International Research Journal of Applied Finance ISSN 2229 – 6891
Vol. VIII Issue – 11 November, 2017 www.irjaf.com
Case Study Series

Employees' Annuity Corporation: Alternative Investment Decisions

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Abstract

This case requires the student to determine which investments to recommend for further analysis out of a pool of nine projects. In addition to selecting up to three investments, the student is to defend both his or her recommendation for further consideration as well as explain why the other projects were rejected for further review. The student is also required to state the maximum amount to invest in each project selected for further review.

Alternative Investment Decisions

Employees' Annuity Corporation (EAC) is one of the premier 401k pension fund managers in the United States. EAC receives funds daily that have been withheld from employee paychecks from client corporations in each of the fifty states. They also receive matching contributions from the corporations themselves. Upon retirement, employees have the option of receiving a lump sum payout, an annuity, or some combination of the two. Given the tax implications of a lump sum payout, almost all of the employees opt for a monthly payout.

EAC's corporate structure has groups that invest in publicly traded stocks, publicly traded bonds, real estate, high risk securities, natural resources, and private placements. The natural resources group invests in agriculture, mining, timber, and fishing.

Prior to retirement an employee can direct how his or her funds are to be invested. When the stock market is rising, more funds are typically invested in publicly held equities. When the market is in decline, bonds and private placements gain favor. Upon retirement, many employees opt for an annuity and by doing so have left EAC free to invest these funds where the firm thinks they can earn the highest return. For several years the portfolio of the natural resources group has outperformed the market.

This case involves a situation that has arisen in the private placement group (PPG). PPG has the responsibility of investing approximately $50,000,000 of new money each week. This is in addition to reinvesting the proceeds of any loan in the portfolio that reaches maturity. It is EAC's policy that the group's portfolio must maintain an average BB credit rating. In addition to conducting research and making recommendations on potential private placement opportunities, analysts are charged with monitoring their portfolios on an ongoing basis to check for any change in the borrower's credit rating as well as for any violations of the private placement covenants.

In addition to the credit rating restriction, PPG must maintain an expense ratio of less than .75%. This group's expense ratio is currently well below this limit. This has enabled PPG to take advantage of accepting qualified internal transfers of personnel and to hire from the outside when the need arises. Since clients are guaranteed a minimum return of 3%, placements cannot be made that will not cover this return as well as associated expenses. EAC has also set limits on how much PPG can lend to a single borrower.

Given the volume of lending that is required, PPG considers only loans that are of a substantial size. Investment banking firms such as Goldman Sachs and Morgan Stanley frequently contact PPG and other potential lenders on behalf of corporations that are seeking considerable funding. Once a potential private placement has been identified, analyzed, and deemed acceptable, it is sent to in-house attorneys to determine any covenants to include in a potential loan agreement. EAC then makes an offer that consists of both the maximum amount that it is willing to lend and the interest rate it is seeking on the loan. There is no guarantee that EAC's offer will be accepted. If EAC's offer is accepted, it is not unusual for the investment banker to make a deal for less than the maximum that EAC is willing to extend. The investment bankers and thus PPG usually know the length of time that the borrower seeks the funds. The size of the loan request is a bit more uncertain. The amount requested may go up or down as a result of the various potential lenders' interest rate requests.

Once all the potential lenders make their commitments, it is up to the investment banker to determine the percentage of the deal each lender will get. The big players (lenders) in this arena usually get treated more favorably than the smaller firms who can only supply a small piece of the action. Investment bankers frequently will specify a range into which they expect the lenders' pricing of the loan to fall. If PPG's interest rate exceeds this range, they might get a second chance to reprice the loan. While it is not common, a potential lender may offer to lend at a rate below the range given by the investment banker.

In addition to getting potential deals from the investment banking firms, EAC has established relationships with many large banks. These institutions may have borrowers that seek considerable funding for an extended period. Frequently banks prefer to finance the short-term needs of their clients and bring in lenders such as EAC for the long-term financing.

It should be noted that PPG does not make an offer on all deals that are brought to it by investment bankers or large banks. The potentials borrower's credit rating is the first hurdle that must be cleared. If the borrower does not have a credit rating, PPG uses an outside agency to determine if the borrower could be considered "investment grade". While the credit rating of the potential borrower prohibits PPG from getting involved in a considerable number of deals, there are also other considerations to be taken into account. PPG has banned deals to firms located in several countries due to economic and geopolitical uncertainty. While the potential borrower may have a good credit rating, that does not mean that a particular deal is without considerable risk. EAC is not only concerned with the risk of a deal going bad, it must also consider the impact which foreclosing on a loan could have on its image. EAC does not want a headline to read, "EAC forecloses on city's only hospital." The in-house attorneys and risk assessment team have stopped several deals in their tracks.

The covenants written into a loan agreement often put a variety of restrictions on the borrower. These restrictions may include such things as a limit on additional funding the borrower may seek from other sources. There may be restrictions on the borrower's paying dividends. The failure of the borrower to maintain certain financial ratios such as the current ratio may have implications on whether the loan is called.

Given the size of the loans that PPG makes, much time is spent in researching both the potential borrower as well as the purpose for which the extended funds will be used. Frequently there is a "road show" in which the investment banking firm goes over the general aspects of the loan request. If it appears that PPG is seriously interested in being part of the deal, a due diligence trip to the potential borrower is common. Both the road show and due diligence trips take time and cost money.

