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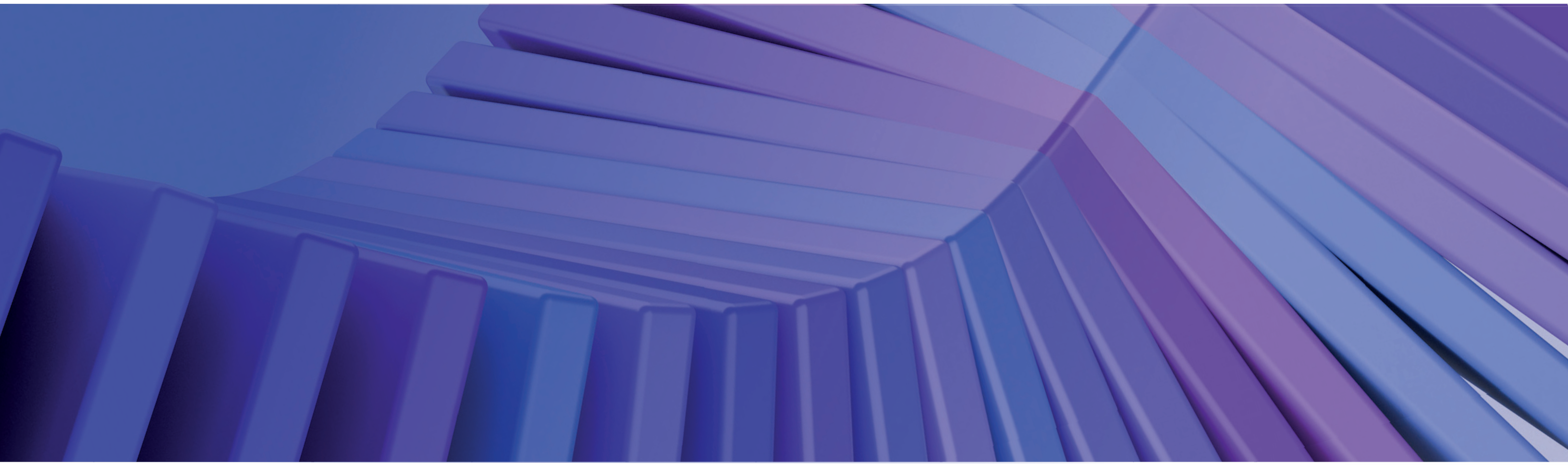


FRANK LATORRACA
Senior Portfolio Manager,
Head of Private Placements

CHUCK DEVEREUX
Senior Portfolio Manager,
Private Placements

LORI CUNEO
Senior Portfolio Manager,
Private Placements

JASON PRATT
Global Head of Insurance Fixed Income

How to Get the Most From Private Placement Debt

Private Placement Debt can offer fixed income investments enhanced diversification, risk-adjusted yield and downside mitigation. We anticipate growing recognition of the role it can play in a wide range of investor portfolios.

Many investors access the market via managers affiliated with large insurance companies. As demand grows, we believe investors could benefit from an independent route into the market. In this paper, we explain why we think non-affiliated asset managers get to see more transactions, and can tailor portfolios that are better aligned with investors' specific needs.

Executive Summary

- We believe Private Placement Debt has three major advantages over public markets:
  - Greater diversification: Corporate issuance is complemented by significant project finance, infrastructure, real estate debt and asset-backed issuance.
  - Higher risk-adjusted yield potential: Typical liquidity and complexity premiums can generate significant additional spread relative to comparable public credits.
  - Enhanced downside mitigation: In the small number of historical defaults, investor-friendly covenants and other protections are associated with higher rates of recovery relative to public bonds.
- We view Private Placements as a natural buy-and-maintain asset to match the long-dated liabilities of life companies, pension plans and endowments, but the yield pick-up makes them potentially attractive to many other types of eligible investor.
- Allocations remain relatively modest, on average, even for the life insurance investors that have traditionally dominated the market; considering Private Placements as an extension of investment grade credit portfolios could incentivize larger allocations.
- In our view, accessing the market through an independent asset manager, rather than a manager affiliated with a large insurance company, brings considerable advantages.
  - An independent manager needs to put less capital to work: It may be better equipped to consider smaller, more complex or more idiosyncratic transactions.
  - An independent manager is not buying Private Placements for its own balance sheet or liability-matching needs: It can dedicate itself to sourcing paper that is better aligned with investors' specific needs.
- We believe now is an opportune time for all types of eligible investor to consider Private Placement Debt for their portfolios, and to reconsider how they access this market.

