Kuhn, BayernLB: You’re completely right. The more international you become, the more likely you will have definitions of three or four pages. It’s totally uncommon for regular German corporations. It’s based on German
The LMA is writing a guidance about it and there will be a draft documentation. Not really for everybody, but it’s supposed to be a starting point for discussion and providing 70%-80% of the core. And around that, it’s going to be adjusted to the needs of issuers as well as investors, depending on who we are talking about. That might push it a little bit more down the road into the UK market.

**GlobalCapital: What is involved in choosing between US PP and Schuldschein, or other kinds of debt?**

**Martin Leighton**

_Great Portland Estates_

**Leighton, Great Portland Estates:** It may sound odd for a corporate to say this, but this concept of a covenant light structure isn’t something that’s very attractive to me. Provided that the covenants are in line with our bank group covenants, then we’re not doing anything extra and if there’s a market out there that isn’t really interested in covenants, certainly for a property company where we’re used to having covenants on any kind of borrowing that we do, at worst these investors don’t understand the market and they’re going to be a bit flaky when times get worse or, at best, they do understand it, but I’m paying for that lack of covenant structure in the margin. I’d rather have some covenants and a lower coupon.

**Barker, Pricoa:** Not only in the US private placement market do you get tenor and currency, but you get investors that are relationship-based and you know who they are and you get a lot of flexibility around how you can structure it.

**Boehmer, Helaba:** The point we always make is that the Schuldschein has the advantage of smaller sizes, but you can upscale it, you can run it like a programme. The corporates we have arranged Schuldschein placements for, they come back, like you do with US PP. They like it. The terms have changed over time as well. We used to have three to five years. Now we have seven to 10 years, sometimes even beyond.

What we have seen in Europe over the last few years is they want to get away from core funding, diversify more, so Schuldschein is one of the parts which customers appreciate.

**Kuhn, BayernLB:** What’s difficult about Schuldschein is it’s very difficult to put it into one section of the capital market. We realise transactions up to €2.2bn, meaning that’s quadruple the size of a regular benchmark public bond. We did a Schuldschein as low as €15m.

We did a Schuldschein with one single investor going up to €300m. It’s really a private placement in that case. But we also did transactions with 300-400 investors in one single trade, meaning you can do something between very private and public. You can do something with longer tenor that then becomes more like a US PP.

We did up to 30 years and it’s probably not really known in the market. Those volumes are not €300m-€400m in that case, but whenever you have one transaction having five tranches and you have seven, 10, 12, 15 and 20 years in one deal, you will have very different investors.

In a shorter tenor, you will end up having the majority being banks. Whenever you go beyond 10 years, you end up having insurance companies and pension funds. Then it becomes totally different and the requirement from insurance companies and pension funds is more stringent and directed towards financial covenants versus the banks, which feel comfortable lending money without covenants, having a five year term agreed.

It’s very difficult to have one section without and one section with financial covenants.

That doesn’t work. But whenever the issuer is looking for longer tenors you get close to a US PP. It is more comparable.

**Rothenberg, MetLife:** There’s been a lot of talk in recent years about these various markets in Europe coming together and merging, but you have different investors with different needs. So I haven’t really seen any convergence of private debt markets across Europe. They still seem to be quite distinct and each one serves issuers in a different way.

**GlobalCapital: Would the European private debt market benefit from a similar system to the NAIC grading system for US PP?**

**Smith, Commerzbank:** A large part of the investor base is bank driven, and they will always do their own ratings internally, so having an outside rating system wouldn’t particularly help them. It would perhaps be of more interest for the institutional investors.

**Kuhn, BayernLB:** One of the key aspects for many issuers to go there without external rating is that you don’t need an external rating as the vast majority of the investors have the requirement to do their own rating. As the Americans say, ‘if it ain’t broke, don’t fix it’. We have €28m in volume without an extra rating for that product. It works.

Some rating providers imply that a rating would spur and help the quality of the market, but that’s a business model-driven argument.
**Smith, Commerzbank**: I understand the NAIC rating is only given at the end of a transaction, so investors aren’t aware of the actual rating at the outset when they’re doing their analysis.

**Rothenberg, MetLife**: Yes, there’s an opportunity to pay for pre-designation on a deal, but almost always the designation from the regulator only comes after the deal is done.

**Fretwell, M&G**: The NAIC allocates a rating that the insurance companies very rarely pay any attention to, with the exception of the allocation of capital. That’s what it’s there for — the regulator allocating capital. So it’s generally assigned after the deal is done and so it would be no use to an investor. UK investors are ruled by Solvency II and so NAIC ratings are not useful for them.

An illustration of how much it is pure regulatory is the number of restructurings where there’s a danger the NAIC will rate something a ‘3’ or lower, which means a much higher capital allocation than an NAIC ‘2’. But the US investors will say “maybe we can find a rating agency opinion that will coincide with our preference capital allocation and they could get us a triple-B kind of rating”. The NAIC has said that it will take that external rating over its own rating. So, I guess the phrase that comes to mind is gauging the system.

Having a system that is so transparently there for the convenience of the regulator and not the investor, I can’t see what it would add at all. US investors are very sophisticated, so they do their own credit work and so would take an external rating of interest, but not rely on it.

**Boehmer, Helaba**: In the Schuldschein market, most issuers appreciate that there’s no rating requirement. Less complexity, less cost, same as with the documentation. So there are two selling points. On the investor side, they do their own diligence.

**Leighton, Great Portland Estates**: The NAIC feels like a very opaque institution. We’ve been upgraded once, downgraded twice, I think, but it’s very hard to know. All unrated propcos were downgraded by the NAIC following the referendum. That’s what I’ve been told by banks — unless you have a rating. Which, to me, is nonsensical. To think that every company, irrespective of anything to do with their credit, needs to be downgraded undermines the institution.

**GlobalCapital**: What needs to be learnt from the recent Carillion and Steinhoff debacles? Will there be a retreat from those sectors or from riskier credits in general?

**Fretwell, M&G**: Let’s deal with Steinhoff because it’s easier, in a way. That’s your traditional accounting irregularity. What do you learn from that? That one man cannot do all these deeds by themselves, so there must be a question of governance, and then you’ve got to ask about the quality of the audit. Both of those will be inspected.

In terms of Carillion, it’s not the only one in the construction support services sector to have problems, but it went spectacularly wrong. It went wrong so quickly as I understand, they didn’t get the chance to do a restructuring and it went straight into insolvency.

**Simon Fretwell**

*M&G Investments*

Again, one would think, reading the newspapers, that the auditor will be answering a few questions as to what work they did and why they thought it was adequate. That might come up as governance. This international Schuldschein, not the Mittelstand stuff, the US PP side are looking at it and thinking how does this work?

There was another case, Premier Oil. There’s a big question. You’ve got a bank loan and you’ve got a syndicate manager. The syndicate manager takes the votes, tots them up, gets a majority, you go forward. The US private placements does the same, but unless, as I understand it, you have a Schuldschein in Germany, then you will not obviously be able to apply, for instance, UK scheme of arrangement, which is a way of getting rid of minorities. So therefore you need 100% of your Schuldschein investors to approve something.

When Premier Oil got restructured last year, looking at the information that went public, it said that the Schuldschein investors received an extra 100bp over other financial lenders and 50bp more in fees. I can only think that’s because it smoothed their way, and one of the things they did was change from German law to English law, which would make any scheme of arrangement easier to effect.

So what do we think about Schuldschein? We would certainly look at them with more respect for some of the surprises that might come down the line if anything goes wrong, pretty much the way that we woke up to pension schemes when that regulation changed. It takes a bit of a focus. For UK issuers, we would certainly look at them very carefully, what they might mean.

**Barker, Pricoa**: I have been trying to answer the question of whether there’s going to be lower issuance in the construction and support services sector by thinking about it from a supply and demand perspective. Clearly, from an investor side, there is going to be more scrutiny and more reticence to invest in those sectors. That is always the case when there’s a high profile default in a sector.

And from the supply side, the government’s clearly going to be looking at the financial condition of these companies much more carefully in the future, and so they’re going to run with lower leverage and so there’s going to be lower issuance.

So I think there’s going to be lower issuance, but that’s not to say that a support services or construction company couldn’t get a deal done in our market. They’d clearly find it tougher at this point, but I think the investor base likes to think they’re an intelligent group and
can take each credit on its merits. I don’t think Carillion has shut down the whole market.

**Fretwell, M&G:** There’s been a bit of a mantra in the US. If you’re lending to asset-light companies, then you should expect problems when things go wrong. And it’s a whole sectoral problem. They’re all egging each other on and complicit in their collective misery.

Asset-light, is that good? If interest rates go up, one suspects asset prices will go down. So why will companies go bust? I think if we talk about support services, we’re probably fighting the last war. I think if we look ahead, what’s going to cause us real problems is probably higher interest rates and asset prices.

It won’t be because companies default on interest covers because the kind of people we lend to, they’ll be all hedged. We may see problems two years down the line if everyone wants to sell all at once and they all cram into the exit. That’s when you get volatile asset prices. So what have we learnt? To think about things more.

**Kuhn, BayernLB:** Carillion and Steinhoff are not a product issue. It was an event of default in the Carillion case and Steinhoff was just in trouble. It’s definitely something where all the investors were relying on audited financial statements. It was not an unknown auditing company, it was Deloitte for the last five years or more and everybody was relying on that.

Steinhoff had an investment grade rating until they announced the December event and irregular things on the balance sheet. Until then, everything was fine. The ECB was buying bonds off Steinhoff. So nobody is saying anything about Carillion and Steinhoff in relation to all the other products.

Everybody is talking about those two issuers of Schuldchein and that’s not really fair towards the product. Whenever a company gets into real trouble and defaults maybe, Schuldchein is not the best product to be in. Whenever you have 100 or 200 investors, you end up having 300 different investors who have a legal bilateral. From a credit perspective, the market, so you can’t really avoid companies where the kind of people we lend to, they’ll all be all hedged.

From Carillion, the investors who are on board will make sure in future that it’s pure German law. In that case, nothing happens in the default case. But a default in the Schuldchein is something very uncommon and supposed to remain that way. That’s why that product is not meant for somebody who is crossover investment grade or sub-investment grade. It’s supposed to focus on investment grade and nobody wants to change it to become more suitable for those weaker companies.

**Fretwell, M&G:** Talking about the international Schuldchein, do you think, potentially, banks have brought deals that maybe they wouldn’t have brought if it had been purely German investors, just because there is a big demand from the Far East, for instance?

