The corporate hybrid: Expanding market offers opportunities

For professional investors, qualified investors and qualified clients only

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We have seen increased issuance of hybrid instruments by European companies over the past couple of years. These instruments offer the potential for a higher return compared to the company's senior debt. The higher return is, of course, accompanied by a higher degree of risk. Careful security selection is paramount. Invesco takes a broad resource-based and consistent approach globally to uncover opportunities in this growing asset class.

What are corporate hybrids?

Corporate hybrid instruments are subordinated bonds which have some characteristics of debt and some of equity. They have a dual appeal:

- Corporate hybrids are often attractive to issuers because they are regarded as partly equity by the credit rating agencies, which helps support issuer credit ratings.
- Corporate hybrids offer opportunities to investors to benefit from idiosyncratic situations at attractive yields.

Corporate hybrids are similar to contingent convertible capital securities issued by financial firms, but are issued by non-financial corporates. While the asset class has grown tremendously in recent years, it is not new. It has been in existence for more than a decade, ever since the German industrial gases company, Linde, placed hybrid bonds in the market in 2003. Back then, these bonds were widely considered to be just costly debt securities, with little recognition of their equity features.

It was not until 2005 that the French retail group, Casino, issued hybrid paper that actually allowed Standard and Poor's (S&P) to treat it as part equity due to its "perpetual" maturity date and the ability of the issuer to defer coupons. The bonds interested credit investors who recognized that the "debt" characteristic provided funding and supported the issuer's credit ratings (since the agencies treat them only partly as debt). It also helped to satisfy equity investors since the "equity" characteristics were viewed as an effective way to raise capital without diluting existing shareholder ownership. From that point on, we have seen exponential-like growth in the corporate hybrid sector, due to its appeal to both investors and issuers.

Most corporate hybrids are rated investment grade, although a high yield segment of the market is developing. At the present time, most hybrids are issued by European entities. Most of the issuance has been in the European utilities and telecommunications sectors. This is not surprising since structural changes in those sectors are putting pressure on corporate credit quality. For utilities, the structural changes relate to European governments' shift towards low carbon energy, which means credit metrics are under pressure partly due to high capital expenditure needs. Because the rating agencies treat hybrids as partly equity, they are often issued by companies facing such fundamental challenges as a way to raise financing while protecting their credit ratings.

Why bond investors should consider hybrids

There are three key characteristics we look for in an asset class before considering whether it is investable from a strategic perspective:

1. Strong potential returns not only on an absolute and relative basis, but also on a risk-adjusted basis to minimize the volatility of returns.
2. Sustainable growth and longevity of the asset class (such as issuer and investor demand), to help create liquidity and provide a greater level of transparency.
3. Distinctive features that allow differentiation among securities (such as bond structure and language) to enable investors to identify any mispricing and generate alpha.

We believe that corporate hybrids tick all of the above boxes and we see merit in investing in the corporate hybrid asset class as part of a fixed income portfolio. In this paper, we aim to provide a comprehensive overview of this asset class and examine these investable traits in detail, as well as highlight the key risks that we consider before investing in these securities.

Hybrids have appealed to both issuers and investors

Strong issuer and investor interest in hybrids help to explain the rapid expansion in this market. Various incentives to issue and invest are likely to continue generating liquidity in this asset class, which we view as positive from an investment standpoint.

- **Benefits to issuers:**

  Even though hybrids are a more costly form of funding than senior debt, companies can use them as a way to support their credit metrics and their investment grade ratings since they are treated as partly equity by the credit rating agencies. Companies may also use hybrids to fund acquisitions. Indeed, many of the early hybrids were created for corporations to finance acquisitions and other restructurings without damaging their credit ratings. Nowadays, companies may also choose to issue hybrids to increase their financial flexibility or to diversify and widen their investor bases. Unlike dividends, the interest paid on hybrids can be tax deductible for the company, depending on the jurisdiction.