At the start of the post-pandemic credit cycle, investors face uniquely challenging conditions.

Typically, a cycle opens with high yields, driven in part by wider credit spreads, as investors require attractive risk premiums while the economy regains its footing. On this occasion, unprecedented fiscal and monetary policy support has kept yields low and spreads tight, severely limiting the return opportunity across most fixed income sectors.

Overall, credit fundamentals remain fairly strong. The resilience of BBB bond issuers through the pandemic is testament to how much larger, more liquid and flexible their balance sheets have become since the Great Financial Crisis. However, at current yield and duration, we believe the average BBB public market issuer offers only modest return expectations in exchange for significant potential downside due to interest rate risk.

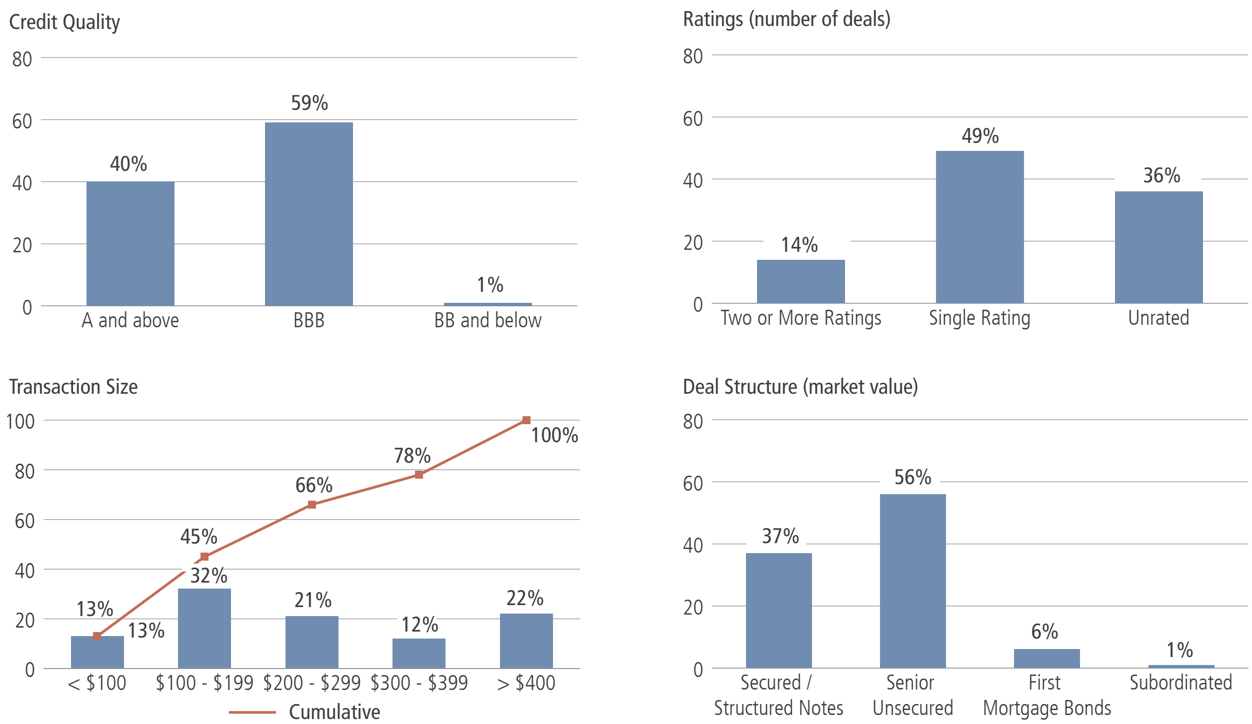
Many investors will be aware that credit with similar ratings to these BBB public bonds, often with risk mitigation features and higher yield profiles, is available in the form of traditional Private Placement Debt transactions. The market is comparatively small, at around $1 trillion outstanding and new issuance of approximately $100 bn a year. For reference, this is about 10% of the annual new issuance supply of the public investment grade bond market. But overall, the market comes with significant advantages in terms of diversification, yield and downside mitigation.

