



Identifying market and regulatory obstacles to the development of private placement of debt in the EU

Executive Summary

Prepared by

BCG

THE BOSTON CONSULTING GROUP

Linklaters

Disclaimer

The information and views set out in this study are those of the author(s) and do not necessarily reflect the official opinion of the European Commission. The European Commission does not guarantee the accuracy of the data included in this study. Neither the European Commission nor any person acting on the European Commission's behalf may be held responsible for the use which may be made of the information contained therein.

doi: 10.2874/108273
ISBN: 978-92-79-66414-4

Executive Summary

Motivation and purpose of the study

One of the key priorities of the European Commission is to build and foster a stable and viable European environment in order to ensure the wealth of its citizens. This includes promoting growth and job creation, but also responding to emerging financial risks. One of the key initiatives to support these goals is to build a **single capital market** for all EU Member States.

In September 2015, the European Commission launched the **Action Plan of Building a Capital Markets Union** (CMU Action Plan) as an umbrella for several steps that need to be taken to deliver a unified capital market. One of the main priorities of this action plan is to provide more funding choices for Europe's businesses and especially small and medium-sized enterprises (subsequently abbreviated as SMEs). As one measure to achieve this goal, the Commission highlights the importance of alternative forms of business financing, including the **private placement of debt**.

To support the implementation of the CMU Action Plan, the Commission contracted The Boston Consulting Group (BCG) and Linklaters LLP (Linklaters) to conduct a study on the development of the private placement of debt in the EU. The main objectives of this study are to **identify best practices** for and **assess potential regulatory obstacles** to the development of private placement markets in the EU.

Moreover, the study assesses the **growth potential of private placement markets in the EU** and should help the Commission assess whether there is a need for modifications to the capital charges calibration under Solvency II for insurance companies investing in privately placed debt. Finally, it serves to **increase awareness** of private placement instruments and their benefits for the different market participants in order to encourage issuers, arrangers and investors to use private placements when appropriate.

Methodology and approach

The study comprises an **economic and a legal part**. Both parts of the study analyse private placements from different stakeholders' perspectives: the issuers, arrangers and investors of private placements. In addition, the legal part also focuses on regulators as a further stakeholder group. In both parts, the study integrates both **quantitative and qualitative sources**.

For the economic part, three approaches are pursued. First, for analysis of **existing private placement markets in the EU**, the study focusses on two countries where private placement as a funding tool has been highly successful, namely (i) the *Schuldschein* (SSD) market in Germany and (ii) the Euro-PP market in France. For comparison purposes, the study also analyses (iii) the US PP market in the United States as the most established market for private placements. The study uses information from commercial databases, including Thomson Reuters Loan Connector, Thomson One, Dealogic, CMS Bureau Francis Lefebvre and the Private Placement Monitor.

Second, to **assess the growth potential** for cross-border activities and the development of new domestic markets, information on relevant companies in the

respective national markets was collected from Orbis, Capital IQ and Bloomberg. Based on this, the potential issuer base was determined and a potential growth scenario derived.

Third, **qualitative data** was collected to close gaps in the databases and to obtain insights that are beyond pure numbers. A thorough literature review covered academic and press reports on private placements as well as analyst reports and publications from rating agencies and regulators. Furthermore, BCG and Linklaters jointly conducted over 60 interviews with a wide range of issuers, arrangers, investors and regulators to include their expertise of both existing and potential new markets.

For the legal part, three different approaches are pursued. First, to identify **regulatory best practice in the well-functioning private placement markets**, the study focuses on the legal environment for private placements in Germany, France and the United States.

Second, to identify **regulatory obstacles to the development of private placement markets across the EU**, both at an EU level and at a national level, additional interviews were conducted with regulators to understand their concerns on the current regulatory framework. Local experts were commissioned to provide an overview of any regulatory obstacles at an EU or national level hindering development of either a local national private placement market or cross-border transactions with the more established private placement markets.

Third, to identify the **most common risk mitigation provisions in private placement documentation**, a detailed analysis of the typical form of documentation used for each of the established European private placement instruments was undertaken. With respect to the Schuldschein market, which does not have a market “standard form”, this entailed analysis of a substantial amount of Schuldschein documentation and the legislation underpinning such documentation. In regard to the Euro-PP market, this entailed the analysis of the standard form of Euro-PP documentation and a large sampling of Euro-PP deal documentation in respect of the more bespoke provisions (e.g. financial covenants). Finally, an analysis of the LMA and US PP private placement documentation was carried out for comparison purposes.

