CREDIT SPECIAL

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Hybrid bonds:
Shoring up defences in good time

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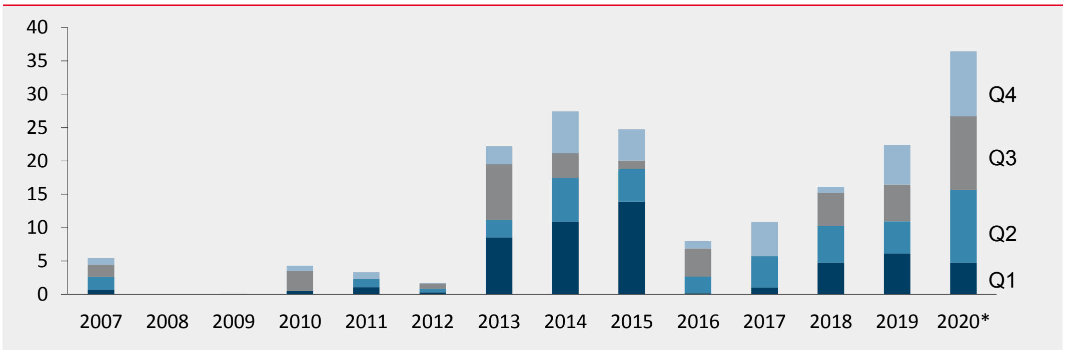
This year, the volume of euro-denominated hybrid bond placements is heading for a new all-time high. A major factor in this trend has been the significant fall in the cost of capital for these bonds. Subordinated bonds with equity features offer companies a comparatively simple and cost-effective way of financing their capital expenditure projects that protects the balance sheet and helps to preserve credit ratings. It is likely that companies will increasingly come to appreciate these advantages, especially in the current tough economic environment. Consequently, over the next few months, issuers from cyclical sectors are expected to make greater use of these instruments. At the same time, the importance of sustainability aspects will see rapid growth in this debt capital segment as well.

Hybrid bonds on course to break records

Issuance activity in the hybrid segment has experienced stronger growth this year than in any other segment of the primary market for euro corporate bonds. Towards the end of October, total placement volume had reached a level of around EUR 36 billion and was therefore some 60 % higher than the whole of 2019 as well as a third higher than the previous record year of 2014. In the first ten months of 2020, issuers on the primary market for euro corporate bonds raised in excess of 8 % of their total funding requirements in the form of hybrid capital. Yet, the popularity of this financial instrument only really took off in recent years, with the first significant amounts being issued in 2013. Since then, however, hybrid bonds have established themselves as a key component of the corporate primary market.

Demand for hybrid bonds stronger than ever

Issuance volume (in EUR billions)



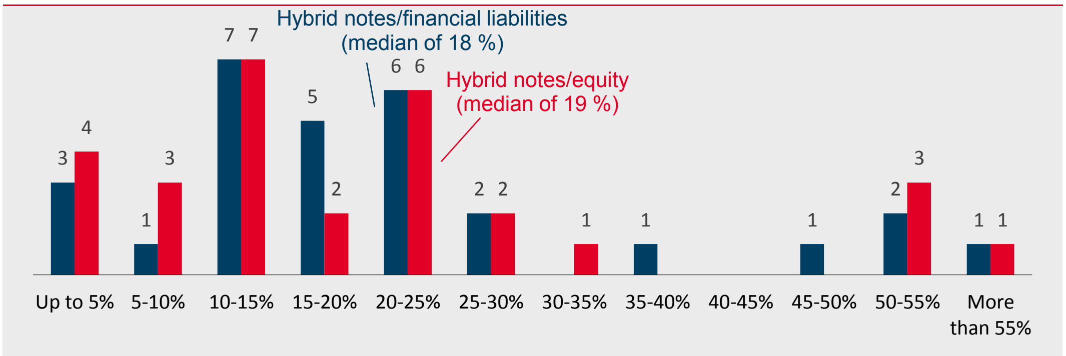
*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

Recognition as equity the main advantage

In issuing hybrid capital, many issuers combine the goal of further diversifying their funding sources with that of tapping new groups of investors. However, there is another reason why the popularity of this instrument has surged in 2020, in particular. The Covid-19 pandemic triggered a sudden economic slump and this has had an extremely damaging impact on the performance of many companies, putting considerable pressure on their credit and liquidity profiles. Compared to increases in share capital, hybrid bonds offer companies a cost-effective way of meeting their funding needs while helping to maintain credit ratings and protecting balance sheets.