Private Placements are currently dominated by large insurance investors, which already snap up much of the vanilla, broadly syndicated issuance for themselves. Other investors have tended to gain access through the asset management divisions of these insurers. We believe this was always a sub-optimal way to build portfolios, and we think it will become more problematic as the large insurance companies increase their demand for investment grade yield for their own balance sheets. In our view, seeking deals with an independent partner will be the best way to facilitate access to the most diversifying and attractive transactions available in the Private Placement market.

In this paper, we explain why we believe now is an opportune time for all types of eligible investor—not only the traditional insurance investors—to consider Private Placement Debt for their portfolios. Just as importantly, we think investors should reconsider how they access this market.

FIGURE 1. PRIVATE PLACEMENT MARKET SNAPSHOT

Private Placement Debt market overview, 2021 issuance



Source: Bank of America. Secured/Structured Notes includes senior secured notes, leveraged leases, credit-linked notes and credit tenant leases. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.**

Comparison of typical private placements with bank loans and publicly traded bonds

	Bank Loans	Private Placement Debt	Public Bonds
Credit Quality	Investment Grade and Non-IG	Investment Grade	Investment Grade and Non-IG
Coupon Structure	Floating Rate	Fixed and Floating Rate	Fixed Rate
Tenor	3-7 Years	3-40 Years	5, 7, 10 and 30 Years
Structure	1st and 2nd Lien Secured	Secured and Unsecured	Unsecured
Coupon	Leverage Ratio Grid	Fixed for Life	Fixed for Life
Liquidity	Unregistered / Good	Unregistered / Some (typically buy-and-maintain)	Registered / Very Good
NRSRO Ratings	90%+	60%+	100%

Source: Neuberger Berman. For illustrative purposes only. A nationally recognized statistical rating organization (NRSRO) is a credit rating agency registered with and subject to oversight by the U.S. Securities and Exchange Commission (SEC).

