U. S. Private Placement Debt Markets in the 1990s

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Introduction

From the late 1980s, through the last recession, to today, mid-sized firms in America have experienced a severe credit crunch that has restricted their ability to grow and expand. The origins of this credit crunch are found in a simultaneous constriction of bank lending, coupled with a reduction of available funds in the traditional markets of private placement. The result has been lost jobs in America, lost opportunities, and lost growth.

The traditional private placement debt market has been shrinking for two reasons. First, there is a lack of intermediaries who bring together pools of capital and potential borrowers. This role used to be performed by large insurance companies but changes within their industry that occurred in the late 1980s and since, has seen them leave the field. To date there has been no major institutional investor to take their place. Secondly, a change within the private placement market itself occurred in 1990, creating a secondary market for private placement debt that was specifically designed to attract foreign issuers to American capital markets. By 1994, Rule 144A private placement funds accounted for $53.5 billion of U.S. assets, roughly 40% of all private placement issues made that year, of that a full 39% or $20.0 billion was invested in private placement foreign debt by U.S. lenders.

Growing American Pension Funds

While our mid-sized companies have faced a credit crunch, American workers savings and deferred wages have been growing, along with other elements of American capital markets. Pension funds hit a record level of $3.47 trillion by 1991. In that year the public sector pension funds alone had an asset base of $950 billion. To date pension funds in America account for a full third of all financial assets. The growth of these assets has been reflected in the booming public bond and equity markets, and in the rapid expansion of mutual funds, but are not evident in the private placement debt market.

During this period we have seen dramatic increases in 401Ks and other retirement savings vehicles. New generations of workers fear that their retirement will not be secure through federal government social security and are seeking greater individual control of their retirement savings plans. Much of the growth of private and retirement savings is reflected in the phenomenal development of Mutual Funds over these years, reaching $1.3 trillion in 1995. Most of this pooled capital is reflected in the public markets, especially in the stock market which continues to break record levels unheard of ten or twenty years ago.

Pension fund managers tend toward public stock and bond markets because available public information allows for any risk involved in the venture to be rated publicly. However, there is a role for pension funds to play in private as well as public capital markets. As insurance companies move away from the private placement debt market, it is a natural fit for their role to be taken on by pension funds. Private placement debt requires lenders with long term time horizons and 'patient' capital. Pension funds by definition have low liquidity demands and long time lines. While pension funds are dominant players in private equity issues, they are not strong in private placement debt. Private placement equity issues in 1993 and '94 accounted for $19 billion and $20 billion respectively, while private debt markets were $173 billion and $133 billion in those two years. Given the relative size of

the two markets, this paper will focus on the private placement debt markets and the role for pension funds in it.

Who Borrows in Private Placement Markets and Why

Mid-size firms in the United States are the primary traditional borrowers in the private placement markets. These companies are defined by annual sales of between five million and one hundred million dollars. They generally maintain single plant operations, and the majority are privately held. According to the 1987 U.S. Census of Manufactures, single establishment firms employed 5 million American workers and provided $212 trillion dollars of value added process to the United States economy annually. The major barrier to growth in this sector of the economy is ready and easy access to patient, long term capital for development and expansion. These small, mostly private firms have limited access to capital. Because of their size investors usually prefer debt financing to equity financing, and a substantial debt to equity problem persists for middle market firms. Even before the last recession it was estimated that small and mid- sized firms required $60 billion of patient, high risk value added equity capital, which was twice the amount then available in U.S. capital markets.

Not only are these firms predominantly in debt markets rather than equity markets, they are also primary users of private rather than public capital markets. Public markets require registration with the SEC with a public filing of information. Given the limited size of these private firms and the small amount of the debt issue, such a process is unwarranted. Private capital markets consist of either bank financing for short term, relatively small financing needs; or private placement debt for long term, larger financing requirements. The average size and duration of bank loans for American companies is $1 million and five years with a floating interest rate, while the typical size and duration for private placement debt is $32 million with a maturity of ten years and a fixed interest rate. In contrast the average public bond debt issue is for $150 million.

Mid-size private companies seek private placement debt issues because they are SEC exempt. While the public bond and equity markets require publicly available information to rate the riskiness of the loan or stock, private placements require the lender to seek his own information, due diligence, and loan monitoring. This creates information problems that significantly raise the cost of capital for borrowers and raises both the risk and the information/transaction costs for lenders.