**Boehmer, Helaba:** The international side did grow because there was more demand coming from places like the Far East. Last year, we had the big Lufthansa Schuldchein. There was a very big single tranche signed by Chinese investors, but Lufthansa asked specifically to go there. The Chinese, Japanese and Taiwanese have an appetite in terms of corporate risk, and that’s the reason why they do it. They invest and put it in their portfolio.

**Smith, Commerzbank:** But it’s also a yield thing. A few years ago, we saw triple-B credits and didn’t really see sub-investment grade issuers. But investors want yield, returns are going down, so the only way they’re going to get higher incomes is to look at sub-investment grade if the BBB+ names don’t meet their return criteria now.

**Kuhn, BayernLB:** The majority of German investors are looking for strong connectivity of footprint. That might be a global corporation but the issuing entity needs to be a German one. The smaller they are the more likely they are to have their own bylaws that they are only allowed to invest in German issuers. So we would lose more than 50% of the 400 investors and we do lose those numbers whenever it’s an international issuer.

There are no investors going away from the product because of those events. People are now realising they are at the end of a corporate loan risk and it’s supposed to be risky. As long as people are aware of that fact, or reminded by such an event, it’s not the worst thing, as long as the market remains.

**Boehmer, Helaba:** Someone said earlier that Schuldchein hasn’t been through cycles. That’s not necessarily true. Schuldchein has been around for 30 or 40 years. It’s become more international in the last 10 years, but it’s been through cycles.

**GlobalCapital:** Are investors asking which other companies are these auditors auditing?

**Rothenberg, MetLife:** They’re going to be prevalent in the market, so you can’t really avoid companies where certain auditors are involved. From a credit perspective, there are a number of asset-light companies that have issued in the private placement market and one of the things you look for in those companies is long-term contracts.

One of the lessons from Carillion, in my opinion, is there will be more scrutiny of long-term, fixed-price contracts, because there’s not a lot of transparency around how successful or how profitable those contracts may be, especially if the company is aggressively bidding for new business in a competitive market. You have to look at governance procedures internally around that bidding and rely, to some degree, on the track record of the company.

Seasonality of debt is another factor. Many companies...
private debt markets? and environmental, social and governance analysis in made to private debt markets? impact on the market in terms of supply or demand. The more third-party money you manage and the more environment and social investing in its own right, but sure. It's a self-perpetuating problem in the sector. In a private market, usually it's buy-and-hold and nobody cares that much about secondary market liquidity. So public green bonds may be something way more important than in the private market.

**Barker, Pricoa:** When some of Carillion’s peer group have gone for amendments over the last year, one of the things that investors have been ensuring they get is greater transparency of things like payment terms and trying to scrutinise what companies are doing with their working capital.

Even if companies try to become more rational in their bidding strategies, as they lower their workload, the working capital unwind just means that, from a liquidity perspective, they're immediately under pressure. It's a self-perpetuating problem in the sector.

**GlobalCapital:** What differences, if any, has MiFID II made to private debt markets?

**Smith, Commerzbank:** Schuldschein is not impacted by MiFID.

**Merkofe, UniCredit:** On the Euro PP side, it's different compared to standard private placements — MTNs. You deal with buy-and-hold investors and a secondary market is less relevant. The introduction was generally very smooth for private placements.

**Rothenberg, MetLife:** I have not seen a noticeable impact on the market in terms of supply or demand.

**Fretwell, M&C:** We’ve seen more formalisation of reporting and checking and central recording. One of the big focuses is that we’re not being induced by banks and brokers, so we now have to pay for research, and what that’ll mean is a smaller universe of equity analysts who will give us information. So there will be a drop-off in research houses, but in terms of what we do, no.

**GlobalCapital:** What is the role of responsible investing and environmental, social and governance analysis in private debt markets?

**Fretwell, M&C:** These things are becoming explicit focuses of certain investors. At M&C we’ve got one portfolio manager focused on environmental and social investing and we’ve got external investors, who all have their own view on different aspects of environment and social investing, the more of a focus it’s going to be.

**Kuhn, BayernLB:** It’s going to be very important in the future. It already has some importance, but, going forward, it’s going to be more important in a public market, as you will be able to provide better secondary market liquidity for your green issues.

In a private market, usually it’s buy-and-hold and nobody cares that much about secondary market liquidity. So public green bonds may be something way more important than in the private market.

**Rothenberg, MetLife:** We have an ESG policy in place that guides how we invest across all asset classes. We take into consideration ESG factors because it’s the right thing to do and from the potential of having an impact on credit quality – such as environmental liabilities and governance. And we intend to devote more resources. We recently created a new business unit called Responsible Investment Strategies to increase our focus on ESG investing.

**Leighton, Great Portland Estates:** There is plenty of interest in it in the public markets, both the equity and debt markets. We’ve seen less from the private debt market to date, but it’s a huge area of focus for us, making sure that all our buildings are appropriately designed and managed and that we meet certain thresholds. It’s already very big and it’s growing.

**Smith, Commerzbank:** A few years ago I was never asked by borrowers about green issues and now more often than not I am, and often by borrowers that you wouldn’t think would have any interest. The Schuldschein has followed the green bond principles, so the proceeds need to be used for a green project. However, some of the people I speak to say they haven’t got a big enough project, so can’t they do it based on sustainability objectives only. So far, we haven’t seen a Schuldschein done on that basis, but maybe we will. It’s becoming a topic at an earlier stage in discussions than it ever was before.

**Kuhn, BayernLB:** So far there have been six green Schuldscheine and in mid-March there was another, so it’s going to be there and definitely more visible and frequent in the future.
Euro PP awaits end of QE but pan-European hopes fade

The Euro private placement market has had to fight competition on all sides, and quantitative easing has helped to make that more intense, with banks, the Schuldchein market and public bonds offering very cheap funding. Prospects of the cheap money tide ebbing are raising spirits.

But as Silas Brown reports, the idea of one Euro PP market covering Europe is fading.

FOR A MARKET ONLY six years old, the Euro private placement has had quite a tumultuous life. Born in 2012 amid high hopes of building a European market to rival the old-established US private placement market, the Euro PP quickly achieved success and strong institutional backing in its home market, France.

But issuance growth then peters out, amid the weird financial conditions of Europe’s long recovery from the financial and sovereign debt crises. The market has grown, both within and outside France — but not as much as participants had hoped.

Now, as the European Central Bank takes its foot off the financial accelerator, the market may have more room to breathe.

But at the same time, there has been a subtle change. Participants who maintained that, little by little, Euro PPs would expand into a pan-European market have largely given up on those claims. Instead, they say the Euro PP concept will spread across Europe, but perhaps in the form of multiple local markets with their own characteristics.

For the France-based Euro PP market, last year ended better than it began.

Larger borrowers had shunned the market for a few years. But in the last two months of 2017, four of them — Financière Agache, FFP, Mercialys and Orpea — issued larger-than-average Euro PPs.

“Treasurers began to realise that rates will rise soon, as the ECB withdraws from the public markets, and so companies were looking to lock in funding now,” says a Euro PP banker.

The ECB is widely expected to choose September to make another reduction in its quantitative easing policy of buying public sector, covered and corporate bonds. Just how QE and other very expansionary monetary policy measures have affected private debt markets in Europe is a matter of some debate. But there is certainly a view that by depressing yields and encouraging banks to lend, they have made it harder for institutions offering private debt funding to compete.

“Our clients were in an unprecedented, challenging environment”

Thierry Vallière, Amundi

Euro PP issuance wilted in 2017 to as little as €4bn-€5bn, from a high of nearly €9bn in 2016. So there was relief in the market in November, when Mercialys, the shopping centre owner 40% owned by Casino, placed €150m of 2% 2027 notes.

FFP, the Paris-listed holding company 79.5% owned by the Peugeot family, then tapped its 2025 Euro PP for €37.5m, and issued €10m of new 2.6% 2026 and €20m of new 3% 2027 notes.

Orpea, the listed nursing homes company that was an early Euro PP issuer and has also issued Schuldchein, sold €63m of 2.2% 2024 Euro PP notes in mid-December. Financière Agache, a holding company owned by Groupe Arnault that holds indirect stakes in Christian Dior and LVMH, closed the year by tapping an existing deal expiring in 2022 for €70m, paying a coupon of 1.204%.

“They’re still paying coupons that are higher than what they find in public markets, or even the Schuldchein, but I think they’re beginning to realise that that reality might end soon, as the ECB winds up its purchasing programme,” says the banker.

ECB to lift its heavy hand

It is too early to say whether the exit from QE and eventual tightening of monetary policy will lead to a flourishing of private debt. But Euro PP investors certainly feel QE has made life particularly tough for them.

“Our clients were in an unprecedented, challenging environment, from unconventional policies of the ECB having a number of adverse consequences across asset classes,” says Thierry Vallière, global head of private debt at Amundi in Paris.

Institutional investors expect to be paid an illiquidity premium for holding Euro PP notes. That premium was particularly visible in a climate where euro public bond yields were stick-thin — and where central banks were pumping money into banks through measures such as the targeted longer term refinancing operation (TLTRO).

But when the season changes and rates begin to rise, the case may strengthen for companies to diversify their funding away from banks and bond markets.

“Our pitch of a smaller number of investors with larger ticket sizes, that can offer longer tenors, would be that much more attractive if there wasn’t such a difference in yield,” says another institutional investor in Paris.

Corporate treasurers appear to be getting the message. Les Cinémas Gaumont Pathé, a subsidiary of
Pathé Group, issued its first Euro PP in March, at quite a large size for the market. After holding meetings with investors from February, it placed €120m of seven year notes with a closed group of seven investors via BNP Paribas.

In late January, French casino and hotel operator Groupe Lucien Barrière had issued €90m of six and seven year Euro PP notes to a group of five investors, arranged by BNP Paribas. Holiday village firm Pierre & Vacances issued €76m of 3.9% February 2025 Euro PP notes via BNP Paribas, Crédit Agricole and Natixis.

“2016 was the year for Schuldschein issuance, with the likes of Plastic Omnium and Groupe SEB, and 2017 was the year for unrated bonds,” says Fabien Calixte, European head of BNP Paribas’s unrated credit platform in Paris. “So far this year, there is a question mark.”

The Euro PP market has a chance to tempt larger issuers away from other funding sources. This is good news, as funding opportunities are beginning to emerge elsewhere for the smaller companies that have kept Euro PPs going in recent years.