Three Major Advantages Over Public Markets

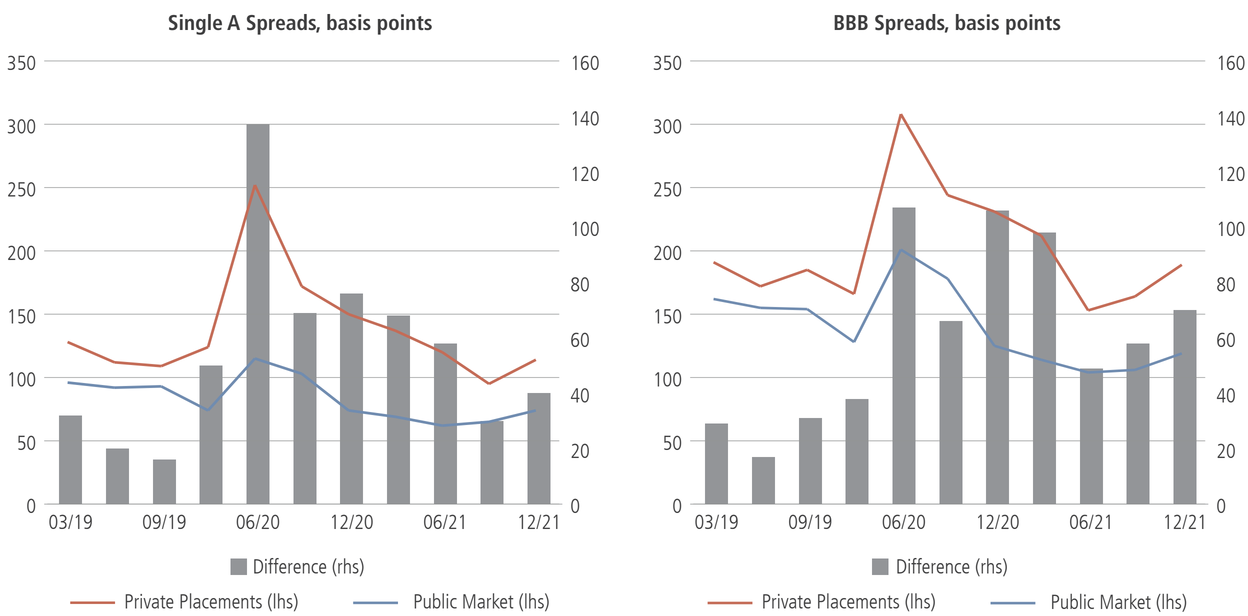
Figure 1 offers an overview of the Private Placement Debt market and how its features typically compare with bank loans and publicly traded bonds. We believe Private Placement Debt offers three major advantages over competing markets:

- Greater diversification
- Higher risk-adjusted yield profile
- Enhanced downside mitigation

Diversification is a baked-in feature of Private Placement Debt. In addition to corporate issuers, the market is a favored route for infrastructure and project finance, esoteric structured asset-backed transactions, and real estate credit tenant leases. Compared with a benchmark corporate bond index, the Private Placement market is less concentrated in financials, healthcare and energy, with more balanced exposure to real estate, infrastructure and utilities, and a variety of other stable cash-flowing, counter-cyclical industries. Issuers are typically investment grade quality. They often utilize the Private Placement market for diversification of lending sources, confidentiality, bespoke tenors, or more flexibility around rating requirements; or to facilitate smaller deals, multi-currency issuance, delayed drawdowns or other types of structured transactions.

Yield enhancement derives from the illiquidity and complexity of these transactions, relative to publicly traded bonds. Corporate transactions, which typically have a 10-year maturity, tend to price 30 – 40 basis points cheaper than their publicly traded, BBB equivalents—although figure 2 shows that the difference has risen well above 40 basis points in the post-pandemic environment.

FIGURE 2. SPREAD DIFFERENCE BETWEEN CORPORATE PRIVATE PLACEMENTS AND PUBLIC BONDS



Source: Public: Bloomberg (Single A and BBB Corporate Indices); Private: Bank of America. Data for March 2020 is excluded due to the short period without private market transactions during the initial implementation of worldwide COVID-19 restrictions. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.**

Go beyond corporate issuers, and investors can find even wider spreads. Even before the pandemic, infrastructure deals, project finance deals and credit tenant leases, which typically have a maturity between 10 and 20 years, priced 60 – 100 basis points cheaper than similarly rated comparable bonds. Asset backed securities (ABS) tend to be shorter-dated, at five years, with 100 – 175 basis points of extra spread—and they also tend to carry higher, single A ratings, on average.[1] Most issuance is fixed-rate, but floating rates are available across a variety of issuer and transaction types.

Despite the typically higher yields, Private Placements tend to have more investor-friendly covenants and other structural protections than public bonds. Project finance, infrastructure and ABS deals, a growing part of the market, are typically secured against collateral, for example. Most Private Placements are pari passu with the issuer's senior debt, and include limitations on structural subordination. They generally come with maintenance covenants. The fact that they are private transactions with relatively few counterparties means that any necessary modification of covenants is generally based on consensus and shared long-term interests, and often comes with work fees and/or coupon bumps that can further enhance long-term total returns and risk mitigation. Covenants like these have been tested through multiple credit cycles.

