DDJ CAPITAL MANAGEMENT, LLC
SPECIALISTS IN HIGH YIELD AND LEVERAGED CREDIT INVESTMENTS

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"144As" – A Large But Often Misunderstood Segment of the High Yield Bond Market

> Rule 144A enables qualified institutional buyers ("QIBs") to trade rule 144A bonds with one another as frequently as SEC registered bonds can be traded amongst all market participants

> As a result of Rule 144A, 144A securities are generally as liquid as SEC registered bonds

> DDJ expects the high yield 144A bond market to continue growing and thus should be viewed as a meaningful component of any high yield portfolio

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Introduction

Bonds issued via Rule 144A have become a significant – and growing – portion of the high yield market, and as a result represent meaningful holdings across many DDJ-managed funds and accounts. Given the growth of 144A issuances and their increased importance in the high yield market, we thought it would be informative to provide an overview of Rule 144A and the bonds issued under such rule. Below we have broken this discussion into two sections – ***Section 1*** provides a summary of Rule 144A together with key terminology and definitions that applies to all bonds issued via Rule 144A, while ***Section 2*** is specific to 144A bonds that are issued in the high yield market.

Section 1

Summary of Rule 144A and the Rule's objective:

Rule 144A issued under the Securities Act of 1933 is a non-exclusive safe harbor exemption from the Securities and Exchange Commission ("SEC") registration requirements as it pertains to the resales of certain securities to qualified institutional buyers, or QIBs[1]. In layman's terms, Rule 144A permits underwriters (and their assignees) to resell unregistered securities immediately after their issuance to large institutional investors. Rule 144A also applies to secondary market trading of private placements (i.e., securities not registered with the SEC) and allows the resale of securities issued via the rule to QIBs without any applicable holding period requirement being met prior to the occurrence of such sales. Rule 144A enables QIBs to trade Rule 144A bonds with one another as frequently as SEC registered bonds can be traded amongst broader market participants. Prior to the enactment of Rule 144A, a private placement was typically significantly less liquid than an SEC registered security, primarily due to resale restrictions, and in particular, a two-year holding period requirement before such security could be sold absent another exemption from registration. This holding period applied to all market participants, including QIBs. As a result, bonds issued in private placements were much less liquid than registered bonds, and therefore issuers could expect to pay a higher interest rate to compensate investors for lower liquidity when selling a bond issued via a private placement compared with an SEC registered security. Rule 144A is therefore very valuable to issuers, as it reduced the cost of capital by improving the liquidity of the institutional secondary market for privately placed bonds. Although SEC registered securities may still benefit from a liquidity premium, the size of such premium has decreased significantly as the 144A market has grown.

In addition, Rule 144A is attractive from an issuer's perspective as the speed in which the issuer can access the capital markets via a 144A bond is typically faster than with an SEC registered bond. The process of registering a securities issue with the SEC can be a months-long process, requiring an SEC review of key documents associated with the issuance together with final SEC sign-off on an issuer's registration statement. The more efficient, streamlined 144A process provides the issuer better control over when they can access the capital markets. As market conditions can change rapidly, the ability to issue a bond quickly via Rule 144A is very beneficial for issuers, allowing them to act swiftly and lock in favorable terms when market technicals shift in their favor. Furthermore, the initial issuance costs and ongoing reporting requirements for SEC registered bonds are generally more costly and onerous than the costs associated with issuing 144A bonds.

To better understand 144A bonds, below are detailed descriptions of some of the key characteristics and terminology surrounding such issues; please also refer to the summary table set forth on Appendix A.

Becoming familiar with Rule 144A: What do these terms really mean?