Hybrid bonds often key element of capital structure

Issuers in 2020: Outstanding hybrid capital as proportion of reported financial liabilities, excl. leasing and balance sheet equity (in %)



*as of 6 November 2020. Sources: Bloomberg, Helaba Research

This is because, under certain circumstances, rating agencies classify hybrid bonds only to a certain extent as debt. In order to qualify for this preferential treatment, however, the notes must meet specific criteria, such as having a very long maturity or the ability to defer coupon payments. The degree to which equity credit is granted varies according to the particular features of the bonds. In most cases, however, it amounts to 50 %. At the beginning of 2018, Standard & Poor's adjusted its methodology and this provided companies with additional flexibility when issuing hybrid capital. Since then, it has been possible to substitute hybrid notes before their call date with new bonds of the same type without losing this privilege[1].

That said, there are restrictions on the total amount of equity credit granted by the agencies. Moody's recognises a maximum of 30 % of adjusted equity[2]. At Standard & Poor's, the threshold is typically 15 % of the company's total capital, defined as the aggregate of financial liabilities, hybrid debt and equity (adjusted for goodwill)[3].

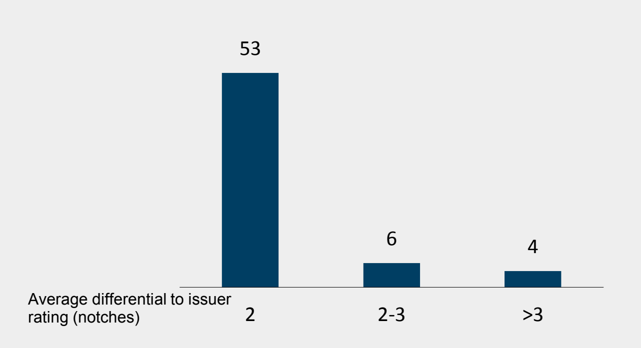
Rating agencies classify hybrid bonds as subordinated debt instruments and rate them below the issuer credit rating. For bonds issued since the start of 2019, this differential has normally been two notches. As a rule, the issuing companies possessed credit ratings from at least two agencies.

Under IFRS, hybrid securities are even eligible for full recognition as equity while coupon payments remain tax deductible in many countries. However, IAS 32 stipulates that the bond must rank below all other financial liabilities of the company, that a deferral or cancellation of the coupon payment is possible and that the note is issued without a stated maturity date. These so-called perpetuals account for around 80 % of hybrid issues this year. Usually, issuers of hybrid bonds rule out redemption - the first call date - within the first five years after placement, but longer periods of up to 10 years are not uncommon.

[1] Cf. Standard & Poor's: Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation of 16 January 2018
[2] Cf. Moody's: Cross-Sector Rating methodology. Hybrid Equity Credit of 10 September 2018.
[3] Cf. Standard&Poor's: Hybrid Capital Handbook of 12 May 2008.

Rating differential normally 2 notches

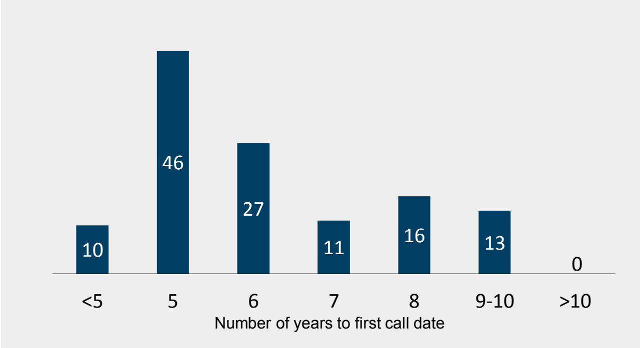
Issues since beginning of 2019: average rating differential to issuer rating



