

INSTITUTIONAL

PRIVATE PLACEMENT LANDSCAPE IN CANADA



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Institutional investors are continuously faced with an ever-changing investment landscape. At CIBC Asset Management, one of our client portfolio manager mandates is to provide you with research that helps make sense of some of these changes. This piece discusses the evolving fixed income benchmark, particularly issuance structures that have required a rethink of some commonly used investment constraints.

Previously, a clearer distinction existed between public fixed income securities (prospectus-based issuers) and private placement issuers (offering memorandum-based issuers). There was, and perhaps remains, confusion regarding what a private placement is and the additional risks, if any, that investors assume by owning a private placement versus a public bond offering. It can become even more confusing when the private placement being considered is in a widely accepted bond index versus those that are not. Some investors see private placements as inherently riskier than public bond offerings; others are concerned that private placements imply limited liquidity. As a result, institutional investors have added an investment constraint on private placements (often a maximum allocation of 5%) to protect their portfolios from having too much private placement exposure.

The private issuer market has evolved over the years. Public issuers that can issue public bonds have started, in some instances, issuing bonds through private placements to be more efficient. Over time, this complicated the private placement constraint institutional investors imposed on their investments as high-quality issuers, such as universities, were caught in imposed 'private placement' limits. As much as 7% of today's public bond index could be considered private placements, based on how the bonds were issued.

However, these companies should not be avoided based on the original spirit of private placement constraints. Some investors adapted to this change by altering their investment constraint to an out-of-benchmark maximum allowable allocation. This ensures that standard public bond offerings through a private placement that are index eligible are not caught up in this fixed income market evolution.

In recent years, it has become increasingly common for bond issuers to issue private placement securities that end up in the Canadian fixed income bond universe. This paper explains what a private placement is, what types of documentation are used and why issuers may elect to use a private placement versus a traditional public bond offering. We also explore the prevalence of private placements in the Canadian public bond market, the risk profile of a private placement and what the implications of a private placement are for investors' portfolios.

Before we walk through the Canadian fixed income market's statistics on private placements, below are some helpful definitions to explain the subtle distinctions of the structures.

What is a prospectus?

Each Canadian province and territory has its own securities law and regulator. For simplicity, laws are generally aligned across jurisdictions. In most instances, fixed income securities must be offered to the public under a prospectus. A prospectus provides detailed information on the issuing company and the security being marketed. It is filed with and reviewed by regulators in each of the jurisdictions that the security is offered.

What is a private placement?

There is an alternative to the prospectus market. This is the exempt market, where fixed income securities can be issued through one of several prospectus exemptions. These prospectus exemptions allow an issuer to raise capital without the cost and longer timeline associated with preparing a prospectus.

Securities not sold through a prospectus are referred to as private placements. A private placement is a method of raising capital where securities are sold to an often smaller group of select, accredited investors. Not all market players can invest in private placements. Main market participants typically include institutional investors, such as banks, insurance companies, asset managers and pension funds.

The process of distributing securities through a private placement is often more straightforward. It is also considerably more cost effective, versus issuing through a prospectus, for several reasons, including:

- While the document is filed, it is not typically reviewed by provincial regulators.
- Quarterly financial statements do not have to be audited (only annual statements are audited).
- Financial statements are issued only to parties that invested in the security versus making them publicly available.
- If the issuer is not a reporting issuer in Canada, private placements will not typically trigger a requirement to provide ongoing compliance and disclosure obligations, other than a potential filing distribution.
- There is normally no obligation to translate offering materials into French.

An offering memorandum is typically used to issue a private placement.

What is an offering memorandum?

With a private placement, an issuer may distribute its securities using the offering memorandum exemption. An offering memorandum is a legal document, like a prospectus, but is shorter and less detailed. It must include a description of the company's operations, present annual financial statements, outline relevant company and security risks, and describe the company's plans for the capital being raised. It must be filed with a regulator; however, this can be done after outreach to investors has been made.

Are securities issued through an offering memorandum riskier?

Bonds sold through offering memorandums require a different evaluation process than bonds offered through a prospectus. While greater knowledge is required of investors (or their agents, such as an asset manager acting on behalf of investors), there is no automatic increase in the riskiness of the underlying security. The riskiness of the security is dependent on different factors, including the quality of management; the company's operations, competitive landscape and cash flow-generating ability; and the covenants package of the bond. These are issues that are generally consistent, regardless of the type of debt issuance (public or private).