With Registration Rights or Without Registration Rights

We described Rule 144A securities above as private placements – or more generally, securities that have been issued without being registered with the SEC. Technically, however, Rule 144A securities can be issued with or without accompanying registration rights. 144A securities issued with registration rights typically provide that the issuer must register the securities with the SEC within a certain

[1] A QIB includes certain entities that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers

Non-reporting issuers have 144A bonds outstanding but do not have any public securities registered with the SEC

timeframe – usually within one year.[2] Once this registration occurs, the issuer must comply with the SEC reporting requirements regarding the security, while the security can trade freely amongst all market participants, and not just QIBs. 144A securities issued without registration rights (commonly referred to in the industry as "144A-for-life") are not required to be registered with the SEC and have become much more common in the marketplace than 144As issued with registration rights. In Section 2 below, we will touch on the main drivers of the increase in 144A-for-life issuances as a percentage of total 144A issuance in the high yield market. As a caveat, many 144As that are issued with registration rights are never registered because the registration rights agreement will state that registration must occur only if the securities are not freely tradeable by the date that the securities are required to be registered pursuant to the registration rights agreement (with such date generally occurring after the applicable Rule 144 holding period requirement is met, which is discussed below).

Reporting vs. Non-Reporting

Under Rule 144A, issuers of 144A securities are classified as either "reporting" or "non-reporting" companies. These classifications are used in determining the holding period requirements before 144A securities can be freely sold amongst broader market participants. It is important to note that whether an issuer is classified as a reporting or non-reporting company does not affect the ability of QIBs to trade Rule 144A bonds. As noted at the outset of this paper, QIBs can trade 144As amongst themselves immediately after issuance, the same timeframe as SEC registered bonds can be traded.

Reporting issuers have 144A bonds outstanding and also have public (SEC registered) securities outstanding (e.g., bonds and/or equity); such companies are required, pursuant to the Securities Exchange Act of 1934, to file certain reports/financials with the SEC as a result of their outstanding SEC registered securities. While these reports filed with the SEC are not specific to the 144A bonds issues by such companies, they nonetheless contain financial and other information about the issuer (and oftentimes more granular information, such as segment level data), which may be relevant to 144A bond holders that are conducting fundamental analysis of the issuer.

Non-reporting issuers have 144A bonds outstanding but do not have any public securities registered with the SEC outstanding. As such, these issuers are not required to adhere to SEC reporting requirements. They must, however, adhere to the Rule 144A minimum information reporting requirements described in the next section. The classification as a reporting or non-reporting issuer does not determine if a 144A bond will be issued with or without registration rights; for example, a non-reporting issuer can issue a 144A bond with registration rights and a reporting issuer can issue a 144A bond without registration rights. However, if a non-reporting issuer issues 144A bonds with registration rights, then to the extent that it registers such bonds with the SEC, that issuer will become a reporting issuer and subject to the SEC's ongoing reporting requirements.

Access to information

One common misconception about 144A securities, particularly those issued by non-reporting companies, is that very limited information is available regarding the company and its ongoing operational performance. In DDJ's experience, the information available to prospective investors in 144A bonds (both issued by reporting as well as non-reporting issuers) and SEC registered bonds is essentially the same. Further, DDJ has found access to management – for due diligence purposes – to be similar for issuers of both 144A bonds and SEC registered bonds. However, one noteworthy difference in reporting requirements is that 144A issuers are not required to, and typically do not, provide separate audited consolidated financial statements for their subsidiaries (both guarantors and non-guarantors), while issuers of SEC registered securities are required to provide this information.

In terms of the specific information provided, Rule 144A requires that non-reporting issuers provide qualified investors who purchase (or are contemplating purchasing) a bond issued via Rule 144A, at a minimum, a brief description of the issuer's business, products, and services; the issuer's most recent balance sheet, profit and loss statement; and retained earnings statements together with similar financial statements for the two preceding fiscal years. In practice, DDJ has found non-reporting 144A issuers typically provide more detailed reporting than the minimum required under Rule

[2] Typically, when an issuer seeks to register previously issued Rule 144A securities, it will exchange such Rule 144A securities for otherwise equivalent securities that have been registered with the SEC.

144A. For example, while not a requirement for non-reporting issuers of 144A bonds, it has, in DDJ's experience, become industry standard for such issuers to provide additional disclosures such as segment level data as well as to hold quarterly conference calls (where investors can engage directly with management). In the event that a 144A bond is issued by a reporting issuer (i.e., the company has publicly traded equity and/or SEC registered bonds outstanding), the information available to holders of that 144A bond is identical to that of an SEC registered bond because that issuer already files and makes publicly available the information required by the SEC for registered securities.