- **Appeal to investors:**

  Hybrid instruments carry risks on top of the risks carried by senior debt. However, in many cases, investors can be potentially compensated for these additional risks with additional return. This makes hybrids a potentially attractive investment, in our view, particularly in the current low interest rate environment. As mentioned above, companies that issue hybrids are often under some fundamental pressure. However, hybrid issuers are typically rated comfortably within the investment grade category (at the senior level). In general, we have a preference for issuers that we think are better placed to face these fundamental pressures over the next few years. For these reasons, we are comfortable investing in the hybrid issues of a selection of these companies. While we often do not see value in the senior debt of these companies, we think that investors can be well compensated lower down the capital structure.

Anatomy of a corporate hybrid

Hybrid securities are bond-like in that they pay a predetermined coupon not tied to operational performance. They are equity-like in that their coupons can be deferred indefinitely at the option of the issuer and their maturities are either perpetual or very long-dated. Due to these equity-like features, the rating agencies typically treat these instruments as 50% debt and 50% equity. They usually rate them two notches below the company's senior unsecured rating, which reflects the hybrid's subordination and the option to defer interest payments. The average composite rating for corporate hybrids is typically BBB, which reflects their junior status versus the senior debt of what are typically high-quality corporates.

In practice, these instruments become callable a number of years (often, but not always, five years) after issuance. The call option makes these instruments more affordable to issuers – the coupon rate can be closer to a five-year yield than a 50-year yield, for example.

In terms of seniority, hybrids rank between a company's senior unsecured debt and its common equity. Therefore hybrids carry greater risk than senior debt due to their subordination risk. They also carry coupon deferral and extension risk (the risk that they are not called on the first call date). Investors can, however, be potentially compensated with additional return for taking on these additional risks. This makes carefully selected hybrids an attractive opportunity, in our view, particularly in the current low interest rate environment.

The differences in structure and language among hybrids, along with their broad issuance across various sectors, generates dispersion in spreads which, we believe, creates relative value or alpha opportunities for investors.

Some of the key features of a corporate hybrid include:

Coupon deferral option: Coupons may be deferred at the option of the issuer. Deferred coupons may be cumulative or cumulative and compounding. A few hybrids also have mandatory coupon deferral clauses whereby coupons are deferred if, for example, a certain credit ratio is breached. We prefer deferred coupons to be both cumulative and compounding.

Coupon step-up over time: While hybrid structures are not uniform, the coupon typically resets on the first call date to the five-year swap rate plus the spread at which the hybrid was issued, with no step-up. Often, the coupon steps up by 25 basis points on the next reset date, followed by an additional 75 basis points further down the line.

Clauses which can trigger an early call: Typically these clauses refer to an "accounting event" (change in a hybrid's accounting treatment), "tax event" (change in a hybrid's tax treatment) or "rating agency event" (rating agency methodology change resulting in a lower equity benefit). The call price is fixed (often at 101) or based on a "make-whole" price. (The make-whole price is the redemption price defined in spread terms in the bond prospectus, for example, "bund yield plus 50 basis points.") Our preference is for clauses which reference a make-whole price, although these are relatively rare nowadays.

Dividend pusher and stopper: A dividend pusher means that a dividend payment constitutes a mandatory payment of deferred interest. A dividend stopper means that coupon deferral blocks the company from paying a dividend. We view these features as supportive when we analyze the terms of coupon deferral.

Replacement capital clause: This clause says that the company is obliged to (or intends to) replace the hybrid with a similar or lower ranking instrument if it is called. If such a clause exists, we prefer hybrids for which the effective date of the clause is one day after the first call date. This is because if the clause comes into effect one day after the first call date, there is a greater incentive for the hybrid to be called than if the clause is effective from issuance. This means there is less extension risk (see below).

How do we analyse corporate hybrids?