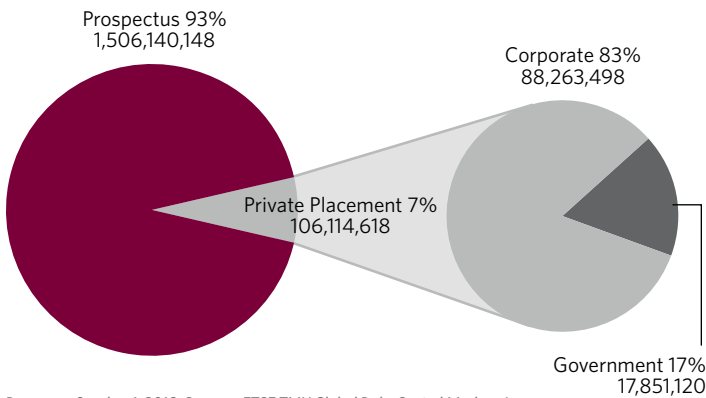
The one primary difference between the two is the size of the market. As it is a private offering, there is sometimes only a small group of buyers. This allows buyers to have greater ability to influence the terms and covenants of the bond offering. In other words, the covenants and protection package can be stronger for bonds issued through a private placement compared with that of a public prospectus.

A public bond is generally arranged by an investment dealer, and buyers can either take the deal (accept the proposed terms and purchase the bond) or leave it (pass on investing in the deal). In contrast, private placements are more likely to be a negotiated process between the issuer and investors. This often results in more robust covenant and protection packages for bondholders, provided there is an expert team on the investor side handling the due diligence and negotiation process.

Statistics of private placements in the FTSE TMX Universe Bond Index

Private placements make up a material part of the FTSE Russell Canada Universe Bond Index. Private placements are 6.6% of the entire Canadian bond universe, with corporate bonds at 5.5% and government bonds at 1.1%. Beyond the Canadian investmentgrade market, most high-yield and Maple bond issuers use private placement structures.

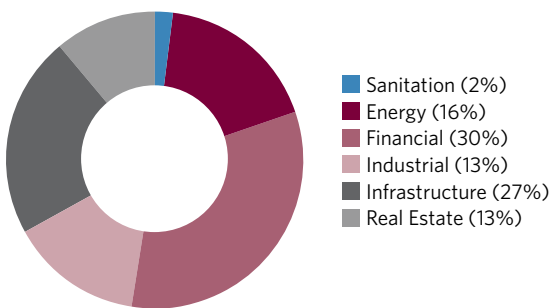
Canadian bond universe - prospectus and private placement issuers



Data as at October 1, 2018. Sources: FTSE TMX Global Debt Capital Markets Inc. and CIBC Asset Management Inc.

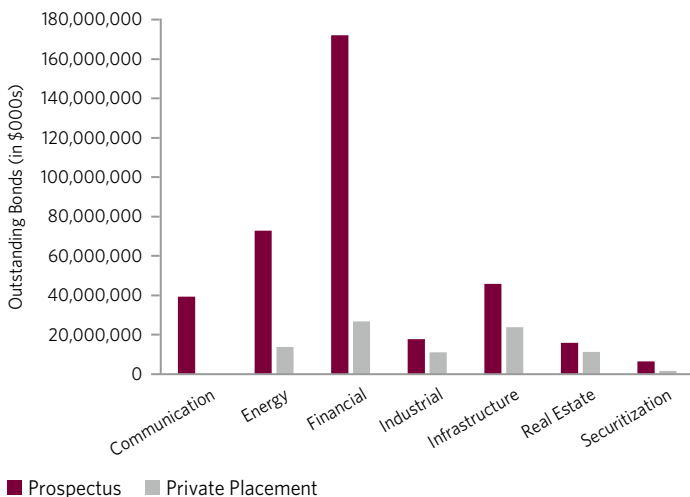
The breadth of issuers using prospectus exemption and issuing through an offering memorandum is substantial.

Breakdown of corporate private placements



Data as at October 1, 2018. Sources: FTSE TMX Global Debt Capital Markets Inc. and CIBC Asset Management Inc.