Market Efficiency Misallocations

The central idea behind modern economic theory is the notion of efficient markets and our reliance upon them. In capital markets this efficiency would be measured by the extent to which capital is available for the uses from which we as a society gain the most productive benefits. Other projects with less certainty or lower productive outcomes would have to queue up behind, and as capital became scarcer its price would rise. This rising price makes the positive outcomes of risky projects even less attainable. In this way an efficient market allocates scarce resources only to those projects from which we are certain to receive a net positive benefit. But there are intrinsic failures in all markets, and capital markets are no exception. The assumption of perfect information is required to allocate an efficient market. When we lack perfect information between parties in an exchange, we experience a market failure.

Private placement debt and equity markets have, by their very definition, information asymmetry problems. That is, the sellers of the private debt have more information about the firm, then do the buyers. This is analogous to the problem every person who has ever stepped onto a used car lot has

experienced. Because private placement is information problematic it places a greater cost on the lender. This cost is measured as an information cost, a transaction cost, and without adequate information, a perceived increase in the riskiness of the loan or equity. But this failure does not mean that the firm that issues debt in the market would not use the capital efficiently and increase productivity if they had access to it. What it means is that to get capital to this market we must find ways to overcome the information problems that are its major defining characteristic.

Statistically firms can be placed on an information continuum that corresponds to their access to capital markets. Small new firms with no collateral and extreme information problems are restricted to internal funding or seed money through venture capital.

"Somewhat stronger borrowers obtain bank credit....Even less information problematic firms have access to the private placement market. These firms still have enough information problems to require the services of an intermediary, but they are not so problematic as commercial bank borrowers. Thus they can issue debt with looser covenants then those that exist in the bank loan market. Finally firms that pose minimal information problems for lenders can issue in the public debt markets."

Private placement issues and mid-size private firms that borrow in this market are information problematic. They require specialized agents and intermediaries to act between the investors and the clients.

The Role Of Intermediaries

Information problematic firms issuing private placement debt, are either not rated by bond rating agencies or are classified as below investment grade. Therefore the perceived risk for investment is higher here then in public markets because the requirement to exercise due diligence and monitoring falls on the investor. But much of the risk for investors lies in the information problematic nature of these firms. Intermediaries lower the information cost and lower the monitoring cost, also known as transaction cost, for investors. They do this in a number of ways. First they have specialized knowledge about these firms and often have agents who bring the parties in these deals together. Agents who operate close to the geographic region they serve are more successful in this task then those who serve national markets. Second, they are able to pool sources of capital so that the number of parties in the lending are reduced, usually to three or four major players per loan. Fixed costs make having few lenders for each borrower more economical. This lowers information costs between the parties. Third, intermediaries establish economies of scale that reduce costs to individual parties. Finally, intermediaries offer effective monitoring of the loans for their clients, they use restrictive covenants that allow for due diligence, and bring with that monitoring a reputation for fair dealing. Covenants are the restrictions, or terms of the loan that are placed on the borrower by the lender. They ensure the value of the asset on which the loan is made remains intact. Covenants require continual reporting by the borrower to the intermediary.

"In the paradigm, information intensive financial intermediaries serve information problematic borrowers, not so much because they can efficiently produce information at the origination stage but because they can efficiently employ covenants to control bond holder - stockholder (owner) conflicts."

While private placements have less restrictive covenants then bank lending and are therefore more attractive to borrowers, they allow for a closer monitoring of the assets then do public markets. The triggering of potential default is therefore much faster in private placement markets, and occurs before substantial damage has been done to the underlying assets. Private placement debt markets are known

for their successful renegotiation of covenants that allow for potentially successful firms to remain viable. Under similar circumstances banks more often foreclose on the firm, while in public markets bad management practices are allowed to continue much longer, with greater erosion of the asset base, before trouble is signaled to investors and bond holders. Successful intermediaries are known for fair dealing reputations and the presence of covenants that allow for flexible renegotiation is one of the efficient features of this market. With private placement markets viable firms remain in business, workers retain their jobs, and communities remain strong.