The study acknowledges that private placements are not uniform. The definition used in this study is based on the one provided by the International Capital Market Association (ICMA) in 2015, defining private placement as a “medium or long-term debt financing transaction between a listed or unlisted company and a limited number of institutional investors, based on deal-specific documentation negotiated between the borrower [...] and the investor(s) [...] with the participation of one or more bank intermediaries as arranger [...] usually acting in an agency capacity”.

Key results of the study

Increasing relevance of private placement over past years – two main, well-functioning markets established in the EU

Private placements have become a relevant source of company funding in recent years. In the EU there are several variants of privately placed debt across different Member States, but the study identifies the **German Schuldschein (SSD)** market and the **French Euro-PP market** as the dominant private placement markets. For comparison, the study also analyses the **US PP market** as the most established private placement market.

The **German Schuldschein (SSD)** market has grown significantly over the past ten years. Starting at a total issuance volume of €1.2B and less than 20 known deals in 2006, it has risen to record levels of €25B in 2016 and about 120 known deals. Forecasts expect similar values in 2017, ranging from €20B to €25B total issuance volume.

The **French Euro-PP** market is the second largest private placement market in Europe despite only having been established in 2012. While the yearly volume of the Euro-PP market is still significantly smaller than the SSD market (total issuance volume €4.5B in 2016), the number of deals has tripled in this period: 23 recorded deals in 2012 to 68 in 2016.

In comparison to the two European markets, the **US PP** market is larger and more established – in line with similar observations for the bond markets. The total issuance volume of private placements in 2016 was €47B and 196 deals were recorded. US PPs have strong international exposure with traditionally more than 50% international issuers but due to the rise of the Euro-PP and the SSD market, the number of international issuers has decreased.

Private placements constitute a building block of company funding – but no universal remedy for every company and situation

In general, private placements **allow companies to diversify their funding**. Private placements are a financing instrument, classed between bank financing and corporate bonds, which **enables companies to choose the most appropriate funding source** in terms of maturity, minimum issuance size, rating requirements and others. Serving as an additional option for funding, it can **reduce reliance on bank funding** – supporting the pronounced objective of many authorities after the financial crisis in 2008/09.

Furthermore, private placements – specifically the SSD - have been observed to be rather **resilient in times of economic crisis**. SSD have remained a viable source of company funding during the financial crisis, even reaching record volumes.

Despite these general rationales, the study reveals that the three focus markets of this study (Germany, France and the US) **differ with respect to size and credit quality of the issuer**. The Schuldschein (SSD) is a loan that is typically issued by medium-sized to large firms with revenues below €5B (73% in 2016) of which the majority has investment-grade quality. Euro-PPs are mostly issued by small- and medium-sized firms with revenues below €1B, which accounted for around 80% of issuers in 2016. Credit quality in the Euro-PP market is perceived to be more diverse than the SSD

market with increasing numbers of companies with crossover and sub-investment grade quality. The US PP is dominated by mostly investment-grade issuers, which are primarily large companies. Around 45% of issuers generated revenues of €1–5B in 2016 and more than 95% had an investment-grade equivalent rating.

Furthermore, the markets also differ with respect to the **size of deals**. In general, private placements are particularly suitable for companies seeking to raise unrated debt in smaller denominations. In both the US PP and SSD market, the average deal size in 2016 was around €210M, but deal sizes varied widely, e.g. SSD deals ranged from €10M to €1.6B. For the Euro-PP, where issuers include smaller companies compared to Germany and the US, deal sizes ranged from €4M to €380M with an average around €70M.

Finally, the instruments also differ with respect to their **structure**. While the SSD is structured in a loan format, the Euro-PP also allows for the bond format – both listed and unlisted. Given these observations, the study concludes that the different private placement instruments are not in competition with each other but are complementary sources of financial funding that cater to the specific needs and risk profiles of the issuers and investors.

In comparison to corporate bonds, **documentation for private placements is, in general, simpler and more flexible**. In contrast to direct bank funding, private placements are more standardised on average and can therefore simplify the process of debt financing. In addition, private placement transactions are **confidential by nature**, there are no disclosure requirements of business-sensitive information to the public as most transactions are unlisted.

The main cost elements for issuing a private placement are considered to be one-time arranger and legal fees as well as the regular coupon payments. Costs may vary depending on the chosen private placement format (Euro-PP vs. SSD, rated vs. unrated, etc.), the issuer profile and the requested yield. Nonetheless, overall, **private placements offer lower issuance costs**, especially compared to public markets.