According to the *Society of Actuaries 2003-2015 Credit Risk Loss Experience Study,* Private Placement Bonds rated BBB and above have experienced a slightly higher default rate than publicly traded bonds (0.15% versus 0.12%), but posted higher recoveries (a 0.09% loss rate in BBB deals, versus 0.12% for publicly traded bonds). This result is not surprising given the typical covenant protections in Private Placements. The same study suggests that, when withdrawn ratings are excluded, the probability of a BBB rated Private Placement being downgraded to high yield in any single year is just 2.5%.[2]

Private Placements are typically treated as a buy-and-maintain asset. Experienced secondary trading specialists estimate that around 3 – 4% turns over in the secondary market each year. That said, recent market conditions suggest that, when it comes to liquidity, accessing deals is often a bigger challenge than selling them; relationships with secondary traders can offer the potential for liquidity should the credit opinion change.

Fitting Private Placements Into Asset-Liability Management

The fact that so many investors access the Private Placement market via the asset management arms of large insurers already indicates the usefulness of this asset class to insurance investors. Maturities stretching out as far as 40 years, together with make-whole protections against early calls, make Private Placements a natural buy-and-maintain asset to match the long-dated liabilities of life companies, pension plans and endowments. This is especially the case for the European life insurers, under the matching adjustment rules of Solvency II.

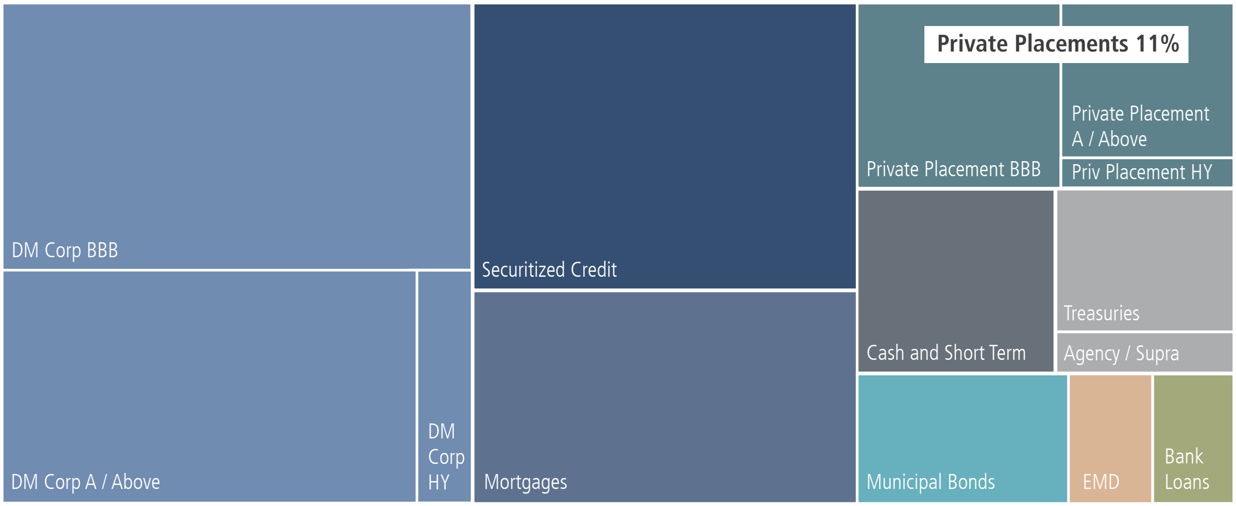
The case is more complex for Property & Casualty insurers, whose shorter-dated liabilities make them more focused on total return and interest rate sensitivity, but in our view the potential yield pick-up should bring Private Placements into consideration, nonetheless. A strategy led by an independent asset manager that combines public credit and Private Placements could be used to build a portfolio of shorter-dated paper, particularly in the ABS sector, for example. Floating rate exposures could go some way to offsetting the interest rate sensitivity of other Private Placements in the portfolio.