Traditionally the role of intermediary was supplied by large insurance companies who were able to match the illiquidity in this market to their own portfolio requirements. They accounted for 82.6% of the dollar volume in private placement debt markets in 1990/92. By comparison pension funds were only 1.7% of this market during those years. But during this period a number of changes occurred in the insurance industry that resulted in a steady withdrawal from the traditional private placement market.

"Problems in asset quality at life insurance companies, a change in regulatory reporting requirements, and runs on a few insurers combined to raise doubts about the solvency and liquidity of insurance companies and to focus the public's and the rating agencies' attention on the proportion of an issuer's assets invested in below -investment-grade securities as a signal of insolvency."

With insurance companies as the dominant lender in the market, changes in their own industry meant a sharp reduction of the supply of capital that was not correlated to an increase in the risk by the underlying asset. At every level of risk in the private placement market there is now less capital available to borrowers, rather then the typical reduction of supply due to an increase in risk.

The withdrawal of insurance companies from this market requires replacement by a new source of capital. Given the matching liquidity requirements between private placement debt and pension funds, they would make the logical replacement in this market. But to date pension fund managers have been reluctant to enter the field. Barriers to entry include high start-up costs and lack of familiarity with the market.

"Because non participants lack a clear understanding of the private market, the public has a strong tendency to equate below investment grade private placements with public junk bonds."

They do not understand the role of covenants. However, some market analysts believe that in the long run pension funds will become large scale contributors to this market, especially given their growing asset base projected for the future. Because of the information intensive nature of middle market companies however, pension funds will either need to use financial intermediaries like insurance companies for their investment or; "the alternative is for pension funds themselves to acquire the capacity for conducting due diligence and monitoring."

Economically Targeted Investments

Some private placement debt and equity issues are already incorporated in State Public Employees Pension Funds through economically targeted investment (ETI) programs. These funds generally have geographic preferences and other covenants in place for the investments. The 1995 survey of Pension Funds and Small Business Financing conducted by the SBA concluded that the impediments to pension fund investment are high risk (fiduciary responsibility) and the lack of a good fund manager in

private placements. "There is a general dichotomy of opinion among fund managers. That is, there are those who believe ETIs provide ancillary benefits that are important to a state's economic development, while on the other hand there are pension fund officials who believe that both financial returns and "collateral benefits" cannot be pursued simultaneously." Yet surveys from 1989 forward, demonstrate that pension funds with ETIs express overwhelming satisfaction with their returns from the funds. By definition ETIs expect to make a rate of return on their investments that is commensurate to the risk that is taken on, and therefore does not conflict with the fiduciary duty of fund managers. This conclusion reinforces the need for informing the potential market participants more fully in order to familiarize pension funds managers with the benefits both, in "collateral" terms and in potential rates of return on investment, from private placement debt issues.

The 144A Market in Private Placement Debt

In 1990 the SEC adopted a ruling that allowed the trading of private placement debt between Qualified Institutional Buyers. The 144A ruling has in effect created a secondary market in private placement debt that is wholly unregulated by the SEC authorities. Qualified Institutional Buyers are deemed to be institutions who own or invest on a discretionary basis $100 million in securities. This includes most securities firms, banks, insurance companies, and pension funds. Prior to Rule 144A foreign issuers would have been required to go through the costly and time consuming process of registering with the SEC from which they are now exempt. The SEC had two motivations in introducing 144A, one was to introduce greater liquidity in the private placement market, "The other was to make the private placement market more attractive to foreign issuers." The ruling was specifically designed to attract foreign issuers to U.S. capital markets, and it has succeeded.

Since 1990, year over year growth in the 144A market has far outstripped traditional private placement issues. The average size of issues in this market has increased to $92 million. In the domestic market these borrowers are primarily large corporations with complex borrowing needs, who are being underwritten by U.S. securities firms. While the market in such debt has become more liquid, and currently behaves in a quasi-public manner, the size of loans that are sought for this form of underwriting have excluded most mid-sized companies in the traditional private placement market. By 1994 traditional markets had slipped to $47 billion, while 144A markets had reached $53 billion and growing.

In addition to large domestic corporations, this market has made American capital accessible to foreign private borrowers. A full 39% of the 144A market represents American assets funding foreign expansion and growth. In the meantime American gross investment in plant and equipment has fallen to a mere 2% of GDP.