**Rivals from below**

The Euro PP market is facing a growing challenge for business from crowdfunding and technology platforms offering quick, low cost loans.

Online lenders like Lendix and Nivaura aim to speed up the process of raising debt for small and medium-sized companies, while cutting arranging and legal fees too.

“This could seriously affect deal numbers in the Euro PP market as, in a sense, it makes sense for smaller companies to use these platforms,” says a Euro PP banker.

That would include issuers like property companies Bird AM and Capelli, which sold Euro PPs in 2017 for €75m and €22m, paying 6% and 6.25%.

“Advisory fees and arrangership costs are pretty much comparable for a €15m deal as for a €500m deal,” says Phil Smith, debt capital markets partner at Allen & Overy in London. “Furthermore, often there is even more of a time lag.”

But losing such deals might not be the end of the world for institutional investors, as they require so much effort. Given the choice, investors prefer to work on bigger deals.

“2016 was the year for Schuldschein issuance, and 2017 was the year for unrated bonds. This year, there is a question mark”

Fabien Calixte, BNP Paribas

“The smaller the Euro PP issuer, the more bespoke the transaction has to be,” says Calixte.

The credit analysis for small companies can be time-consuming and costly.

“It’s a credit-driven market,” says Floriano Ascensao, Crédit Agricole’s head of European private placements in Paris. “You have to understand the credit with a deep diligence, which is a long process.”

One institutional investor based in Paris says: “It’s a bit of a hassle to analyse a small credit when you know you’re only going to get a tiny ticket. What we’re hoping for is larger issuers from Benelux, France, Italy and Spain in particular to sell Euro PPs.”

**Proliferation 2.0**

However, the hope that issuers across Europe will come to regard the Euro PP product as a natural source of funding is starting to fade.

A few years ago, you would have been hard pressed to find a Euro PP participant who had not set his or her sights on taking the instrument across Europe. The EU’s Capital Markets Union drive was widely expected to help build a pan-European market — Brussels is usually in favour of promoting things by harmonising them.

But a CMU report in February, while praising the Euro PP market, tended more in the direction of other European countries aping the French success by creating their own separate domestic markets.

Countries that were well positioned to do so would have a healthy supply of small and medium sized enterprise (SME) borrowers needing alternative financing for domestic private debt markets to prosper, the report found. “This can be amplified, for instance, by a high dependency on bank loans or a rather illiquid banking [system], as is the case in Spain or Italy,” it said.

Italy, for example, has some 4,755 prospective issuers, with annual revenues in the targeted range of €75m-€5bn, as well as a government with a track record of supporting alternative financing.

“Italy introduced legal changes and standardised documentation to support its private placement instruments, launching the ExtraMot Pro [the multilateral trading facility] for corporate bonds, including also the Italian minibonds, in 2013,” the report noted.

The CMU report contains a design for the best foundation for growth — focused on constructing standardised documentation and facilitating active participation by institutional investors.

“The report confirmed what we already knew about the Euro PP market,” says one Euro PP banker.

“Basically, the momentum to take the product across Europe fell as we realised it was simpler to tie up domestic institutional investors and domestic issuers that all know the same legal and regulatory frameworks.”

The European Commission does not wish to impose regulations on a supranational level, which makes harmonising private debt across Europe less possible.

This is recognised by the shrewder market players, who are beginning to accept that the Euro PP market could remain French-focussed for the foreseeable future.

“It is less likely that issuers European-wide will start using this specific product than it was three or four years ago,” says the banker.

“I’m afraid it might be time for us to give up the name ‘Euro PP’.”
Investors keep discipline, wait for narrow space to broaden

Paris is a centre for continental European private debt activity that goes on outside the German Schuldschein and US private placement markets, which are both clearly defined by their legal documents.

This field of activity has great potential, above all because of two secular trends: the migration of corporate debt off banks’ balance sheets and into capital markets; and the exploration of institutional investors into private, illiquid credit.

But in recent years institutions investing in this space have been squeezed on several sides: by resurgent bank demand for credit, whether through loans or Schuldscheine; and by a bullish public corporate bond market, rated and unrated. Both have been stimulated by the European Central Bank’s assiduous quantitative easing.

With that set to end soon, will the space available to institutional lenders expand? And have investors managed to keep their discipline during these lean years and avoid taking dangerous risks?

GlobalCapital gathered leading private debt investors and banks in Paris in March to discuss these issues and other facets of this intriguing market.

Participants in the roundtable were:
- Frederick de Graaf, origination, French corporates and public sector borrowers, Helaba
- Kyra Guerrida, head of sales, France, UniCredit
- Antoine Maspétiol, head of private corporate debt, Aviva Investors
- Sandrine Richard, head of private debt in France and co-head of pan-European fund, Muzinich
- Michael Spitzner, senior originator, debt capital markets corporates, BayernLB
- Thierry Vallière, global head of private debt group, Amundi
- Richard Waddington, head of loan sales and private debt, Commerzbank
- Toby Fildes, GlobalCapital (moderator)

GlobalCapital: We’re here to talk about all aspects of private debt. But seeing that we’re in Paris, let’s start with the Euro private placement market, which began here and established itself very quickly. In the last couple of years issuance has fallen a bit, although the number of deals has been quite high, which indicates it’s becoming a small to mid-cap specialist product. But it seems to be having a bit of a resurgence — the last two or three months have been quite good for deals. Is that due to the imminent phasing out of quantitative easy and treasurers wanting to lock in low rates?

Antoine Maspétiol, Aviva: Volume has been somehow disappointing, since the first start of this market. However, it’s a new market, so we should not expect very big volumes, like those in the Schuldschein market and the US private placement market, which are much more mature.

And yes, the market is addressing smaller companies, so we continue to see a significant number of deals and the overall volumes reflect the size of the companies.

Back in 2012 and 2011 even, €100m tickets were frequent. I think now the average size of the ticket can be €10m or €20m, so it’s quite different in terms of our approach.

Richard Waddington, Commerzbank: The Euro PP is probably more bespoke in terms of the solutions it provides, and requires more focus and attention. On the whole, the deals are sub-investment grade, so they need to be structured correctly, and typically they’re small, club-style transactions.

Thierry Vallière, Amundi: Of course volume is a bit dis-
appointing but the market is still not mature. However, it’s growing, because disintermediation is really a long term trend. It answers some needs, for companies that need to diversify their funding.

You also have some M&A and a lot of private equity funds that have raised record funds. So there is a huge demand for debt.

And on the other side, investors are evolving into an unprecedented, changing environment. They have to face unconventional monetary policy from the central banks. So they need to diversify their investments. They need to find assets with high return, low volatility and low correlation to other assets. This asset class answers to those needs.

Sandrine Richard, Muzinich: We have not invested in any Euro PP transactions so far. We have invested in more than 35 private debt transactions, but private debt is not only the Euro PP and Schuldenschein. There are different instruments, typically senior debt, like club loans, unitranche, stretched senior, mezzanine.

For an acquisition it could be easy to have two different options on the table for an issuer. The right option would depend on the structure and if it addresses the points important to the board.

Also, you have optimisation of cost. And in their decision the board and shareholders also consider execution risk, among other constraints.

These types of instruments are not new but we have more and more appetite from investors for them. They compete with the Euro PP but I’m not sure the overlap is so important because they address different investors and different needs for the company.

GlobalCapital: So you’re providing their first capital market financing?

Richard, Muzinich: Sometimes, it’s the first time a company raises debt outside its bank pool.

GlobalCapital: Thierry, you first mentioned the word disintermediation. Will finding new sources of funding away from bank loans become an even bigger factor?

Vallière, Amundi: All the funding sources are complementary to each other. Sometimes we compete for transactions with banks, but we have an absolutely different business model. Following the financial crisis, banks have really stringent regulations and this is not going to stop. Their cost of capital has increased loads and they have to rethink themselves and change their business models to originate to distribute.

On the other side, institutional investors are in a very challenging world, with this unconventional monetary policy that has adverse consequences across the asset class. So they also need to diversify themselves, to find some yield. These private markets are a perfect fit for them, because they have some premium and a relatively low volatility and low correlation to other asset classes. But they don’t have people on the ground very close to the companies.

Sandrine Richard, Muzinich

Sandrine Richard, Muzinich: Yes, but in France and some other countries direct lending is not real direct lending. Sometimes we still have to, and I say it positively, work with banks.

We mostly focus on small companies — typically in France companies with Ebitda below €20m. Ninety percent of them have all their financing provided by banks and are just looking for a partial diversification of funding.

Of course, because the price is so low, it would be a bit stupid not to raise money today. But the objective is not to push out the banks. It’s just to have diversification of funding, more flexibility, especially in the debt amortisation schedule — and to prepare the expansion of the company and the sophistication of their financial strategy. Usually, the steps are: direct lending, Euro PP or leveraged loans, then high yield and at the end of the day investment grade.

GlobalCapital: Despite the creation of the Euro PP market about six years ago, we’ve seen a surprising
development in the past couple of years: the Schuldschein has really taken off for French issuers. What do you think is behind its success?

**Frederick De Graaf, Helaba:** There has been a great appetite from our issuers to do Schuldschein deals. I think it comes from the Schuldschein’s light documentation and the trend of increasing issuance in the market since 2014. There was about €27bn issued last year. We are developing our branch in France because there's quite a huge demand from issuers to do Schuldscheines.

**Waddington, Commerzbank:** You're right; the Schuldschein has been successful in France. For a lot of French treasurers, it's about their cost of funds. The various private debt products tend to occupy different spaces in the credit spectrum. Initially the Euro PP was investment grade, but quickly it crossed over to sub-investment grade. The Schuldschein is primarily investment grade-equivalent, maybe with a little bit of crossover, and then obviously we have true private debt, more in the single-B space. So you've got stratification of the market and the different private debt products have found their respective credit postcodes that they like to operate in.

The French treasurer is the king at getting the cheapest debt available. Presently, Schuldschein is the least expensive private debt product, principally because the investors want investment grade debt and they're willing to go tighter on prices than the institutions active in the Euro PP space.

The Euro PP investors have a yield requirement that they're less flexible on and the banks are willing to be more flexible in terms of price and structure. But they will remain investment grade.

So the Schuldschein has grown very successfully in France and become embedded as a part of the product offering, although 2017 was less active than 2016, because the unrated bond market has been very aggressive.