Sources: Bloomberg, Helaba Research

Hybrid bonds typically have call option after 5 years

Number of hybrid bonds since 2016 by years to first call date



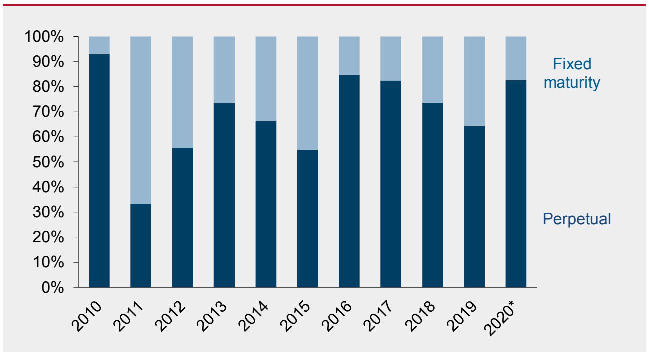
Sources: Bloomberg, Helaba Research

First-time issuers and supplementary issues drive market

In recent months, growth on the market has been mainly fuelled by a significant increase in the number of issuers making use of this instrument for the first time. To date, debut issuers have placed EUR 13.1 billion in 2020 compared to only EUR 3.2 billion last year. This represents a relatively high share of 36 %. In addition, some companies that had previously raised hybrid capital decided to issue additional bonds. More than one in every three euros was raised by supplementary notes. In contrast, the refinancing of maturing notes played a smaller role than in 2019.

Perpetuals the most common form of issuance

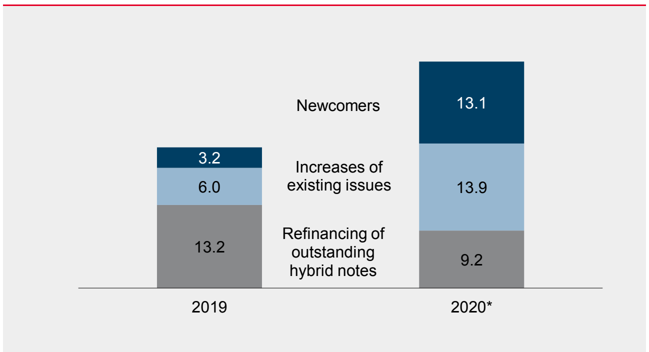
In % of placement volume



*includes issues until end of October 2020
Sources: Bloomberg, Helaba Research

Considerably more newcomers than last year

Volume (in EUR billions)

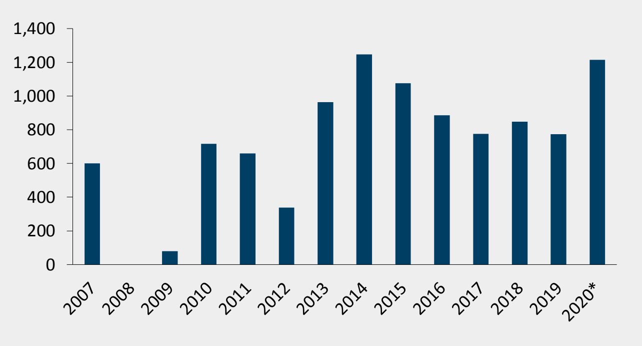


*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

Although the number of issues placed has not risen substantially compared to last year, issuing companies have raised larger sums. On average, each of the 30 transactions raised around EUR 1.2 billion. Nevertheless, the range of proceeds is very broad: while the smallest transaction had a volume of a mere EUR 75 million, the largest raised almost EUR 5 billion. In addition, the variety of sectors has also undergone major changes of late. While defensive sectors have traditionally dominated the picture in most years, considerably more cyclical companies have recently tapped the hybrid segment to raise funds. Many companies operating in economically sensitive industries have presumably felt the need to respond to increasing pressure on their credit profiles by issuing special subordinated capital.

Average issue volume much bigger than last year

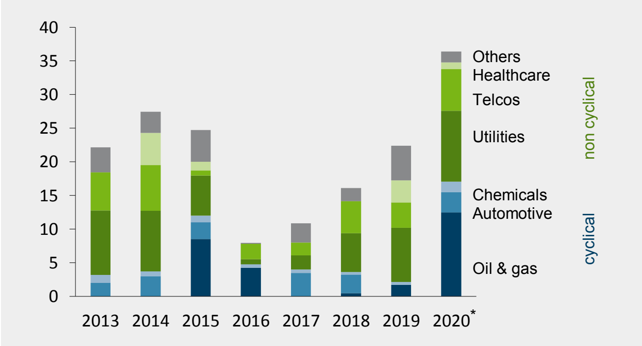
Average transaction volume (in EUR millions)



*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

Remarkably high number of cyclical players on market

Volume (in EUR billions)