The difference between information available to holders of bonds issued by reporting as opposed to non-reporting issuers is less about the substance of the information that is made available, and more about how that information is distributed. Issuers of 144A bonds that are classified as non-reporting usually distribute information through a password-protected information site. Qualified prospective and existing investors are generally given access to such sites subject to standard "click through" confidentiality agreements. Reporting issuers, on the other hand, file information statements with the SEC, making access to such information easier, especially for investors that are unfamiliar with how the 144A bond market operates. DDJ views access to information, both prospectively and over the life of an investment, as crucial to its diligence process and will not make any investment on behalf of our clients if sufficient information is not available to enable DDJ to conduct appropriate fundamental analysis of the specific opportunity.

Holding period

When Rule 144A was originally adopted in 1990, a 144A security was treated as a "restricted security", which meant that it could only be sold to non-QIBs if an exemption from registration applied. Rule 144 provides one such exemption, thereby permitting sales to non-QIBs after required holding periods were met. Effective February 2008, the SEC amended Rule 144, shortening the holding period for restricted securities from one year to six-months for a reporting issuer, provided that such issuer is in compliance with the SEC's public information reporting requirements. The holding period for restricted securities issued by non-reporting issuers remains one year. In DDJ's view, this revision to Rule 144A decreased the incentive to issue 144A bonds with registration rights for reporting companies in particular, as bonds will be generally tradeable subject to compliance with Rule 144 by all market participants in just six months, obviating any need for the issuer to file registration documentation with the SEC. DDJ believes that for non-reporting issuers that have no immediate plans to go public, the "cost" of waiting one-year post issuance until their 144A bonds are freely tradable is more than offset by the benefit of avoiding the onerous and costly SEC registration process. In addition, based on our experience, DDJ believes that QIBs themselves make up a significant portion of the investors in the high yield market, further reducing the value of a bond being "freely tradable" in the eyes of the issuer. Moreover, DDJ believes that over time, market participants – both investment managers and their institutional clients – have become more comfortable with holding 144A bonds. In light of the foregoing, DDJ expects that the increased issuance of 144A-for-life bonds, which has been an ongoing trend in the high yield market over the past several years, to continue.

Section 2

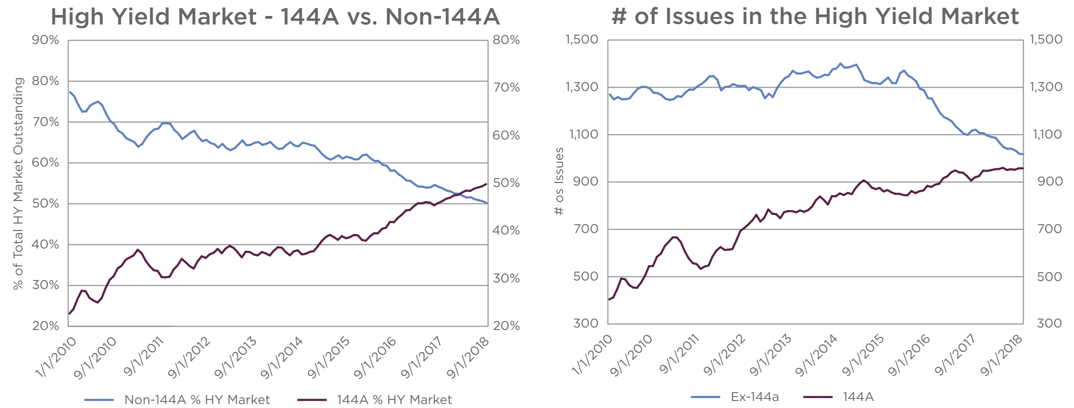
144A Bonds in the High Yield Market

Much of the above commentary applies to the issuance of 144A bonds broadly. The following section focuses on the high yield market specifically and touches on the growth of bonds issued via Rule 144A, the quality composition of 144A and non-144A high yield bonds, the "liquidity" (or yield) premium associated with 144A bonds, and the overall liquidity profile of 144A bonds in the high yield market.

Exhibit 1 below illustrates the growth in 144A bonds in the high yield market using the Bloomberg Barclays U.S. Corporate High Yield Index as a proxy for the high yield market. 144A bonds now represent about half of the outstanding bonds in the U.S. high yield market based on principal amount outstanding. In addition, as shown on the second chart below, this outcome is not the result of a disproportionate number of smaller 144A issues, as the number of issues is currently almost identical for both 144A and non-144A issues in such index.