**GlobalCapital:** What has it replaced, though? Has it replaced the loan market as a source of funding?

**Waddington, Commerzbank:** Yes, I think it has mainly replaced drawn debt in the loan market as well as competing successfully with the unrated bond market. Some of the big Schuldschein deals in 2016 potentially could have been done in the bond market. The bond market tightened in 2017 and I think that's part of the reason the volume of French Schuldschein issuance in 2017 was approximately half that in 2016.

**Michael Spitzner, BayernLB:** I think the development of the Schuldschein market in France came about for several reasons. Among the first countries outside Germany to begin issuing, France was one of the early birds.

It was partly for educational reasons. The product, with all its advantages, including being based on German law, but also its flexibility, ease of handling, was explained to the French corporate world, which helped to make it familiar and increase trust in this formerly German product.

**De Graaf, Helaba:** Also, the economic situation in France is getting better, so we have an appetite from Schuldschein investors, which in turn encourages issuers.

We have our savings bank sector, which is a quite active and recurrent investor in Schuldscheines, but we've also seen since several years that we have Asian investors buying, who are also showing an appetite for French issuers.

**Valliére, Amundi:** The Schuldschein is a bit different from the real disintermediation market. It has had a lot of success but three quarters of the investor base is banks and less than a quarter real money investors, institutional investors. So it's a completely different way to manage a portfolio, to assess the risk. Obviously an institutional investor cannot compete fairly in this market. Companies go in this market for the very cheap funding costs, the ease of execution and the documentation that is so weak.

For an institutional investor, to go on this market, it would be really to diversify. They would have to build a very granular portfolio, because you have absolutely no lever to negotiate with the company. That is completely different from what most institutional investors are doing in private debt. Usually they own quite a concentrated portfolio, between 20 or 40 transactions, and spend a lot of time in due diligence assessing the risk profiles of the companies and negotiating the documentation.

In the Schuldschein market you have only one week to execute, you have not a word to say. So it's a completely different way to manage and this is an investor
base that is completely different from the disintermediation market.

**GlobalCapital: So it’s not necessarily giving an issuer different investors?**

**Waddington, Commerzbank:** On the whole it’s predominantly banks, although there are some institutional investors who invest in the product. But usually it’s non-relationship lenders. So the draw for the issuer is a diversification away from its relationship banks.

**Spitzner, BayernLB:** These types of institutional investors do exist in the Schuldschein as well, but it depends what the issuer’s target is.

If the issuer is seeking to issue long tenors and have a selected group of institutional investors, it can certainly achieve that in both the Euro PP and Schuldschein markets. The history and origin of the two products are different, but the issuer’s objectives can be achieved. When you want to have institutional investors in the order book, of course you adjust some of your yield and structural requirements.

**Valliére, Amundi:** Yes, but the bulk of the market is local, German-speaking banks. In the other 25% are sometimes insurance companies, sometimes Asian clients.

In the Euro PP, the LBO and those kinds of disintermediary markets, you will find 90% of the investor base being institutional investors.

So institutional investors really can’t compete in the Schuldschein and find an attractive risk structure, except if they want to build a very granular portfolio. Because they will compete with banks that have very cheap funding from the ECB.

In the latest LTRO [long term refinancing operation] there was an adjudication of in excess of €200bn with a margin between zero or minus 40bp. So how can you compete if you are an institutional investor? There’s no way.

**GlobalCapital:** That raises an interesting point. With the present monetary conditions potentially tailing off, and the ECB withdrawing its support from the market, does the future look brighter for institutional investors to get involved in private debt?

**Richard, Muzinich:** Maybe on the direct lending side, if banks have less capacity to lend money and companies are continuing to grow and have funding needs for acquisitions, expansion, refinancing, dividend recaps.

On the other hand, I would moderate this optimistic vision by saying that also the end of QE would impact the M&A market, the LBO market. A slowdown in debt capacity will, of course, impact companies, so sometimes it will be difficult to lend money. So it’s not all bright, but it might provide some support.

**Kyra Guerrida, UniCredit:** But we started this discussion by saying that the Euro PP market has been a bit disappointing in volume. I think the end of TLTRO should definitely bring some growth to this market. The Euro PP will probably be more attractive for an issuer, compared with bank financing.

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So, for sure, 2018 should be brighter for Euro PP opportunities because there will probably be less competition. Besides the TLTRO element, rates are expected to rise. We are already seeing some issuers knocking at our door, while years back we were knocking at their doors to pitch the Euro PP market. We are also seeing more demand for longer dated maturities.

**Richard, Muzinich:** And for fixed rates. Because if rates go up, of course for an issuer it’s much better to have a fixed rate.

**Valliére, Amundi:** I think fixed or floating is really a technical factor. Every company and investor has the capacity to manage their interest exposure.

But coming back to the question about QE, there might be a kind of paradox where there is no direct correlation between the capital raised, the excess liquidity and the investment opportunity. Today the market is really characterised by excess liquidity, and really the question is: will investors spend this money wisely? Back in 2008-9, there were very interesting investment opportunities but there was absolutely no capital, no investor willing to invest. So there is not a direct correlation between the capital available and the investment opportunities.

As an institutional investor, when you look at the disintermediation market you need to remain very diligent and disciplined, very rigorous, because what we see at the moment with this excess liquidity is a slippage in risk management, with lower financial covenants and legal documentation. So, it’s a bit of a paradox. Disintermediation is coming up but the excess liquidity reduces the attractiveness of the market.

**Richard, Muzinich:** And what’s difficult is that our end investors are asking us to invest because they also have this excess liquidity on the balance sheet and it’s costly for them. So they ask us to put some pressure to invest. Sometimes we see some great credit profiles — it’s fantastic. But we all recognise that on pricing and documentation something is not really going in the right direction — or is already not right. What do we do? Is it better for the investors to have this cash on balance sheet or to invest at 3% in a transaction that maybe three years ago would have been funded at 5%?
GlobalCapital: I guess it depends on the company?

Richard, Muzinich: You’re perfectly right and I fully agree with Thierry’s approach. Either you say ‘I’m not investing because I don’t want to be part of these market conditions’ or you have a different approach — you say: ‘I will be very rigorous on the credit profile’ but you are more open and flexible regarding the pricing, the documentation.

GlobalCapital: What are you more willing to let go of? Is it margin or is it covenants and strong documentation?

Maspétiol, Aviva: We have agreed with our investors that we will deliver investments within a certain credit spectrum, with a yield. The main danger is to be driven by yield and to go outside this credit spectrum and move south in terms of risk.

I think you have to be very clear with your investors. They know exactly where the market is. The main focus is analysing the risk and making sure it really fits with your mandate.

The second is legal protection. Whilst we have to be pragmatic, we should not get rid of the protections which really matter — but you can allow some flexibility and that’s what corporates are looking for when they are looking at investors. This is where we can add value to them.

We have to remain very disciplined as today there are a lot of transactions in the market. Given the amount of liquidity, almost every company can find a suitable financing.

So you have to be very selective, but if there is a good transaction you have to be ready to be aligned with market pricing.

But the main priority is to stick to your mandate. Sometimes it’s very surprising to see that some asset managers are simply driven by yield.

De Graaf, Helaba: That’s very interesting because we, as a Schuldschein arranger, are really looking for the quality of issuers. We have a responsibility to investors and savings banks to provide them with issuers with good credit profiles. Unfortunately, we have seen in the past that there were some issuers who failed. Helaba is really taking care to provide good issuers.

Helaba only arranges deals for our core clients. In most cases we are one of the issuer’s lending banks. That can happen through a direct engagement in the Schuldschein transaction or other financing facilities of the client. We act as an investor on our balance sheet in roughly 50% of the issues we lead.

Spitzner, BayernLB: This is something every arranger has to do, because that’s the goal: to keep it a high quality market for reliable clients. There are some crossover names, but the bulk of issuers are clearly investment grade.

Of course, spreads have come down, as a result of competition and demand, but the market is growing. New issuers, domestic and international, are coming to the market. They are in turn attracting new investors, also international ones.

That’s why we, as the arrangers, have to pre-select as much as possible and not let the Schuldschein market become some kind of high yield market. We also don’t see the typical Schuldschein investor base, consisting of conservative investors, taking credits that are too complex on to their balance sheets, so there’s a natural selection as well.

Some people talk about the documentation getting looser, with fewer covenants, but it always stays in accordance with the borrower’s other facilities, through, for example, cross-default clauses.

Guerrida, UniCredit: Actually, the Schuldschein market today is mainly an investment grade market. But for sure, there is demand for other types of credit. Because the format is one thing, the quality of the issuer is another.

Another point is that the issuer base for the Schuldschein is diversifying, but it’s still three quarters German and Austrian issuers.

But I’m sure the Euro PP investors looking at French and Italian credit would be more than happy to invest in German credit if some issuers popped up, more on the high yield and crossover space, which is not happening for now.

So today the main channel of Schuldschein funding, the classical bank lenders, want investment grade-type issuers, but I think there will be demand on the investor side for lower quality credit in Germany.

GlobalCapital: Can I just be a little bit mischievous, though, and say that with the Schuldschein, we all think it’s an investment grade market but most of the issuers aren’t rated. I know they have internal bank ratings, but is the Schuldschein market being totally honest with itself?

Guerrida, UniCredit: Well, at least it’s investment grade in terms of pricing.

Waddington, Commerzbank: It’s interesting: investors in Schuldscheine are clearly private debt investors. They invest in unrated credits. However, the level of analytics will probably not be the same as institutional investors conduct, because on the whole the credit they’re looking at will be investment grade or crossover, while in most cases the institutional investor will be looking at much...
longer tenors or investing further down the credit curve.

Are the issuers investment grade or not? Investors have to take their own view on that. Some say ‘no, not for me, thanks’; others, ‘yes, the risk/return works for me’. Certainly the commercial banks have a strong skill set of looking at unrated debt and they’ve been doing it for years. So they usually have a pretty good sense of what works for them and what doesn’t.

Some issuers are net cash positive and others are between two and three times levered on a net debt basis. A lot of these companies wouldn’t get investment grade ratings if they went to an external rater on account of their size. So not all choose to be externally rated. But on the whole, 1.5 to three times is probably the typical net debt to Ebitda metric we see. The leveraged loan borrowers can go from four, if it’s quite a cyclical credit, to maybe six if it’s quite a stable credit in the single-B space.