Even among U.S. life insurers, Private Placements still account for only 11% of fixed income assets on average. That is less than a third of the average allocation to investment grade corporate bonds, despite the many advantages. We think that investors who consider Private Placements as an extension of their investment grade credit portfolio are more likely to raise their allocations, given the spread pick-up and potential duration extension available. Such an approach would represent an exchange of liquidity for enhanced covenants and higher yield within the same asset-class bucket.

[1] Source: Private Placement Monitor, Bloomberg, as of November 2021.

[2] Please note the data presented does not cover any periods after 2015 and may not be indicative of current loss and default rates. No representations or warranties are being made with respect to current loss and default rates.

FIGURE 3. AVERAGE U.S. LIFE INSURER ALLOCATION TO PRIVATE PLACEMENTS, 2020
Allocation in fixed income portfolio



Source: Individual insurer statutory filings, reported by S&P Global and aggregated by Neuberger Berman. Data as of December 31, 2020. For illustrative purposes only.

Accessing the Market: The Advantages of Independence

As we mentioned, investors have tended to gain access to Private Placement transactions through the asset management divisions of large life insurers. We think there are two major downsides to this traditional route.

The first issue is the relatively modest size of the market. A large life insurer with its own Private Placement allocation and, say, 30 clients who want to invest $200m a year, will need to find between $8bn and $10bn of new paper in a market that issues around $100bn. That is already testing the limits of its share of traditional syndicated new issuance, even without any increase in demand. Each new client dilutes existing clients' share and could necessitate compromise on value or quality.

By contrast, an independent asset manager with a similar number of clients may be putting only half as much capital to work each year. Crucially, it also has more latitude to look for smaller issues beyond the larger, syndicated deal flow, as well as club deals and limited distribution transactions. If it has the resources, experience and sourcing network, it can also generate its own bilateral transactions with banks, issuers and sponsors (sometimes called "serve-ups"). A large insurance asset manager may be unable to provide the undivided focus and quick decision-making that an independent can bring to these negotiations. This all adds to the ability to find a full calendar of high-quality, attractively priced deals for clients.

The second issue is lack of alignment of interest. A large life insurer's Private Placement team is primarily focused on sourcing transactions for its own balance sheet and liability-matching needs—and those deals may not be suitable for investors with different profiles. It may have neither the deal flow nor the resources to tailor transactions or portfolios for its outside clients. Some investors value the reassurance that comes from being effectively a "co-investor" with a big insurance industry name, but others recognize the potential of going bespoke in such a notably diverse market. An independent asset manager can offer the operational and administrative capacity to build separate managed accounts for several clients at a time.

To do that, in our view the right partner is essential. We believe Neuberger Berman's independent, experienced Private Placement team, backed by our firm's extensive credit research, dedicated insurance and institutional solutions capabilities, and robust platform for environmental social and governance (ESG) investing, is well positioned to be that partner for our clients. Importantly, members of our team have long experience of not only managing Private Placements for global insurance companies, but also arranging and structuring transactions on the sell side of the market. That experience brings critical skills and longstanding relationships with agent banks in North America, Europe, Asia and Australia, with major sponsors in private equity, private debt, real estate and infrastructure, and with sports teams, leagues and associations. Our team expects to see all of the syndicated market; and between 2017 and 2021, approximately a third of the transactions members of our team participated in or helped originate were limited distribution opportunities, including club deals, bilateral transactions and other unique financing opportunities.[3]

Three examples can serve to illustrate the variety of transactions on which individual members of our team have worked:

1. SYNDICATED DEAL

Key Characteristics	Very Large, Long-Dated, Structured Product
Deal Size	~$1.5 billion
Maturity / Average Life	30 years / 22.6 years
Spread	U.S. Treasury + 180 basis points
Coupon	~5%
Rating	A

This deal was syndicated by an agent bank. It helped to finance the spin-off of one of the leading academic medical centers in the U.S. from its university parent by monetizing in advance a portion of the fees that the medical center agreed to pay to the university over the next 30 years. There are no direct enforcement rights against the medical center, but in our view, that risk is mitigated by noteholders' position in the waterfall (second only to certain operating and administrative expenses), along with the fact that the deal monetized only around 20% of the flows that the university receives from the medical center. We believe the attractive relative value in the transaction represents ample compensation for the deal's unique and complex structure.