For SMEs, private placement can serve as a **first step towards capital markets** and also to **attract new investor groups**. In contrast to corporate bonds, there are generally no external ratings required. Without the formal requirement of a minimum issue size, SMEs can issue smaller volumes compared to corporate bond issuances. Larger companies primarily use private placements to diversify their funding.

Accounting treatment and promising yields qualify private placements as an attractive investment opportunity

In general, there are two types of investors in private placement markets, with banks on the one hand and institutional investors such as insurances, pension funds and asset managers on the other. As for the issuers, the three markets on which this study focusses also show different investor landscapes: In the German SSD market there are around 800–1,000 active investors, the majority of which are bank investors – providing around 90% of the investment volume. The Euro-PP market is dominated by around 30–60 institutional investors, mainly insurers and asset managers, which also holds true for the US PP market with 50–70 active investors.

For all investors, private placements provide a possibility **to diversify their assets** to unrated, private firms while offering **attractive yields**. In addition, most investors are

investing into private placements until maturity and thus can use **accrual accounting basis**, i.e., there is **no mark-to-market valuation** limiting volatility.

Private placements – specifically US PPs and Euro-PPs – usually offer **longer maturities** that match institutional investors' long-term liabilities as well as their investment strategy to hold until maturity. Also for institutional investors of US PPs and Euro-PPs, **financial covenant protection** makes private placements an attractive investment opportunity.

The high number of bank investors are a special characteristic of the German SSD market. SSDs that fulfil certain criteria can be pledged as **ECB collateral**. German Sparkassen and Volksbanken, in particular, value private placements as a vehicle to diversification, creating new **investment opportunities** outside their usual geographic regions and industries.

Although private placements impose **liquidity risk** for the investor on the basis that there is no properly established secondary market for private placements, almost all private placement investors follow a buy-and-hold strategy and therefore accept this risk to obtain an illiquidity premium and generate an additional yield.

Additionally, there are two main challenges for investors that distinguish investing in private placements from more liquid products such as bonds: **in-house credit analysis** and **monitoring financial performance** after the deal is closed. With regards to the former, it requires a significant amount of time and resources to perform a credit analysis given only few issuers have public ratings. For the latter, as there is no secondary market, there is need for on-going monitoring of the issuers' (financial) performance to potentially exercise any investor rights.

Risk-profile of private placement instruments not substantially different from senior unsecured debt – comparable legal risks affect European private placements and corporate bonds

The study reveals that for the private placement markets in focus, there have been **very few cases of default so far**. Two driving factors can be linked to this observation: First, both European markets as they exist today, especially the French Euro-PP market, are relatively young and still have to prove their long-term stability through an entire credit and economic cycle. Second, the high credit quality of issuer's in the US PP and German SSD market implies a low level of credit risk.

A specific drawback of private placements compared to bonds can be the comparably **complex restructuring process**, in particular when a large number of investors is involved. This applies particularly to SSD which, as a loan construct, has no majority voting clauses or similar rules. For the Euro-PP there are typically fewer investors, which simplifies communication and negotiation and also enhances the investors' sense of commitment. Furthermore, the introduction of the Sapin 2 law increased the freedom as to the organisation of bondholders' representation.

In general, the legal risks in European private placements are comparable to those in European corporate bonds. The typical legal risks affecting issuers of, or investors in, private placement instruments, namely the potential complexity of the documentation, the management of covenants, conflicts of laws issues in cross-border transactions and disclosure obligations in listed private placement transaction, are common also to the European corporate bond market.

No significant regulatory obstacles identified to the development of private placement markets – some minor obstacles

Market participants have indicated that they do not currently see significant regulatory obstacles to the continued development of the SSD and Euro PP private placement markets requiring immediate attention. Indeed, the development of the Schuldschein and Euro-PP markets has been characterised by the **identification of potential obstacles and the subsequent addressing** of such obstacles by refining the market standard documentation or amendment to the applicable legal and regulatory framework. Similarly, in the other European jurisdictions with potential to grow a national private placement market, **market participants do not see any significant regulatory obstacles** specific to the development of such private placement markets. Rather, in each of these markets, the potential obstacles that are typically identified are those which also affect the bond markets as a whole, although such obstacles can comprise a bigger challenge for the small and medium-sized enterprises looking to tap such markets. This is primarily the result of such private placement markets operating within the same regulatory framework as other forms of debt financing.