Vallièire, Amundi: At the end of the day, the Schuldschein market is not an institutional investor market. We invest in it when we find really investment grade transactions, but otherwise it’s completely crazy to invest at this kind of price on such a documentation. But there are two different Schuldschein markets. One is really dedicated to local German companies, and how can you say they are investment grade? On average they have €200m or €300m of sales. They are not investment grade because of their size. You don’t have any single investment grade company doing €200m sales. Pricing-wise and documentation-wise, they benefit from investment grade conditions, which is completely crazy from an institutional point of view.

Then there is the second market, for larger companies. This one we consider is more a crossover market than a real investment grade market. We invest in this market, when we are comfortable with the company, the pricing and the documentation. It means we’ve just decided with the company that we should go for a specific legal format, which is the Schuldschein.

Otherwise, we won’t do Schuldschein where you are only going to have one or two weeks to analyse a company that you don’t know and you probably won’t see.

Waddington, Commerzbank: Usually Schuldscheine are three to four weeks in the market. But I take your point. You usually do more in-depth analysis and I would expect that from an institutional investor.

Vallièire, Amundi: Our rationale is really that we should come back to fundamentals. There is asymmetric risk. We are doing credit. There is no upside in what we are doing. If everything goes well, we will be repaid.

So the only thing we can compromise on is not risk management, it’s pricing. If we miss the objective of a fund by 10bp or 20bp, it won’t be a big deal. But if we have to manage one, two, three, four defaults in a portfolio, it will kill the whole return of the portfolio and probably damage our franchise. Because we are not managing very diversified portfolios: we only have between 20 and 40 transactions in the portfolio for this kind of strategy.

Maspétiol, Aviva: In principle, we are agnostic about the format. Whilst we have done Schuldscheine in the past, we don’t any more. We can have a lengthy debate about the importance of the US market or the Schuldschein. I think they are all complementary. Issuers are very agnostic too: they are driven by the price and also by whether the product is borrower-friendly or not.

So on paper we can do everything — US PP, Schuldschein, Euro PP, etc — as long as the risk/reward is attractive for our clients and matches our mandate. So if tomorrow you offer us a Schuldschein which meets all these criteria, we can do it.

GlobalCapital: Just bringing it back to Euro PP, one of the successes in the early years of this market was that it was used by non-French borrowers. Famously, Prada did a Euro PP and some Belgian and Spanish borrowers. Have non-French borrowers been as frequent in the Euro PP market in recent times?

Maspétiol, Aviva: I think part of the answer is: how do you define Euro PP? But that’s another story. We see more non-French borrowers, simply because French investors are more open to them. And part of our strategy is to target a portion of them. For instance, in our fund now we have 30% dedicated to Spain and Italy, so yes, we definitely see more transactions than we used to in the past. Because the barriers about Spain and Portugal and Italy are less important than they used to be. We talk more regularly to our investors about that and they are more open to it, maybe sometimes for the wrong reasons.

GlobalCapital: For yield?

Maspétiol, Aviva: Yes, which is not a good reason from our perspective. Our view is that there are very strong credits in Italy and Spain and we have to identify them. The only restriction we have is that we don’t have a local team. So we have to partner with either banks or independent advisers who can support us to identify the local market and know a bit more about the management, stake out the shareholders, which is key in our credit analysis. We know all the risks in the market pretty well but it’s hard to work outside France when you are not locally based and don’t have local expertise.
Richard, Muzinich: We are 29 people in Europe, spread locally in different countries — Italy, Spain, the UK, Germany, Ireland, France and Switzerland.

We have a bit of a different view on Italy. It’s a very dynamic market, first of all, because banks are not in very good shape, for the reasons mentioned by Antoine. So the companies need a diversified source of funding, that’s for sure.

There are very interesting companies with strong credit profiles. We see a lot of typically family-owned companies that are either looking for growth capital, or starting to bring their capital to private equity firms but for minority stakes. In terms of deal pipeline, the Italian market is the most dynamic for us today.

Spanish companies are in good shape, because they have been able to pass the last crisis and we know it was very difficult in Spain. And the banks there, even if they are limited in number, are in good shape, so able to lend money. And we see more competition from other credit funds and international private debt funds entering this market. So competition is a bit stronger than in Italy, but with good companies.

We hired two people last year in the German market and had exactly the same analysis as Thierry. That is the reason why we did not launch a local fund in Germany, because the pricing was too low. This year, we had closed one transaction in the German market with an underlying risk/return ratio. There are very interesting and numerous opportunities, but not corporate, they are LBO transactions.

GlobalCapital: Are investors feeling more competition from direct lending or unitranche funds, which will take a whole loan themselves and completely bypass the banks?

Maspétiol, Aviva: Generally speaking there’s a lot of competition because there’s a lot of liquidity. Funds are launched every month and some teams are being set up. So I wouldn’t stigmatise the unitranche funds as our main competitors. The overlap is very slight between what they do and what we do.

Our main threats are those who are not disciplined and are ready to accept a lot of flexibility, because of the pressure they have from their limited partners to invest very quickly in many transactions. That’s the main threat in this market.

GlobalCapital: Thierry, are you tempted to do direct lending yourself?

Vallièere, Amundi: We have done very few transactions because the bulk of the direct lending space is really towards unitranche, stretched senior and those kinds of things where you sell investor returns between 5% and 7%. It’s a different business from what we’re doing in most of our funds.

I think there is enough space for everybody. You have some space for commercial investment banks, you have some for institutional investors like us, you have some for unitranche. It might happen that, yes, we chase the same deals but the real issue today is the excess liquidity and how to invest our money in the current market. To do so, we need to stay very rigorous, very vigilant and stick to a disciplined investment process.

Waddington, Commerzbank: Banks will be at the lower end of the return spectrum, insurance companies in the middle and private debt and unitranche lenders at the higher end. Different investors have different sweet spots but the excess liquidity is creating issues for all investors.

Vallièere, Amundi: The way we pitch institutional investors is we tell them this asset class delivers a reasonable premium because there are no tricks in what we are doing. We are not magicians. So if a transaction pays a 7% return, there’s no magic. It means there is an underlying risk. If I’m doing a transaction that pays 3%, it’s because in terms of relative value I can assess that in liquid markets for a similar risk I would be getting 1.5%, 2% or whatever, and I can demonstrate to my institutional investor that, indeed, they come to the private platform and they get the premium they were looking for.
looking for. They get the diversification and all those other aspects.
But there is no magic to what we are doing. We need to deliver a premium in the range of 100bp to 200bp.

**Richard, Muzinich:** Because there is too much liquidity in the market, this theory that the return reflects the risk is not always true.
Maybe the Schuldschein return sometimes doesn’t reflect the risk. Sometimes it could even become an opportunity on transactions. When a company comes to see us, usually it’s after trying before with their banks, especially small companies. That’s the natural way they develop their financial strategy.
If they come to see us, it’s notably because the dialogue with the banks was not conclusive, not because the credit is not good, not always. It’s because their needs — including for execution risk and confidentiality — are not in line with what the banks are willing to offer.
We don’t always have incredible opportunities to take acceptable risks with good pricing, but we have some opportunities. But we also need to be very careful.

**Maspétiol, Aviva:** Coming back to your question about competition, given the complexity of this market, we are trying to differentiate ourselves. It’s hard, but there are three things we look at when we define a strategy. First: what is the depth of the market? Are we able to originate enough transactions with the same discipline? Second: what is our track record? What is our ability to deliver this mandate? Are we credible enough? And the third point is whether the risk-adjusted reward is relevant enough for our investors.
That has really helped us to position ourselves with a different angle. Because the risk otherwise is that your investors won’t see the difference from unitranche, or someone who’s doing LBOs.

**Guerrida, UniCredit:** When a bank meets a corporate issuer, the goal of the meeting is to present different possibilities of funding. At UniCredit we cover corporates from different angles — cash management, lending and many other products.
And when it reaches the point of proposing financing, we are bound professionally to present the different options: one could be bank lending, one could be classical syndicated loans, a revolving credit facility, one could be a Euro PP...
It’s not necessarily that one will replace another, it could be a combination. An issuer can do bank lending for part of its needs and a seven year PP with a bullet maturity, depending on its credit quality.
I think it’s a bit of a shortcut to say that issuers go to investors because they don’t find bank lending. With bank lending, the average maturity is probably between one and three or four years, and depending on the market conditions and the excess of liquidity, we have been seeing more and more bank lending with very light covenants.

**Waddington, Commerzbank:** If you wind the clock back 10 years to 2008, this conversation about the choice of different private debt products just would not have been possible. Here in France the options on the table were a rated bond issue or bank debt. There wouldn’t have been a lot of additional options.
The loan market in 2008 wasn’t in great shape. Most banks were having a tough time and their balance sheets were constrained.
Today, issuers have lots of choice. There is the unrated bond, you’ve got Schuldscheine, the Euro PP, and you’ve also got direct lending...
There’s more competition, more choice — and probably too much liquidity — but an issuer has many more options than it had in 2008.

**GlobalCapital:** We’ve talked a lot about liquidity, meaning excess demand. I keep hearing from some of you that we have to be careful, we have to select the right credit, we have to proceed with caution, and that tells me you are worried about how liquid things are and how long it can carry on. If we gather here in a year’s time, do you think demand will have fallen in debt markets? Do you think we’ll be talking about a tighter market? And could the great choice issuers are enjoying start to decrease as the central banks begin to normalise conditions?

**Richard, Muzinich:** There is a point where we cannot continue in this direction. Leverage is going higher and higher, margins are decreasing day after day. For us it wouldn’t work. At some point in time, investors will have less appetite because below a certain level they are not interested any more. But it will also be a matter of relative value.

**Guerrida, UniCredit:** I think that the end of QE in Europe will be a trigger element in capital markets as a whole.
Euro PPs will then be assessed relative to other instruments. If investment grade comes back to 2% at 10 years, a Euro PP will probably require 3.5%. The question is not: is it right to buy today at 3% when two years ago it would have been 5%? It’s what you can get today, relative to another asset of a different quality.
It’s a dynamic market with dynamic pricing, which I think is very difficult for investors.

**Waddington, Commerzbank:** I think the products are here to stay. Obviously as some of the excess liquid-
ity is taken out of the market I would expect pricing and structures to normalise. We’ve been living in this world of über-liquidity for a while and from an investor’s perspective, seeing some of it ebb away is not a bad thing.

The issuers might have to pay a bit more, but they’re paying an unnaturally low coupon at the moment. In Europe we still have a very competitive banking market compared with the US, where capital markets are much more efficient.

Over time I think we will see more institutional activity and deeper capital markets coming to bear, not to the same intensity as in the US, but I can see Europe moving more in this direction.