Who are the investors in the 144A market? In 1991 insurance companies purchased 75% of these issues, mutual funds purchased 15%, and pension funds 5%. But between August of '91 and April of '92 insurance companies had slipped to 60% of purchases with mutual funds and pension funds climbing to 40%. With the reduction of traditional funds to private placement issuers from 100% of the market in 1990 and a dollar value of $134 billion, to 35% by 1994 with a dollar value of $47 billion, it is little wonder that mid-size American companies are feeling the credit crunch.

Conclusion
Middle market firms in America have a limited access to capital because of size, and because of the information problematic nature of their debt issues. The traditional sources of capital available to these firms were found both in bank lending, and in the private placement markets of equity and debt financing. But the crisis in the U.S. banking industry during the 1980s primarily fueled by the collapse of commercial real estate values, problems with foreign loans made to developing countries, and a faltering energy sector, produced a credit crunch in commercial lending that included the mid-sized market.

Simultaneously, the primary source of private placement capital, U.S. insurance companies, were facing regulatory changes in their portfolio management and a greater public scrutiny of all their assets. As a result, insurance companies unwilling to have such high exposure to either unrated or below investment grade debt, restricted their lending in private placement markets. Coupled with the loss of their major intermediary, the private placement debt market itself underwent regulatory changes with the introduction of Rule 144A of the SEC. This ruling opened a new secondary market for private placement debt, but the result benefited large U.S. firms and foreign borrowers, it shrunk even further the traditional sources of capital for mid-sized companies. The result of all three changes in the market has been a severe lack of capital to fund the growth and expansion of American mid-sized companies in the 1990s.

There is an opportunity for pension funds to move aggressively into the role that used to be played by insurance companies in this market. Like insurance companies, pension funds have matching time lines, low liquidity demands, and 'patient capital' to invest. Though this market is either unrated or rated below investment grade, the presence of covenants on the loans, and the role of intermediary agents, lowers the risk and information costs for lenders.

While investment in private placements with mid-sized firms has collateral benefits for America's communities and workers, it also brings a fair rate of return commensurate with the level of risk, and therefore does not interfere with pension funds fiduciary responsibility.

Public markets need not be the only avenues for the investment of American workers deferred wages, there is also a vital and necessary role for pension funds to play in the private placement markets of growing U.S. mid-sized firms.

Summary:

- Americans have lost jobs because of the inability of privately-held mid-sized companies to obtain capital to grow and expand. The relative small size of these companies (annual sales of between $5 million and $100 million,) and the information intensive process necessary to underwrite them has made it particularly difficult for them to obtain debt financing.
- From the late 1980s through the last recession, several factors have contributed to this capital gap for "critical middle" firms. First, bank lending has diminished. Secondly, the major "intermediary" for providing capital to these firms--insurance companies--have moved out of this business, with no major institutional investor taking their place. Intermediaries are vital for mid-market companies to obtain capital, because of the information-intensive process necessary for evaluating them.
- The private placement market is the avenue through which insurance companies have provided capital to "critical middle" firms. In 1994, the private placement debt market amounted to $133.8 billion. The equity market was much smaller, accounting for $20 billion.
- The introduction of the Rule 144A in 1990 has spurred U.S. investors to increasingly focus their private debt placements in foreign securities, instead of domestic companies that create U.S. jobs. Currently, a full 39 percent of the 144A market represent American assets funding foreign expansion and growth. Further, 144A borrowers are primarily large corporations with complex borrowing needs, who are being underwritten by U.S. securities firms. The size of loans sought for this form of underwriting have excluded most mid-sized companies from this expanding market.
- Pension funds, which are increasingly dominating the capital markets, are not strong players in the private placement debt market. However, they are ideally suited to provide long-term privately placed capital, because of their long-term time horizons.

Recommendations:

- Pension funds must become more active as investors in the private placement market for domestic companies. Their increased participation is vital if "critical middle" companies are going to survive, and serve their role as centers of U.S. job growth and contributors to technological innovation and economic competitiveness.
- There must be more disclosure of pension funds' private placement holdings, specifically to inform plan participants whether their pension money is invested in such holdings, and where those investments were placed.

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