2. CLUB DEAL

Key Characteristics	Large, Intermediate Tenor, Infrastructure, Structured Product
Deal Size	~$420m
Maturity / Average Life	9 years / 5 years
Spread	U.S. Treasury + 265 basis points
Coupon	~3%
Rating	Baa1 / A-

This deal was offered as a club deal by an agent bank. It provided funding for a portion of the compensation for early termination of power purchase agreement between a South American mining company and a power plant operator. The agreement was due to last until 2029, but in 2019 the mining company's majority owner announced an initiative to reduce its greenhouse gas emissions, and switched from its coal-fired power purchase agreement to renewable power agreements. The mining company's underlying contractual obligation represents an irrevocable and unconditional payment obligation denominated in U.S. dollars under the debt acknowledgment contract governed by relevant non-U.S. law, preserving source of payment for Private Placement investors.

[3] Based on the team's internal analysis of deals participated in from January 2017 through June 2021, relying on information from the deal agents. The Private Placement Debt team recently joined Neuberger Berman and has not managed portfolios investing in private placement debt at Neuberger Berman. The prior performance and investment experience of the portfolio managers and other investment professionals of the Private Placement Debt team at firms other than Neuberger Berman may not be indicative of the likely performance or investment experience of the strategy at Neuberger Berman.

3. BILATERAL DEAL

Key Characteristics	Small, Short-Dated, Sports, Naming Rights
Deal Size	~$20m
Maturity / Average Life	2.7 years / 1.4 years
Spread	U.S. Treasury + 154 basis points
Coupon	~4%
Rating	BBB

This deal was offered as a "serve-up" from a leading agent bank, and a member of our team advised the sole investor. It financed naming rights monetization for a project and renovations at a major sports league's Hall of Fame, and was secured against all the assets of the issuer, specifically including the right to receive monthly sponsorship payments. The naming rights contract was structured to default if there was a failure to deliver the project at the scheduled date, and risk of nonpayment was mitigated by timing of the payments three months in advance. The transaction originated when the agent bank approached a member of our team, with whom it had an established relationship, for advice on structuring the deal. In recognition of that partnership, the client was awarded the full allocation.[4]

Conclusion: An Attractive Asset Class That Investors Can Shape to Their Needs

This sports naming rights transaction is a good example of how critical longstanding relationships are in the Private Placement business, and how those relationships are fostered over complex, idiosyncratic, bespoke deals. We think it shows how the combination of complexity and close partnership can result in mutually attractive financing solutions, terms and pricing.

It also offers an insight into how Private Placement Debt can offer more diversification, a higher risk-adjusted yield profile and enhanced downside mitigation, relative to equivalently rated public corporate bonds. In a world of low yields and tight spreads, we think that makes the asset class a focus for potentially fierce competition among fixed income investors over the coming years.

We believe that competition is likely to further increase investors' appetite for bespoke transactions—to secure the required allocations, maintain spreads and tailor portfolios to specific needs. Neuberger Berman's specialist Private Placement team can offer the experience, network and alignment of interest required to participate fully in this fascinating and diverse marketplace.

[4] The Private Placement Debt team recently joined Neuberger Berman and has not managed portfolios investing in private placement debt at Neuberger Berman. The prior performance and investment experience of the portfolio managers and other investment professionals of the Private Placement Debt team at firms other than Neuberger Berman may not be indicative of the likely performance or investment experience of the strategy at Neuberger Berman. The case studies discussed do not represent all past investments involving members of the Private Placement Debt team. It should not be assumed that an investment in any case study listed was or will be profitable. The details related to these investments are non-public and confidential and these case studies are intended to show investment process and not performance.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com