This chart shows that 144A-for-life bonds currently comprise roughly 40% of the overall U.S. high yield market

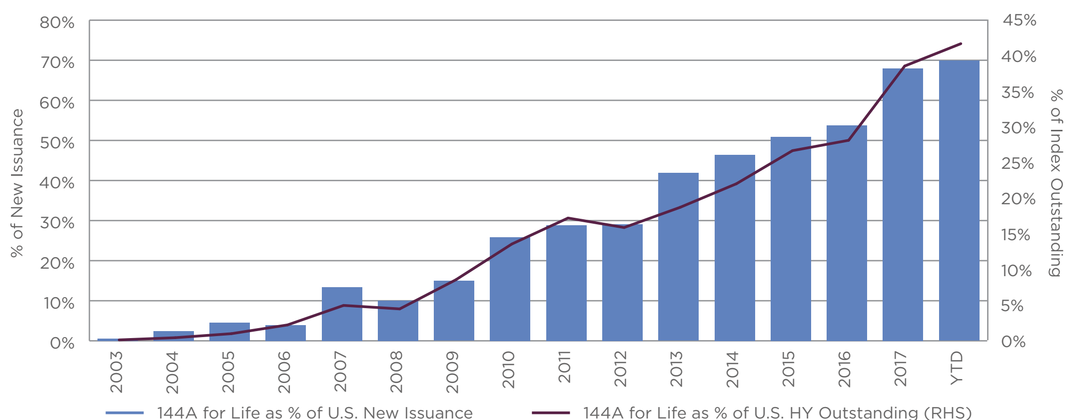
Exhibit 1



Source: Barclays; Based on month-end data from February 2011 through September 2018; high yield market represented by Bloomberg Barclays U.S. Corporate High Yield Index

Another trend in the high yield market regarding 144A bonds is the prevalence of 144A-for-life bond issuance (those issued without registration rights) relative to 144A high yield bonds issued with registration rights. As Exhibit 2 below demonstrates, 144A-for-life bonds have grown significantly over the last several years. The purple line in the chart displays the percentage that 144A-for-life issues represent of the entire high yield bond market outstanding, based on principal amount outstanding (with such percentages listed on the right-side axis), as represented by the J.P. Morgan U.S. High Yield Index. The blue bars (with the number above) represent the percentage of total new issuance that is 144A-for-life in each calendar year. This chart shows that 144A-for-life bonds currently comprise roughly 40% of the overall U.S. high yield market. Examining Exhibit 2 more closely in conjunction with the first chart in Exhibit 1 above, which displays that 144A bonds (both 144A-for-life and 144A with registration rights) comprise approximately 50% of the total U.S. high yield market outstanding, one can conclude that approximately 80% of 144A bonds outstanding in the high yield market are 144A-for-life. In DDJ's view, it makes sense that a disproportionate amount of 144A high yield bonds have been issued as 144A-for-life due to the large number of private issuers in such market that do not already have any publicly traded stock or other SEC registered securities outstanding. Given the additional requirements and costs that accompany such registration, such issuers have far less of an incentive to issue a security that will require SEC registration, instead simply utilizing Rule 144A for its financing requirements without any associated registration obligation. We will touch again on the dominance of 144A-for-life bonds in the high yield market in the ratings agency classification section below.

Exhibit 2: J.P. Morgan U.S. High Yield Index - 144A For Life



Source: J.P. Morgan. YTD is through September 30, 2018.

Rating Agency Classifications

One characteristic to note regarding 144A high yield bonds relative to non-144A high yield bonds is the difference in rating agency classifications. Exhibit 3 below displays the ratings classifications of the Bloomberg Barclays U.S. High Yield Index – broken out into 144A bonds (which includes both 144A-for-life and 144A with registration rights) and non-144A bonds.