De Graaf, Helaba: It’s a macroeconomic effect and we are anticipating that the ECB is going to change its policy in September. Another thing is we see more volatility in the market, on the equity market and on unrated bonds, for example. I think the volatility is a signal that the situation will be going back to normal.

GlobalCapital: As we have discussed, Europe doesn’t have a single private debt market but lots of different markets. I think that’s great, but should the European Commission be doing more to encourage a more co-ordinated approach to private debt in Europe?

Guerrida, UniCredit: What does that mean, a co-ordinated approach? Tax co-ordination?

De Graaf, Helaba: Even more regulation?

GlobalCapital: Yes. Or less regulation. We’ve talked about how lots of different markets are working maybe against each other — Schuldschein versus Euro PP, etc. Could you do it in a single product?

Richard, Muzinich: As in the US, you don’t have a single product. Because the products have to answer two needs — the borrower’s and the investor’s. Do we have one single type of investor? Do we have one single type of borrower? No and no.

Guerrida, UniCredit: And the strength of the Euro PP market — which is probably what you are pitching to your end clients — is the abilities and resources many investors have to negotiate terms bilaterally with the issuer.

If you get too harmonised a market, then the Euro PP would be like the Schuldschein and I’m not sure everyone would be happy with it. And then there is the default law, which in each country is different.

Maspétiol, Aviva: So far, the regulator, the finance ministry, the central banks are looking very closely at how these markets develop but equally letting the stakeholders drive it. And they have a pretty clear message — ‘we trust you, but don’t get things wrong’. So we are accountable and that’s probably a good way of working.

Spitzner, BayernLB: Yes, that’s absolutely correct. I think too much regulation does not help in the end because it leads to inefficiencies and too much administration. Competition itself will help to guide the market in the right direction.

GlobalCapital: What about the impact of technology? We’re beginning to see businesses offering a platform for companies to borrow from, without banks or direct contact with investors. If we’re here in 12 months’ time do we expect to have a fintech person in the corner talking to us about how they are the future of private debt markets?

De Graaf, Helaba: That’s a really good point: in mid-March we launched our digital platform to distribute the corporate Schuldschein with our partner, VC Trade. It’s a single platform where everything from the origination side, the legal side, the issuers and investors up to the back office, it’s all done on the same platform.

Our first deal was a green Schuldschein from Verbund, a leading energy provider in Austria. Other deals are in the pipeline. Digitalisation helps the issuer to have more transparency and cost-efficiency for placements. We anticipate it would also reduce the time it takes to place a Schuldschein from about nine to five or six weeks.

GlobalCapital: It’s interesting that the Schuldschein is a product where blockchain has been applied, with deals for Daimler and Telefonica Deutschland.

De Graaf, Helaba: It’s a different approach. The advantage of our platform is that it’s an open platform, it’s not just for Helaba.

Guerrida, UniCredit: But I hardly see it as suitable for the Euro PP market. I can’t imagine an Italian mid-cap company where it is a struggle to publish results in English going digital...

Richard, Muzinich: In France online lending represents 1% of the debt funding raised. It’s small but the development is incredible. In some platforms you have retail investors putting in hundreds of euros per transaction, and on the other side vehicles dedicated to institutional investors putting in a large part of the funding. I’m sure that in one year it would be interesting to have a person from the lending platform and a blockchain expert to speak, as well.
**Direct lending – a bite out of banks’ business**

New investors are pouring into direct lending and they are scrapping for bigger ticket sizes. Competition has grown quickly, allowing deals of increased complexity and variety to get done. But with everyone chasing the same deals, some have opted to compromise on credit quality. Can the industry weather a change in the credit cycle when it inevitably arrives? Nell Mackenzie reports.

In the direct lending landscape, it looks like funds, rather than banks, are riding high. Deloitte’s alternative lending tracker recorded $50tr in Europe in the quarter to 2017 – the highest level on record.

Lending to small and medium sized businesses used to be firmly the province of banks, often local relationship institutions, but things have changed. Raising cash from funds used to be a niche option for borrowers with peculiar ambitions or difficult capital structures – after all, bank loans ought always to be cheaper. But this is unlikely to turn back the clock. An end to ECB purchasing will hit liquid markets like government bonds first, and hardest. High yield buyers could also return en masse to investment grade corporates, once no longer priced out by central banks.

If private debt funds see withdrawals, the illiquidity of the asset class could be a problem — selling books of loans is far harder than selling securities. In general, funds have lent money expecting to be invested for the long term.

More importantly, the funds entering the market have invested heavily in infrastructure and hiring people that can access the direct lending market, and they are unlikely to pull out just because interest rates go up.

Direct lending has lots going for it. It is easier for someone who establishes a fund, you don’t need a complete lending engine, which a bank has got in situ,” says Paul Burdell, a co-founder of LCM Partners, which runs a direct lending fund, data company and loan servicer.

To understand the growth of private debt, Burdell says, it is worth looking back at the financial crisis.

“Clients looking for loans have complained that in order to support a multinational operation across several European countries they have had to establish relationships with different bank branches.

That causes our clients a lot of angst. We don’t have this problem. As a fund we are borderless,” says Burdell, whose fund has 10 offices in eight European countries.

David Hirschmann, head of direct lending at Permira Debt Managers in London, says funds tend to have more execution prowess, moving quickly to spot opportunities.

When you are a bank you have the infrastructure, you have back offices. It is easier for someone who establishes a fund, you don’t need a complete lending engine, which a bank has got in situ,” says Paul Burdell, a co-founder of LCM Partners, which runs a direct lending fund, data company and loan servicer.

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Paul Burdell, LCM Partners

“Companies have direct access to the people who sit on the investment committee and make lending decisions on a pan-European basis.”

These funds have lots of money to be deployed into direct lending strategies. Deloitte cites $30.7bn of cash raised for direct lending in 2017, up from $25.8bn the year before.

**Bigger and riskier**

That has spurred larger deals in the private markets, which have encroached on the traditional territory of syndicated bank loans.

Nigel Houghton, managing director at the Loan Market Association, says competition for smaller mid-cap business is hot. “However, instead of going further down the scale into corporate SME territory,” he says, “these funds are scaling up to target what would ordinarily have been a bank club deal or smaller syndication.”

And as the direct lending market matures, funds are looking beyond standard loans — and even beyond unitranche or stretched senior.

Funds are using payment-in-kind (PIK) debt, where the interest is rolled up as extra debt instead of being paid in cash on a running basis. PIK loans can be made available to the holding company of a unitranche borrower so that it can increase its overall leverage. Alternatively, funds can offer preferred equity or a synthetic equivalent, where the transaction would not allow for increased leverage.

“These instruments improve
returns in a relatively low margin environment, but also add more rewards to deals that carry more risk,” says Philip Stopford, finance partner at law firm Shearman & Sterling.

Many of these companies looking for more aggressive leverage than they could easily get from banks are private equity-owned midcaps.

“At PDM, about 80% of our direct lending activity is to small and mid-sized companies that are owned by private equity firms,” says Hirschmann.

**Dog eat dog**

The competition between all these debt providers is not always friendly. Sometimes a firm, or its adviser, might try to convince funds offering direct lending to compete. This would involve asking for a shortened version of terms and conditions and pricing called a ‘short form grid’ from each prospective lender, and then playing one against the other.

That is different from a borrower shopping around between banks, but still, the advent of direct competition is hurting direct lenders’ returns and weakening creditor protection.

Larger funds have also started to swipe deals from under banks’ noses.

In 2016 chemical company Pol-ynt began a merger with Reichhold, which was slated to be financed with a bond. But GSO Capital Finance cut in on the banks’ business with a €625m unitranche loan, the largest such deal it had financed at that point.

“It was huge,” says Stopford. Sometimes, though, banks are simply taking deals from each other. Last summer, Goldman Sachs swooped to provide Bridgepoint a unitranche loan instead of the syndicated loan it had been negotiating with HSBC, Royal Bank of Scotland and Lloyds Bank.

Some deals have involved more aggressive competition, but some have just got bigger. In North America, where direct lending has been around for longer and is more developed, unitranche loans were used for two of the biggest direct lending deals in 2017.

Apollo’s purchase of West Corp, a telecoms company, used a unitranche loan within its $4.1bn financing and Golub Capital helped Saba Software’s acquisition of Halogen Software with a $375m unitranche loan.

“Direct lenders are becoming more aggressive on both pricing and risk taking — sometimes deploying capital on deals that got rejected by banks,” said Bank of America Merril Lynch in a research note in February.

It’s not all competition, though. Direct lenders are increasingly clubbing together to do deals, much as a bank might syndicate a large issue.

So far, the young direct lending market has not suffered many defaults — hardly surprising, when it has not been through a credit downcycle yet. What worries some market participants is what will happen to the more aggressive deals when the economy hits trouble.

Paul Mullen, a unitranche partner at law firm Hogan Lovells, says that in two defaults he has come across, the corporate restructuring has been worked out, sometimes with the lender ending up with equity. But it might be harder if a wave of restructurings happen at once.

“Do these funds have the internal resources to deal with a number of restructurings going on at the same time?” asks Mullen. “Some of the debt funds that have been out there for a long time have seen this as a possibility and have taken on board their own restructuring specialist, but not all of them, by any means.”

There is no easy exit door by selling out. Unitranche deals are effectively bilateral loans but drafted and documented as if they were syndicated loans. Although it is legally possible to transfer them, there is no real secondary market.

**Small is beautiful**

While aggression has played out in the top of the market, the rest of the industry has continued to function and mature. Single deals now average up to $300m, says Mullen. “There are outliers, again. People like GSO, KKR who will do more than that. But the players that you are seeing more regularly in the market are looking at up to the $300m level,” he says.

As more capital, experience and guts have allowed direct lenders to go after larger deals, a gap has opened up in the market again where unitranche and direct lending began — with the smallest companies.

Lending to SMEs often requires a local presence, which incumbent and challenger banks and some smaller funds are better set up for. But some funds simply don’t want to make that level of infrastructure commitment, and prefer to go after midcaps.

Hadrion’s Wall Secured Investments (HWSIL) lends to SMEs in the UK on a whole loan basis. Selected deals on its website range between £1.5m and £14m. Borrowers provide security against the loan in the form of tangible or intangible assets.

Ron Miao, chief operating officer of HWSIL, says some clients chose his company because a bank loan may have too many restrictions or requirements.