1. Credit fundamentals

When we assess the underlying corporate fundamentals, we often find that the company faces some fundamental pressures and that the hybrid is therefore used to maintain the company's creditworthiness and credit ratings. As mentioned above, issuers worthy of consideration, in our view, are typically investment grade credits that have the potential to weather the immediate pressures over the medium term. The credit outlook is therefore a critical part of the analysis.

2. Hybrid structure

- **Extension risk:** The risk that the instrument will not be called on the first call date, meaning that investors will have to bear the impact of an extended term and the correspondent spread widening. We therefore look at a range of factors that could lead an issuer to call or not call a hybrid issue on the first call date. For example, if the company can refinance the hybrid at a cheaper rate than the level at which the coupon will reset on the first call date, then the hybrid is likely to be called.

  Equity benefit **-** We also determine if the instrument will lose the equity benefit attributed by S&P on the first call date. The loss of the equity benefit creates an incentive to call. Among newer hybrids, S&P usually drops the equity benefit on the first call date since, beginning on the first call date, it sees the bonds as less permanent or equity-like.

  Replacement capital clause: Additionally, we look at the details of a so-called binding "replacement capital" clause, if it exists This clause says that the company is obliged to replace the hybrid with a similar or lower ranking instrument if it is called. We can gauge the likelihood of call by looking at the effective date of this clause. If the clause comes into effect one day after the first call date, which is often the case, there is a greater incentive for the hybrid to be called than if the clause is effective from issuance. The logic behind this is that companies generally prefer to avoid being bound by such a clause and would rather maintain their financing flexibility.

  Reputation: Another factor we consider in our assessment of extension risk is the importance of reputation. In order to meet investor expectations and, therefore, maintain open access to the hybrid market, a company may be inclined to call the hybrid, even if it is not able to refinance that particular hybrid at a cheaper rate than the level at which the coupon will reset on the first call date.

- **Coupon deferability**: In addition to extension risk, we look at the terms of coupon deferability. Preferably, any deferred coupons would accumulate on a compounding basis until they are paid. Dividend pushers/stoppers are additional supportive features when looking at the terms of coupon deferability. When considering dividend pushers/stoppers we find it useful to also look at the history of dividend payments.

- **Cash price**: As we analyze the hybrid's structure, we also consider its cash price. This is because, if an early call is triggered at a price of 101 (which is often the prescribed call price) and the hybrid is priced well above 101, then there is greater loss potential than if the hybrid has a lower cash price.

3. Relative value

In order to assess relative value, we look at spread, spread breakeven (spread/duration), spread pick-up over senior debt, spread per turn of leverage (spread/(debt/EBITDA) and spread pick-up per turn of leverage. We compare these measures among various hybrids to pinpoint which appear cheap or expensive. Our view of a hybrid is formed using this entire range of measures (as well as analysis of the credit fundamentals and hybrid structure).

Conclusion

When analyzing hybrids, investors should put together all three of the components described abovehe underlying corporate fundamentals, the hybrid structure and relative value. We believe that out of these three components, at the moment, the market places the least weight on structure. However, we believe that the consideration of a hybrid's structure will become increasingly more important over time as investors become more familiar with these instruments.

The additional spread premium that hybrids offer on top of the yield attached to senior debt makes carefully selected hybrids an attractive investment, in our view. The additional yield is particularly attractive in the context of the current low interest rate environment. Growth of the market will likely be driven by companies seeking to protect their credit ratings and potentially from companies seeking to fund merger and acquisition transactions while limiting the impact on their credit ratings.

We believe increasing investor comfort with these instruments and continued development of the market should support growing demand for this expanding asset class.

Invesco Euro Corporate Hybrid Bond UCITS ETF

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With a pure focus on Euro-denominated bonds, which is the largest and most liquid portion of the hybrids market, this ETF aims to track the total return performance of the Bloomberg Barclays Euro Universal Corporate ex Financial Hybrid Capital Securities 8% Capped Bond Index less fees, expenses and transaction costs.

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Invesco Euro Corporate Hybrid Bond UCITS ETF
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