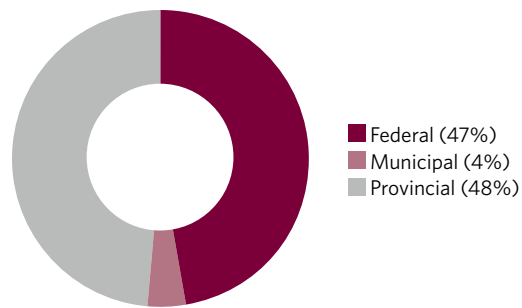
Corporate prospectus based issues vs. corporate private placement issues



Data as at October 1, 2018. Sources: FTSE TMX Global Debt Capital Markets Inc. and CIBC Asset Management Inc.

Issuers across virtually all sectors of the corporate landscape use private placements, including some of the most highly rated and largest issuers in the Canadian bond market. These include regulated utilities, airports, AAA-rated securitizations, global automotive companies, large Canadian pension plans, REITs and essential service government-backed Public Private Partnership (P3) infrastructure assets.

Breakdown of government private placements



Data as at October 1, 2018. Sources: FTSE TMX Global Debt Capital Markets Inc. and CIBC Asset Management Inc.

Among government entities, issuers across all three levels of government use private placements to issue bonds. These include large municipalities, universities, world-renowned Canadian hospitals and agencies with federal government financial support (AAA-rated entities).

Total number of issuers in the index	335
Total number of issuers using private placements	129
39% of issuers in the index use private placements	

Data as at October 1, 2018. Sources: FTSE TMX Global Debt Capital Markets Inc. and CIBC Asset Management Inc.

Not investing in these issuers would substantially limit a portfolio manager’s investable universe. This could mean missing out on strong credits that offer portfolio diversification beyond the major federal, provincial and corporate issuers (a large proportion of the total market).

Why FTSE TMX Universe Bond Index eligibility matters for private placements

It is important to consider the implications of index eligibility requirements. Private placements may be seen as risky for several reasons. These could include the potential for less financial disclosure, less liquidity, potential absence of public ratings and the perceived diminished ability of investors to conduct thorough due diligence. These concerns can be controlled for and mitigated by investors if they have a qualified team to conduct the necessary due diligence.

Even without a trusted advisor, for private placements within the index, these hurdles are substantially mitigated by the requirements for index inclusion. Index eligibility provides a natural filter for private placements, only including securities that the vast majority of Canadian bond investors would want to hold in their portfolios.

The following conditions must be satisfied for bonds to be included in the index:

- The issue size must be at least C\$100 million for corporate bonds and C\$50 million for government bonds.
- There must be a minimum of 10 different buyers.
- There must be multiple sources (investment dealers) quoting prices on an ongoing basis.
- There must be at least one rating issued by a public rating agency.

A consequence for these index-included private placements is that they benefit from increased liquidity. Their level of liquidity can be comparable to prospectus-issued securities, as these bonds must meet the same standards for index inclusion. The confusion arises when index-included private placements are compared with illiquid private placements. This is an unjust comparison between small, private companies with limited disclosures conducting a private placement and relatively large bond offerings with public ratings, numerous buyers and investment dealers who readily make markets in these securities.

We propose that plans which already have a private placement restriction in their policy, or are considering adding one, should strongly consider delineating between liquid and illiquid private placements. This can be done by:

1. **Having two sets of restrictions in the policy**, with one restricting a maximum exposure to illiquid private placements and another restricting more liquid private placements. This way, the two categories are not lumped together and are treated differently. This is an improvement over the more blunt restriction that many policies currently use but could be further enhanced.
2. **Confining the private placement restriction to only private placements that are not in the index.** This appropriately restricts the riskier allocation to illiquid assets without the unintended consequence of limiting core fixed income exposure.

We recommend the second option as it properly accounts for and limits the exposure that plans intended to restrict in the first place without arbitrarily limiting index eligible exposures. When plans are seeking core Canadian fixed income exposure, they should not treat index-eligible securities as essentially being 'out of benchmark'.

In both cases, index eligibility is the criteria for what is to be considered liquid versus illiquid. While they are called private placements because of their method of issuance, they are public securities as treated by index providers and all major market participants. Investment committees should consider this to ensure plans do not limit their investable universe and miss out on potentially strong opportunities due to a misunderstanding of the risks of index-eligible private placements.

Let's Connect

Working together on behalf of our clients, the Fixed Income Team and Institutional Team at CIBC Asset Management publish a variety of papers to help Canadian institutional investors remain current on the fixed income landscape in Canada. Connect with us to learn more about our research and opinions that could impact decision-making for your fixed income portfolio.



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