Exhibit 3

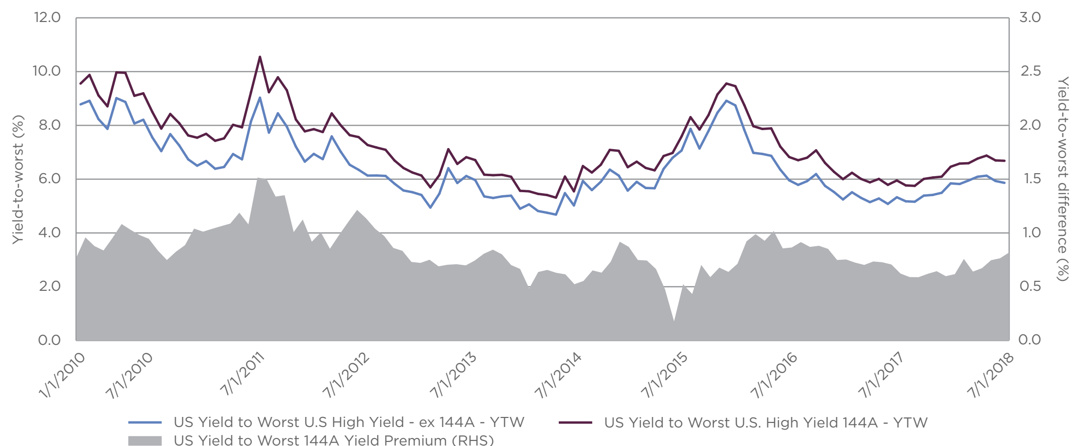
Quality Breakdown %

As of 9/30/18	*BB*	*B*	*CCC*	*< CCC*
Bloomberg Barclays High Yield 144A Index	32.2%	48.4%	18.1%	1.3%
Bloomberg Barclays High Yield Ex-144A Index	53.4%	35.5%	10.5%	0.7%
Bloomberg Barclays U.S. Corporate High Yield Index	42.8%	41.9%	14.3%	1.0%

Source: Barclays

As set forth in the chart above, the 144A bonds in the Bloomberg Barclays U.S. Corporate High Yield Index have a lower ratings tilt (i.e., a lower percentage of BB-rated bonds and a higher percentage of CCC-rated bonds) than the Bloomberg Barclays High Yield Ex-144A Index. This result comports with DDJ's view of the reason that 144A-for-life bonds dominate total 144A high yield bond issuance. More specifically, issuers of 144A bonds tend to be private issuers with no public SEC registered securities outstanding and in DDJ's experience, such private issuers typically tend to have a lower credit rating than the large cap issuers in the index (which frequently have publicly traded stock as well as SEC registered bonds outstanding). Furthermore, DDJ believes that the ratings composition difference contributes to part of the aggregate yield differences between 144A high yield bonds and non-144A high yield bonds, as represented in Exhibit 4 below. Some market participants may look at the aggregate yield advantage of 144A high yield bonds relative to SEC registered (ex-144A) high yield bonds and conclude that the yield difference is compensation – or a "liquidity premium" – to investors due to the less liquid nature of 144A bonds. While DDJ does believe that a liquidity premium exists in the 144A high yield bond market to some extent, the size of the liquidity premium has decreased significantly as the 144A market has grown and matured. Exhibit 4 below highlights the yield-to-worst for both the 144A component and non-144A component of the Bloomberg Barclays U.S. Corporate High Yield Index. It is important to note again that the yields in Exhibit 4 are on an aggregate basis (144A component of the Bloomberg Barclays U.S. Corporate High Yield Index vs. the non-144A component of such index). DDJ believes that if the ratings composition differences highlighted above are taken into account – and the Bloomberg Barclays High Yield 144A Index and Bloomberg Barclays High Yield Ex-144A Index otherwise had the same quality composition – the yield differential between the two indices would meaningfully decline.