“The SME sector is our niche,” says Miao. “We are willing to take the time and energy to establish relationships with small businesses and become a partner with them. We are a term lender. Our borrowers have the certainty of term financing and can therefore grow their business with the confidence of having term capital in place and ultimately get to the point where they are a bankable client.”

After that, Miao says the client can go to a bank and get a much more cost-effective loan. But in the interim, his company gives them access to financing to help them achieve their goals.

If the market is too hot at the top, perhaps it is time for direct lenders to look small again.
Private debt’s attractions grow for infrastructure finance

Infrastructure debt is a favoured corner of the capital markets for policymakers and investors alike. But nowhere is immune from plentiful liquidity in fixed income, and yields have been squeezed. Investors are getting paid less and less for the illiquidity and complexity of the asset class — so they have had to go looking further afield. Owen Sanderson reports.

Infrastructure investment is something that almost everyone can agree on. Hard right US president Donald Trump and left wing UK opposition leader Jeremy Corbyn both want to unleash infrastructure construction programmes in their countries — and so do the globalist elites crowding development bank meetings, and the protestors outside those meetings.

So, too, do fixed income investors, seeking shelter from public markets where returns have become increasingly hard to find. With the pre-crisis monoline insurers hardly to be seen, and limited bank balance sheet on offer, there is an opportunity to be had.

Infrastructure assets are illiquid, but that doesn’t matter — long-term pension fund and insurance money has flooded in to take advantage of the illiquidity premium, and as public bond markets have ground tighter, the attractions of the private market have grown more and more obvious. A December paper from UBS, The Case for Infrastructure Debt said just 1% of institutional investment was in infrastructure — but that’s still a lot of cash.

Moreover, it’s mostly private. The same paper cited figures for the European market in 2016 showing €37bn of infrastructure debt in rated public format, and €97bn in private markets — mostly banks — with just €8bn in institutional private placements.

Even a small shift from banks to institutional private placements, therefore, expands supply in the market extensively.

The report notes: “The mid-market space offers a large addressable market, and could present opportunities for investors able to offer long-term funding, a competitive advantage.”

But it’s not always easy for would-be infrastructure debt buyers to get access to dealflow — this, along with the complexity of the assets, is the major obstacle for institutional buyers.

“Getting out there and bringing in opportunities directly is absolutely essential in delivering alpha compared with syndications,” says Jonathan Stevens, head of European infrastructure debt at BlackRock.

“If you are sitting there waiting for a borrower with two ratings, an adviser and two placement agents to come to you with a deal, your ability to generate alpha is very limited. We see private infrastructure debt as a fixed income business, executed private equity-style.”

Stevens illustrates the broader trends in the market — he headed the European infrastructure group at WestLB before the crisis, moved to CIBC’s team in 2014, before joining BlackRock in 2016.

“Every manager will tell you they have the best proprietary deal access, and I will too — we have 22 investors between London and New York, which gives us sufficient time and impetus to build relationships with corporate treasurers, with sponsors, and generate the broadest possible range of investment opportunities,” says Stevens.

Since the crisis, as well as being reluctant to lend, banks have also been less involved as underwriters of risk, according to Ian Simes, senior vice-president, infrastructure debt at Brookfield Asset Management.

“If a bank is going to underwrite and syndicate risk, then they will be sure to price at a level that makes sure they can move it,” says Simes. “The borrower is paying for that and knows it, so financings are typically done bilaterally, or possibly in a small club.”

Brookfield is a big infrastructure equity investor, which helps give the firm access to dealflow in an intensely private market.

“Sometimes we will look at an asset or a transaction and find the returns don’t make sense from an equity perspective,” says Simes. “But that doesn’t mean we don’t like the asset, and it might end up being an attractive mezzanine. So our equity platform can be a helpful source of dealflow.”

Beneath the surface

BlackRock also runs a public infrastructure debt strategy, but despite much fanfare this asset class never quite caught fire in Europe in the way policymakers once hoped it would.

Lots of major UK infrastructure is financed in public markets — for example, the water companies, Heathrow Airport, port companies ABP and Peel, and High Speed One, the old Channel Tunnel Rail Link. But this is far less prevalent across the rest of Europe. Power assets are often financed on the balance sheets of the major utilities such as EDF or RWE, while municipal assets and transport are usually owned by the state, or state-owned corporations such as SNCF or Deutsche Bahn.

The European Investment Bank, one of the largest infrastructure lenders in Europe in its own right, has a scheme to credit-enhance project bonds — essentially, a mezzanine guarantee to make sure the senior financing for a project makes it to investment grade. But the structure has seen limited use, with many
infrastructure investment has to be split between greenfield (new projects) and brownfield (existing projects). Funds historically found it harder to lend against new projects — infrastructure frequently runs up against political difficulties in getting off the ground, and construction can be prone to overruns of cost and time. Banks, meanwhile, like the shorter-dated risk, and have the flexibility to renegotiate loan terms and timings.

But the lines are blurred — particularly when only a handful of funds are lending to a project, rather than a broad syndication of risk. "We do take construction risk, but selectively," says Stevens. "The risk can be fine, but greenfield lending can be very time-consuming to execute. We might have a mandate with a pension fund or insurer with an investment period of 12 or 24 months, but the cycle of investment for greenfield can be much longer."

**Going deeper**

Another way for funds to source direct lending opportunities in infrastructure is to move down the capital structure. Post-crisis, big money managers have pushed into senior debt, replacing banks in investment grade exposures, and funnelling traditional insurance and pension fund money towards an asset that is still considered alternative. That has pushed down returns. But there’s still some juice offered in mezzanine direct lending, where Brookfield specialises. This can be extending the leverage on an infrastructure asset at construction, or helping an asset owner to releverage and take cash off the table.

According to Simes, this remains a less competitive place to deploy cash privately. "In senior debt, there’s so much liquidity looking for a home, and spreads continue to be under a lot of pressure."

Ian Simes, Brookfield

UBS’s report said that since 2013, about €7bn had been raised for infrastructure debt funds, according to public disclosures, with 2016 seeing record fundraising of €2.6bn. It doesn’t break down how much of it was focused on mezzanine investment, but probably very little — meaning it is still an attractive spot for the specialists.

**Liquidity**

Private debt, in all its form, has always struggled with liquidity — that’s a large part of the attraction for some sections of the buyer base. Private infrastructure debt is no exception. Funds buy intending to hold debt for the lifetime of exposure, usually deploying institutional money with long time horizons. But sometimes things go wrong, and market views can change.

Some senior exposures can be moved quite quickly, if needed, but mezzanine or highly structured debt can take a long time to sell — and a lot of market experience. "There are enough participants in the market for it to be possible to sell exposures, but it’s a long process," says Simes. "Buyers would need to enter confidentiality agreements, review all the documentation, get comfortable with the risk and transaction structure. It’s liquid, but it might take a couple of months."

The market is too illiquid to have a well-developed broker network, meaning a portfolio manager might have to call their competitors directly and try to arrange a bilateral sale if they want to exit a position. Despite all the recent growth in direct infra debt investment, it’s still a niche strategy — and may come under renewed threat from the banks, as balance sheet repairs and European regulatory tweaks designed to boost the market take effect.

But some changes to the market’s structure are permanent. Infrastructure is a complex and difficult asset class that needs independent origination to bring in deals — and much of the market’s expertise has followed the money to the buy-side. Yields might be squeezed here as elsewhere, but the private debt investor is in infrastructure to stay. ▲
Looming volatility set to test unrated bonds’ popularity

Europe, unlike the US, has a market for unrated public bonds. This has been one reason why Europe’s private placement market has not grown as large as that in the US. In good times issuers find it a valid alternative to getting a rating, however, as tougher conditions return, the pendulum may be swinging the other way. Nigel Owen reports.

“LAST YEAR WE saw plenty of unrated bond transactions,” says Karin Arglebe, director, corporate bond origination at Commerzbank in Frankfurt. “There is a market now, but it is more difficult. Investors are challenging unrated issuers and asking why they do not have a rating.”

There used to be two main reasons why an issuer might not have a rating before going to the bond market. The first was if the issue was a one-off, or if the borrower did not expect to be a frequent visitor to the markets. The second was for unlisted, family owned companies or those with a history of family ownership, such as German car rental company Sixt and compatriot retail group Otto.

However, a trend developed for corporates to opt for issuing unrated bonds because they felt the rating agencies would not assign them the ratings they believed they deserved. Investors are becoming less willing to accept that as a valid reason. “Only to answer that you don’t trust the rating agency is not enough,” says Arglebe. “With the traditional reasons, you can convince investors, but if you just say you don’t want it, then investors start to think that if the issuer did get a rating it may be sub-investment grade.

“So a result, if you are a new kid on the block, the groundwork is heavy and has to be done, otherwise investors will not fully understand the company and choose not to invest. If you have a rating, you have the report and opinions, so we have something in a nutshell to share with investors. Without a rating, the work investors have to do to familiarise themselves is much higher.”

Opportunity cost
The work involved will normally involve providing more detailed information to the market on a company’s business model, financial statements, strategies and risks and will almost certainly require an extensive roadshow. Even established names in this asset class often have to undertake a series of investor calls ahead of issuing.

The economics of rated versus unrated are less relevant arguments. The cost of a rating is estimated at between £75,000-£100,000, but that is dwarfed by the premium an unrated issuer has to pay compared to a rated peer.

“We always show unrated issuers the delta between rated and unrated issuers,” says Arglebe. “Currently it is around 80bp, which gives treasurers something to think about. It shrank to 40bp-50bp during 2017, and even less for some issuers, but it has widened as market volatility has returned.”

She adds: “Funding costs are much more attractive for rated issuers. But also the level of execution risk is much lower. If you have an unrated issuer, you have to find the perfect window and, right now, it is tricky to find that window. Even though a treasurer may feel a BBB- rating is not in the area he and his company believe it should be, it is still easier to execute with such a rating than without.”

Arglebe believes more treasurers are understanding this dynamic and the number of corporates without a rating is decreasing.

“Take a name like Hochtief,” she says. “It sold bonds without a rating, but now has a rating and its next deal will be its first as a rated issuer.”

However, there is still plenty of demand for unrated bonds as investors look to diversify their portfolios. The extra pick-up in spread is obviously tempting in a market bereft of yields, so it is often a case of what the ticket size will be, rather than whether to invest or not. The bonds may get allocated internally to different pots, but it is still the same investor names in the order books of deals from unrated issuers as those from rated issuers.