Existing domestic private placement markets expected to grow further

For the German **SSD market**, given the recent strong growth, most market participants expect the market to further grow, but at a slower pace. This study has identified three drivers that may enable the market to grow further: First, **international investors** also from outside the EU, in particular from the Asia-Pacific region, could increase and widen the investor base in the future. In the first half of 2017, multi-currency deals already amounted to 20% of all transactions. Second, **institutional investors** have substantial liquidity and seem to have appetite for the risk-return profile of the Schuldschein market in general. This potential needs to be tapped further by issuers and arrangers to further grow the investor base. Third, market participants expect that a **change in the ECB bond purchase program** might influence the SSD market, especially for large issuers that issue both bonds and SSDs. A reduction in the bond purchase program might render SSDs more competitive for those issuers.

Most market participants expect the **French Euro-PP** market to grow substantially in the future for two reasons. First, there are still many companies in France that fall under the **estimated potential of the Banque de France** that have not yet issued a Euro-PP. Second, **increased awareness** of Euro-PP's use and its benefits will attract more issuers and investors, both nationally and internationally.

Some EU Member States with potential and first steps to establish new domestic private placement market – best practices to support prospering of markets derived

Private placement markets are generally supply driven: only if there are enough attractive potential issuers can a real domestic market develop. The study identifies potential issuers of private placements as medium-sized companies with revenues between €75M to €5B. The study also finds that a relatively low number of investors is already sufficient to establish a market.

An additional criterion to assess possible development paths for a country is the willingness of the banking sector to provide additional loans. Countries in which banks

are looking to reduce loan books may create demand for additional funding sources such as private placements. Several further aspects were considered, including, for example, the relevance of the local currency. Whenever a currency hedge would be expensive, a local PP instrument might be economically feasible, but conflicting views from market experts did not allow for a clear-cut conclusion.

The study identifies three countries that exhibit a large number of potential issuers and have already undertaken first steps to create a new domestic market for private placements: Spain, Italy and the Netherlands. These countries are therefore classified as having the highest short-term **potential to build a new domestic market** for private placements. While Spain and Italy have already undertaken first steps and introduced mini-bond products, they are not yet fully established. The Netherlands is working on a home-market initiative trying to establish a pan-European private placement market similar to the Euro-PP.

Based on analysis of the existing markets, best practices for market design and regulation were derived to help new markets flourish.

- First, as executed for the Euro-PP market, a **collaborative market design** effort of all market participants and relevant public institutions ensures sizeable demand and supply when creating a new market. It also leads to a shared understanding of the instrument and its use, and defines commonly agreed upon market standards.
- Second, **standardised private placement documentation** reduces issuance price and complexity and therefore caters to the needs of SMEs. Such documentation should be complemented by instrument-specific guides and best practice manuals to further facilitate a smooth issuance process.
- Third, to create an active market, it is essential to adjust regulation to facilitate the **engagement of institutional investors** in the private placement market. Countries can take regulatory measures, including modifications to corporate laws, to further facilitate the growth of the market by removing restrictive provisions. For example, several countries, such as Italy and the UK, have introduced **withholding tax exemptions** for private placements and the French treasury has been reforming the **regulation of bondholder representation** (*représentation de la masse*) to enable a more flexible and efficient way of (re)negotiating between investors and issuers in Euro PP transactions.

A further supportive element for a successful market may be a **centralised credit assessment** by a public authority, which fosters a safe market environment and incentivises investors.

To establish trust and long-standing relationships between market participants, particularly issuers and arrangers, a common understanding of the individual credit quality and a strong market discipline is necessary. It is the investors' responsibility to perform a diligent credit analysis before investing and banks' responsibility to educate companies about appropriate funding instruments and careful selection of investors. Having experienced banks involved as an arranger of a private placements significantly facilitates this process and ensures quality. Ultimately, the adherence to certain – even unwritten – quality standards will foster the sustainable development of new private placement markets.

No significant regulatory obstacles to expansion of cross-border activities identified – supply-side characteristics and needs determine growth potential

Besides the growth of domestic markets, the study also identifies **significant potential for cross-border activities in the EU**. In France in 2016, 30% of the market volume was already attributed to international issuers while in Germany, the share of international issuers rose to 40% in 2016.

In general, companies from all EU Member States can issue private placement instruments in the existing markets. Yet, given the experience from previous placements on the two existing markets, the study characterises companies with a €75M–€5B revenue and a strong credit rating as potential issuers. For companies that satisfy these criteria, SSDs or Euro-PPs may serve as an attractive source of company funding to match its strategic goals. As the market is mainly supply driven, with demand for private placements having historically exceeded supply, there is significant potential for increased cross-border issuances. Furthermore, both banks and institutional investors are open to cross-border issuances and show a willingness to invest in foreign issuers.