Anne is a senior analyst in PPG at EAC. She has been given a list of potential investments that have been brought to the firm by Morgan Stanley. There will be a road show for each of the projects outlined below. However, since attending a road show costs money and means time out of the office, Anne has been charged with the task of selecting no more than three of the projects for PPG to pursue.

- InBev is looking for $1.5 billion to build three new breweries in Mexico, England, and South Africa. It expects to pay 3.5% annual interest. It wants the money for 15 years.

- Kroger is looking for $400 million to update and expand their stores. This firm expects to pay 4.6% annual interest. It wants the money for 15 years.

- 3M is going to build a rocket fuel plant in Florida. It wants $600 million and expects to pay 3.25% in interest. They are looking for a 20-year maturity.

- Intel is looking for $1 billion to build 5 microchip plants (South Korea, Thailand, Ireland, India, and West Virginia). It expects to pay 3.2% annual interest and is looking for a 25-year maturity.

- American Railcar is looking for $475 million to purchase a fleet of coal cars (President Trump has pledged to bring coal mining back to prominence). This company is willing to pay 8% annual interest and wants a 30-year maturity.

- Weyerhaeuser is looking for $400 million to build three plants to manufacture artificial deck flooring. It expects to pay 7.75% and wants a 15-year maturity.

- McDonalds is looking for $1 billion to renovate many of its outlets. It expects to pay 4.5% interest and wants a 20-year maturity.

- Rite Aid is looking for $800 million to both expand existing stores and to purchase small independent drug stores. This firm expects to pay 6.5% and needs the money for 20 years.

- Macy's is looking for $350 million to establish a major presence in online shopping. Macy's expects to pay 4.25% and wants the money for 10 years.

Before Ann can make a recommendation to the managing directors, she must consider many other circumstances surrounding this decision. Anne's group has experienced pressure to get money out the door. Funds waiting to be invested often only earn the Federal Fund's interest rate. This is currently substantially less than the 3% investors have been guaranteed as a minimum return on their investment. If PPG cannot invest its approximate $50,000,000 of new weekly pension contributions in addition to any money that must be reinvested due to loans reaching maturity each week, this group will see funds diverted to another group within EAC that can move money out the door. Managing directors spend considerable time lobbying for more funds to invest. They do not want to have these funds taken away from them. We are dealing with people with substantial egos at this firm.

Interest rates are near an all-time low and finding companies with a high credit rating that need substantial funds and are willing to pay an interest rate significantly above 3% are few and far between.

Like many senior analysts in Anne's position, a substantial amount of her compensation comes in the form of an annual bonus. Among other things, Anne is evaluated on the performance of her portfolio, how much money she gets out the door, how many new contacts she can establish, and the quality of the advice she provides to the managing directors. When Anne presents a recommendation to senior management, she wants to be sure that she has left no stone unturned. It is the kiss of death for Anne to say too often, "Gee, I never thought of that".

Anne has asked you, a junior analyst, to identify no more than three of the investments listed above to explore further. In addition, you are to provide the dollar limit that you would recommend investing in each recommended project. There is currently $500 million available to be invested and PPG does not like to take on a project for less than $50 million. PPG also prefers not to invest more than $200 million in any one project but may be willing to invest more than $200 million in any one company. It realizes that on some projects the competition among potential investors may be strong and that the investment bankers are likely not to give a potential investor as large of a piece of the action as they would like to receive.

It would be preferable if your recommended investments were not from the same industry sector. Anne expects you to defend your recommendation and explain why you did not recommend those projects not recommended. The current risk-free rate is 2.5%. PPG loan portfolio of $20 billion is currently rated A3 (7 on the scale below). If your selections turn into actual loam commitments, you are to be confident that the portfolio average rating does not fall below Moody's Baa3. The PPG shies away from investing in firms that have a debt/equity ratio greater 1.5.

Use the table immediately below to indicate what would happen to the average portfolio rating if PPG funds the projects that you have recommended at the dollar amounts that you have suggested.

Moody's Bond ratings	Numerical Score
Aaa	1
Aa1	2
Aa2	3
Aa3	4
A1	5
A2	6
A3	7
Baa1	8
Baa2	9
Baa3	10
Ba1	11
Ba2	12
Ba3	13

B1	14
B2	15
B3	16
Caa1	17
Caa2	18
Caa3	19
Ca	20
C	21

The table below shows the amount of credit the PPG can extend to any one company. It also illustrates how much of that credit line is currently being used.

Company	Credit limit (millions)	Credit currently extended (millions)
3M	$400	$175
American Railcar	$150	$0
Weyerhaeuser	$250	$75
InBev	$450	$125
Intel	$500	$225
Kroger	$225	$40
Macy's	$200	$25
McDonalds	$500	$275
Rite Aid	$250	$110

While it is up to Anne to come up with the recommendation to present to the managing directors, she would like you to express your opinion on this situation. It is 9:00 AM Monday morning and Anne wants your report before you leave for the weekend. The managing directors have told Anne that they want her recommendation at 10:30 AM Monday. She wants to spend the weekend looking over your recommendations.

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