Exhibit 4: Yield Comparison (Yield Difference - 144A vs. Non-144A)



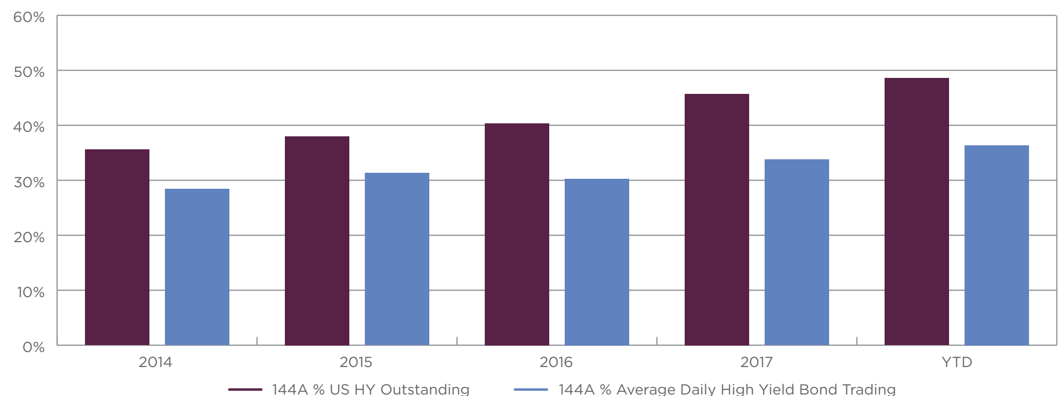
Past performance is no guarantee of future results. One cannot invest directly in an index.

From DDJ's perspective, the overall size of an issue, as opposed to whether the bond is issued as a 144A or registered bond, tends to have a much greater bearing on a bond's liquidity

Liquidity

Liquidity is an important topic regarding 144A bonds in the high yield market and was intentionally saved for last. While, as mentioned above, DDJ does believe that some liquidity premium remains in the 144A high yield bond market, the size of such premium has decreased significantly as the 144A market has grown and matured. Furthermore, DDJ believes that any discussion of liquidity conditions in the 144A high yield bond market must take into account many of the factors listed above, in particular the ratings composition of 144A high yield bonds relative to SEC registered high yield bonds. Exhibit 5 below breaks down the percentage of total high yield bond trading that 144A high yield bonds account for based on average daily trading volume. Also displayed is the percentage of the total high yield bond market represented by 144A bonds. To the casual observer, 144A high yield bonds do not trade as frequently as one would expect given their relative size in the high yield market. At DDJ, however, we believe that simply looking at aggregate statistics to reach a conclusion can be misleading, and such is the case in this instance. DDJ believes the lower ratings bias and private nature of many 144A bond issuers causes such issues to be excluded from many of the large cap high yield bond mutual funds and high yield exchange traded funds ("ETFs"). These mutual funds and ETFs – more specifically, the bonds that they hold – trade frequently because investors use these vehicles to tactically, rather than strategically, invest in the high yield market. Such trading activity can be concentrated in the largest and most liquid issues in the high yield market, and therefore impacts aggregate market trading statistics, such as trading volume. As a result of such ETF and mutual fund trading activity, trading volumes of bonds outside this largest/most liquid group of bonds may appear artificially low in comparison. As discussed above, while being issued as a "144A-for-life" may have meaningfully reduced a bond's liquidity many years ago, given the growth and maturity of the 144A market, DDJ has found 144A bonds offer ample liquidity in order to execute our high yield investment strategies on behalf of our clients. From DDJ's perspective, the overall size of an issue, as opposed to whether the bond is issued as a 144A or registered bond or whether issued by a reporting or non-reporting issuer, tends to have a much greater bearing on a bond's liquidity (with larger issues generally being more liquid than smaller issues, all other things being equal).

Exhibit 5: Trading Volume & % of Market



Source: Barclays, J.P. Morgan; FINRA
Percent of U.S. high yield outstanding based on month-end values of 144A component of Bloomberg Barclays U.S. Corporate High Yield Index
Trading data based on daily trades July 2, 2014 through September 24, 2018

Conclusion

DDJ expects that the recent growth of 144A issuances in the high yield bond market will continue. As a result of such growth, the 144A high yield bond market has matured and now more closely resembles the broader high yield bond market, particularly from an investor participation and a liquidity perspective. Investing in 144A high yield bonds used to be in part about capturing a "liquidity premium"; today, the ability to invest in 144A high yield bonds significantly broadens the investment universe from which DDJ can source attractive investment opportunities on behalf of our clients, irrespective of whether or not such a liquidity premium exists in any particular instance. Given current market dynamics, DDJ believes that investors seeking exposure to high yield should embrace investing in Rule 144A issuances as a meaningful component of such an investment strategy.