Given the heterogeneous economies and corporate landscape across the EU, the potential for private placements differs across the member states. In particular, the disparity between old and new member states with respect to the corporate landscapes translates directly to the assessment of growth potential for private placements. Based on the number of potential issuers across the EU, the study expects substantial potential for cross-border activities for those countries with at least 1,000 potential issuers. This criterion is currently satisfied for **Italy, Spain, the Netherlands, Belgium, Austria, Denmark, Ireland, Sweden, Poland and the United-Kingdom**.

Most importantly, **no significant regulatory obstacles have been identified** that would hinder the expansion of cross-border activities. Notwithstanding certain, mostly minor, regulatory concerns at a national level, there are no substantial regulatory issues affecting these markets requiring immediate attention. Rather, any concerns relate more to reconciling the different national legal and regulatory systems as they apply to such instruments, for example the withholding tax treatment of payments under such instruments.

Overall, **market participants are generally content with the regulatory environment** applicable to private placement markets. Both investors and current issuers have indicated that, to the extent possible, they would like to limit further regulatory changes affecting these markets.

Four areas of innovation in private placement markets

In addition to general policy innovations, the study identifies **four areas of innovation in the private placement market** that can contribute to the development of private placements in the EU. In general, there have been many innovations in the financial industry in recent years – driven by new technologies, processes and business models. The combination of big data analytics and new distribution channels allowed technology start-ups to challenge traditional bank business models. Similar trends can be seen in the private placement markets.

First, the market has seen several **online platforms for private placement transactions**. Different platforms follow different business model strategies and it is unclear which will succeed and which not, but they are all likely to increase transparency in the market and constitute strong competition for established arrangers. These platforms also facilitate the establishment of a secondary market for private placements.

Second, to meet investors' needs and expectations and to further expand the investor base, two **product innovations** have been introduced: **Private placement funds** have been launched by several banks to facilitate the entry to the market and further increase the investor base. Additionally, so called **green private placements** have been issued on the SSD and Euro-PP market that adhere to sustainability standards certified by a third party.

Third, the study identifies two relevant **process innovations**: (i) **standardised documentation** has been published to facilitate the entrance of new market participants by increasing trust and streamlining the issuance process, and (ii) rating agencies have started to offer **private placement ratings** to support institutional investors that lack their own credit assessment teams.

Fourth, the study introduces two policy innovations: (i) **Private placement withholding tax exemptions** i.e. for qualified investors from states with double taxation treaties and (ii) **Reform of bondholder's representation regime** that is currently modernised in France under Sapin II and allows issuers and investors to contractually negotiate and organise the representation of bondholders if the bonds have a denomination of more than €100,000.

Conclusion and implications

From an economic perspective, private placement of debt has considerable potential as it complements traditional funding instruments and offers specific advantages to the different stakeholders, namely issuers, investors and arrangers. Most notably, private placements allow medium-sized firms to access new funding opportunities and diversify their investor portfolio, and investors to diversify their investment portfolio to unrated, private firms while earning an attractive return. More generally, private placements are just one more important pillar of funding in the debt portfolio of an issuer.

In addition, the growth of alternative funding and investment instruments supports the European Commission's goal to reduce reliance on bank funding and thereby increase financial stability.

This study demonstrates that the two existing domestic markets in the EU, the German SSD and the French Euro-PP market, are generally well functioning and are expected to grow further. Moreover, no significant regulatory obstacles that prevent further growth of private placements in the EU have been identified. Market participants and industry experts do not see an immediate need for regulatory or legislative actions.

Notwithstanding, the study demonstrates that legislative action at a national level can facilitate the development of private placement markets, as has been the case in France and Italy for example. In addition to the promotion of best practices from existing markets, the following actions are proposed:

- First, **information campaigns** should be launched to increase the awareness of private placements among potential issuers and also investors and support further market participation across the EU.
- Second, the EU should **facilitate communication** between institutions of different Member States to ensure the exchange of experience and best practices.
- Third, further promotion of **standardisation should be encouraged** by the EU and Member States. In particular, the use of standardised documentation should be promoted and the further development of standardised processes should be supported.
- Fourth, the EU should consider the course of action in the US market and evaluate cost and benefits from providing **an independent, cost efficient third-party opinion on the credit quality** of private placement issuers.
- Fifth, the EU should seek to **clarify the application of the EU regulatory framework** to European private placements and encourage efforts at a national level to **adjust the application of the regulatory framework to private placements** by further relaxing overly restrictive laws and creating private placement specific provisions aimed at facilitating the issuance of, and investment in, private placement instruments.

EV-01-17-163-EN-N

doi: 10.2874/108273
ISBN: 978-92-79-66414-4