Market share
Klaus Schommer, head of syndicate at Helaba, is more optimistic about the unrated bond market’s future as a small but important part of the overall public bond market.

“If you compare 2016 to 2017, volumes in the unrated bond market made good progress,” he says. “We went from €6.8bn to €9.1bn, nearly three times the volume. However, if you look at the share of the overall bond market, including IG and high yield, since 2013, the unrated portion of the market has constantly represented roughly 5% of total issuance.

“2018 has started quietly but the first quarter volumes still imply a 5% share of the overall market. We have seen around 13 deals with a total size of €2.3bn, which is roughly 5%. It seems a fairly normal situation.”

Given the investor demographic
UNRATED BONDS

is very similar, with one notable exception, to that for rated bonds, pricing of rated bonds benefitted from the halo effect of the European Central Bank’s corporate sector purchase programme and Arglebe therefore believes the unrated market will not be affected to any greater or lesser extent than the rated market when the ECB finally ends its buying programme.

“If you have an unrated issuer, you have to find the perfect window and, right now, it is tricky to find that window”

Karin Arglebe, Commerzbank

“When the ECB leaves the market, we believe the whole market will change to higher spreads,” she says. “And we expect the unrated spreads to follow suit. There is nothing else that differentiates the two markets in terms of documentation or regulations, so the two markets should move broadly in parallel.”

Schommer agrees. “I think the unrated market stays as it is. Some issuers will always migrate to getting a rating, but the effect of spread widening is not to push issuers to a public rating. If you want to tap the market on a regular basis, it makes sense to get a rating, but not just because spreads are widening.”

“For companies having their first participation in the corporate bond market it is often a case of publicity,” says Schommer. “To test the capability of the company to issue in the capital markets.”

Insurance companies are noticeably absent from the unrated bond market order books, but this has a simple explanation. The large majority of insurance companies have a requirement that their investments have at least one investment grade rating.

That may also be the case with certain mandates and funds that are managed by pension and other asset managers.

However, within those organisations, there are usually a number of pots of money that can invest in unrated bonds, and often do so to access a more diverse issuer base and to benefit from the enhanced yield the issuers pay, as well as often a premium for the likely lack of liquidity.

With a smaller pool of investors able to buy the bonds, that means lower secondary trading volumes and creates a perception of a lack of liquidity, even if benchmark size rated issues often offer little more liquidity. Investors will push for such a premium particularly when deal sizes are sub-benchmark.

Often unrated transactions tend to be sub-benchmark in size, normally due to the smaller funding requirements of the issuers. But as the size of an issue decreases, the unrated market faces competition from the private placement markets, such as Schuldschein, particularly in shorter maturities, which creates another limiting factor to the growth potential of the unrated bond market. And if such issuers want to look for longer dated funding, the larger and more flexible US private placement market is an option.

The US PP market opens up the insurers not accessible by the unrated public markets. Insurers in that market are large enough and sophisticated enough to do their own credit work and once the deal is priced, the National Association of Insurance Commissioners will assign its own rating which equates to those issued by the more mainstream rating agencies such as Moody’s or Standard & Poor’s.

That process gives unrated European issuers an opportunity to diversify their investor base beyond that of the European public unrated bond market.

Hybrid growth
One recent new development which could bring growth in the sector is that of hybrid bonds. Austrian wood products manufacturer Egger Holzwerkstoffe sold its third hybrid capital deal in February, with its £150m deal its largest size to date.

UK water company Pennon sold a £300m hybrid offering in September 2017 and German agriculture servicing company BayWa sold a €300m hybrid the following month.

“We have seen more private placement sized deals in unrated hybrid format,” says Schommer. “I think there is a real opportunity to grow this area of the unrated sector. The BayWa deal has tightened a lot from where it priced and Egger showed how issuers from different sectors can use issue this product as unrated.

How the unrated market develops in more volatile markets — which look to be ahead as the end of quantitative easing nears and interest rates start to rise — will be one of the corporate bond stories of the year.

While it is clear that there will always be a price, the crucial question is whether issuers will continue to be willing to pay it, given the other options open to them — including an increasingly confident private debt market? ▲
Low rates to end, but fresh challenges await MTNs

The market for corporate MTNs has come under pressure from monetary policy, regulation and a proliferation of alternative products. Dealers have been forced to adapt to new conditions to find ways to demonstrate value, but fresh challenges are approaching, Lewis McLellan reports.

IN THE corporate world, a slew of new private debt options has drawn issuers and investors’ focus away from MTNs. With private debt, and the Schuldschein in particular, in the ascendancy, the corporate MTN world is increasingly the preserve of blue chip frequent issuers — such as utilities and car companies.

The costs of establishing a programme are high (though issuing from it thereafter is cheap), so the format makes sense only for issuers with large enough needs to issue on a regular basis.

“Bespoke private placements, not from MTN programmes, have really drawn the bulk of the attention at the lower end of the credit spectrum,” says the head of MTNs at a bank in London.

But even for borrowers for whom the MTN programme remains a staple of their private debt issuance, competition with public markets has made the market challenging.

The European Central Bank’s asset purchase programme has pushed yields across asset classes and throughout the curve. As a result of the ECB’s presence, corporate issuers have had superb access to the public bond market, enjoying smooth executions during which they have been able to capture low coupons.

“Historically, if you’re getting cheap funding, you have no need for MTNs,” says Richard Proudlove, head of MTNs at ING in London.

“With spreads so tight and rates so low, the appetite for illiquid privately placed products has dried up.”

The rationale for an investor is simple. If it is forced to put money into a 10 year asset yielding 1%, then putting it in a public benchmark with some liquidity and the possibility of switching out into a higher yielding asset is a more attractive option than an illiquid MTN.

However, even if private place-

Because the competition is so strong, banks hoping to charge fees are swiftly undercut by banks willing to forgo them. Even the buy-and-sell margin has been squeezed, to the extent that “some arrangers even subsidise trades just to get something done,” according to Bachmaier.

While subsidising trades is nothing new, thanks to the increasingly intense competition, it may be on the increase. However, no data is available on the proportion of trades that make a loss for the bank.

The value of the MTN for issuers and investors has historically been its flexibility. Unusual tenors at the very long or short ends of the curve have been one of the product’s main points of attraction.

But QE has opened the public market up for longer tenors than ever, stunting the extra value added by MTNs. Rudolf Bayer, head of EMTNs at UniCredit, says: “As we see spreads widen and curves steepen, I expect to see new opportunities in the long end of the curve.”

But not everyone agrees. Some believe the long end of the corporate MTN market may not recover when extraordinary monetary policy support is removed.

The introduction of the Solvency 2 capital regulation for insurance companies has made the long end the almost exclusive domain of high
quality public sector issuers and the very top end of corporate credits. ING’s Proudlove says: “There’s such a high charge for holding long dated assets with credit ratings below triple-A, it’s just not cost-effi- cient for insurance fund investors.”

While government bonds pay a low return, the cost of capital means they are still a preferable investment. The Market Abuse Regulation, which came into force in 2016, has also put a dent in the ease with which corporate MTNs can be put together, particularly for infrequent borrowers. Without large, liquid curves, information on a poten- tial MTN could be market moving, meaning the investor would have to be brought across the wall on the deal. “It adds a layer of complexity to the process,” says Proudlove. “And if it gets harder to do a deal, investors look for alternatives.”

Moreover, issuers have taken advantage of low interest rates to issue large volumes of long maturity debt over the past year or so. With treasuries stuffed with long dated cash, Proudlove suggests corporates are simply not have much need for long end paper in the foreseeable future.

**Structured notes**

Another key product for the MTN market is the structured note. While the 2008 financial crisis hit demand for exotic structures, there is still appetite for paper offering a pick-up in yield, such as callable bonds or those with coupons linked to stock baskets or indices. “With the changing monetary pol- icy environment, floats in the mid-curve are more popular,” says Uni-Credit’s Bayer.

Size appetites are changing too, Bayer adds. “We’re seeing trades in bigger sizes — around €300m often. There are investors who are happy to go for private placements in order to get higher allocation in deals they would not be able to find in the pub- lic market.”

But while demand is returning for structured notes, issuers are less willing to serve it. “They are typi- cally too small to be relevant,” says an MTN dealer in London. “Issu- ers have limited time and resour- ces. Structured notes take up a lot of both but provide only small amounts of funding.”

Just like vanilla MTN products, when public markets are in good health, structured products fall by the wayside. Volatility is the MTN desk’s friend. “Volatility makes access to public markets less straightfor-ward,” the MTN dealer adds. “That prompts issuers to look at other types of deal like structured notes.”

With the end of eurozone QE looming, perhaps as soon as Septem- ber 2018, volatility, long banished from public markets by the ECB’s comforting presence, could make a comeback.

**Technology turbulence**

The adoption of new technologies al- ways heralds a period of turbulence. Capital markets are, like many other industries, being driven by manage- ment to find technological solutions for long-standing difficulties, including high costs.

Those with their eyes on the bot- tom line at investment banks are seeking efficiency savings through digitalisation, automation and disintermediation.

Many banks have their own tech departments, building platforms and solutions in house. All of them are monitoring promising fintech start- ups, eager to spot the next develop- ment that will change the way capi- tal markets business operates. However, some companies are try- ing to cut investment banks out of the business entirely. Marex Solu- tions, a specialist derivatives divi- sion of Marex Spectron, has issued a pair of structured notes direct to an investor. The pair were identical except that one transaction was set- tled via traditional means while the other was printed through block- chain.

By issuing a security via block- chain, Marex was able to cut out expensive depository and custody services, lowering the cost to the investor and speeding up the settle- ment process.

Since investors often only require structured notes of small size, issu- ance costs are a significant barrier to issuance, so reducing these could be a big factor in improving demand. Banks are always likely to have a role in originating such transactions. Spotting opportunities and bring- ing the right issuers and investors together remains the investment banker’s primary value.

Origin Markets, an MTN dealers’ platform, originally set out to bring issuers and investors together. How- ever, it swiftly discovered that the MTN market depends on the input of dealers in generating trades, so it pivoted to become a service communicat- ing issuers’ levels directly to dealers.

Nevertheless, if investment banks are unable to innovate to provide competitive pricing on structured products, then one of the corner- stones of the MTN market may slip out of their grasp.

While MTN dealers have success- fully ridden out a difficult period of low interest rates and volatility, the arrival of new technological systems brings new challenges. The MTN market must continue to adapt if it is to remain a useful part of a corporate issuer’s funding strategy.
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