Appendix A

144A Security vs. SEC Registered Security

	SEC Registered Security	*144A Securities (both with and without registration rights)*
Who Can Buy & Trade	Broad Investor Base	Qualified Institutional Buyers (QIBs)
Generally Included in Broad High Yield Bond Indices	Yes	Yes
Freely tradable in secondary market	Immediately	Freely tradable amongst QIBs immediately. Freely tradable amongst all market participants after six months for reporting companies (companies with SEC registered public securities outstanding that already file certain reports/financials with the SEC); after twelve months for non-reporting companies (companies that do not currently file reports/financials with the SEC)
Yield	At the margin, SEC registered securities have a modestly lower yield than 144As, all else equal	See response on the left
Liquidity	SEC Registered securities, at the margin, are slightly more liquid, all else equal. A more important determinate of liquidity is issue size and/or quality rating	See response on the left
Benefits to the Issuer	Broader buyer base as not limited to only QIBs, which generally increases the liquidity and reduces the yield paid by the issuer; both of these benefits have declined as investors have become more comfortable over time with holding 144A securities	Allows an issuer to avoid the registration requirements of the Securities Act (e.g., SEC registration requires production of detailed information about the issuer and the offering). In addition, 144A issuers typically do not provide audited consolidated financial statements for their subsidiaries - both guarantors and non-guarantors, which is a significant cost savings for the issuer
		A Rule 144A offering provides the issuer with greater control over timing of the offering and potentially quicker access to the U.S. capital markets (e.g., SEC sign off on language in issuer's registration statement can take months)
		The costs and expenses in connection with a Rule 144A offering will generally be lower than an SEC registered public offering as, for example, the issuer will not incur filing fees in connection with review by the SEC,
Benefits of 144A Issuance to QIBs (e.g., DDJ)		Before Rule 144A, private placements were much less liquid/had more restrictions on transacting in secondary markets than current private placements that fall under Rule 144A, which accordingly provides a broader investment universe than would likely be the case if Rule 144A were not adopted
		Though not required, many issuers of 144A securities provide a similar amount of financial information as in an SEC registered public offering.
		While the liquidity of 144A issues in the high yield market has increased dramatically over the years, due in part to the general increase in 144A issue size, securities issued under Rule 144A still typically provide a modest yield advantage versus registered securities, all else equal

Appendix

Liquidity premium: A liquidity premium is the term for the additional yield of a debt instrument demanded by investors when a given security cannot be easily converted into cash for its fair market value.

Yield: The yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

Yield to Worst: Yield to Worst ("YTW") is the lower of the yield to call or yield to maturity.

Disclosures

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Information in this document regarding market or economic trends or the factors influencing historical or future performance reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose.

Diversification does not guarantee against investment loss.

Past performance is no guarantee of future returns.

Investing involves risk, including potential loss of principal.

The Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures, and 144-As are also included. The Bloomberg Barclays High Yield Ex-144A and the Bloomberg Barclays High Yield 144A indices are a subset of such index that excludes and include all 144A bonds, respectively.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including U.S. and international borrowers. Please note that one cannot invest in the index.

Credit ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest). All Fund securities except for those labeled "Not Rated" and "Other" have been rated by Moody's, S&P or Fitch, which are each a Nationally Recognized Statistical Rating Organization ("NRSRO"). All Index securities except for those labeled "Not Rated" have been rated by Moody's or S&P. Credit ratings are subject to change. For information on the rating agencies' methodology please go to: https://www.moodys.com or www.standardandpoors.com.

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ABOUT DDJ CAPITAL MANAGEMENT

DDJ Capital Management's goal is to consistently produce attractive long-term investment returns, while minimizing downside risk for our investors, which include:

> Corporate pension accounts and public retirement plans

> Foundations

> Taft-Hartley Plans

> Other institutional clients

The underpinning of DDJ — a disciplined investment philosophy, coupled with a commitment to exhaustive credit research — has remained constant since our founding in 1996. Our highly skilled team is steadfast and focused on executing our strategy to identify strong risk-adjusted investment opportunities in the leveraged credit markets.

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