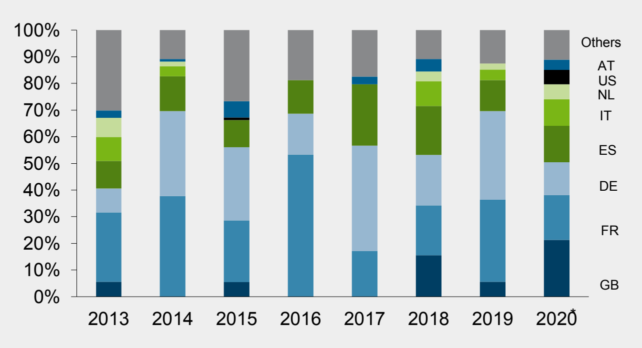


*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

This year, the scene has mainly been dominated by issuers from the United Kingdom, France and Germany with companies from these countries so far accounting for more than half of total market volume. German and French issuers, in particular, have traditionally had a strong presence on the market. However, regional diversification has increased in 2020 with issuers from 16 countries raising fresh capital on the hybrid market. The fact that the hybrid segment is arousing interest from a growing number of regions should, in our opinion, boost its long-term growth momentum.

Increasingly diverse range of countries

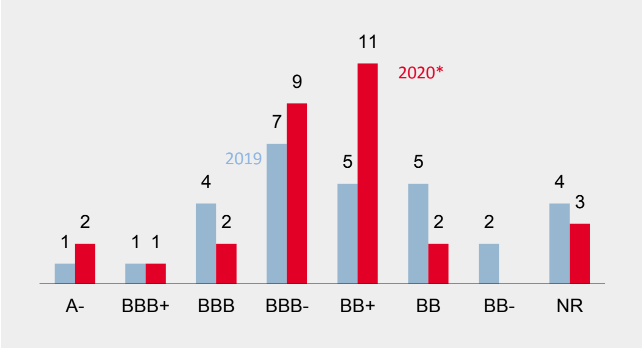
Volume (in %)



*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

Most hybrid ratings on the cusp of IG

Number of hybrid bonds by rating category



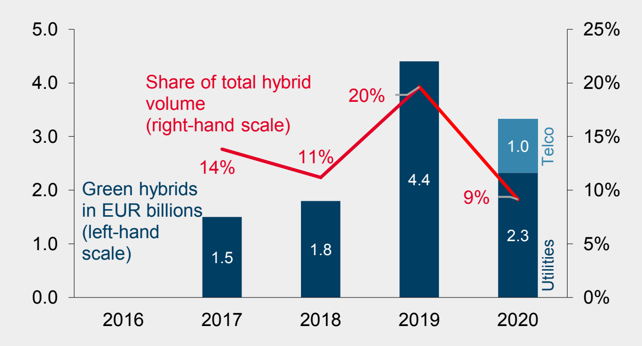
*includes issues until end of October 2020.
Sources: Bloomberg, Helaba Research

Going green – a trend among hybrid bonds, too

In common with other financial instruments, sustainable forms of finance are very much in vogue for hybrid bonds as well. Currently, green issues account for 9 % of total hybrid issuance, an above-average share compared to the overall market for euro-denominated corporate bonds. The latter has so far made up 5.4 % of issues in 2020. In terms of sector, utilities have been responsible for almost all green hybrid notes issued to date (14 issues since 2017), where they are mainly used to finance renewable energy projects. In the telecommunications sector, on the other hand, green bonds were primarily used to finance the expansion of optic fibre networks. However, the number of projects that are eligible for earmarked green finance is likely to remain limited, despite the fact that the EU's rather loosely defined taxonomy of environmentally sustainable activities opens the door for additional sectors to enter this segment. For this reason, so-called sustainability-linked structures have evolved in other segments such as the Schuldschein market (see Credit Special: Corprorate Schuldscheindarlehen – ESG has sustainable impact on Schuldschein market of 14 May 2020). The proceeds of these issues are not earmarked for any specific purpose. Instead, the interest costs are linked to specific sustainability indicators, such as a company's CO_2 emissions, or depend on the rating of the issuer by special sustainability rating agencies. We believe it is conceivable that this trend will also catch on in the hybrid market, with the result that this form of sustainable financing could become attractive for a variety of industries.

Large proportion of green hybrid capital …

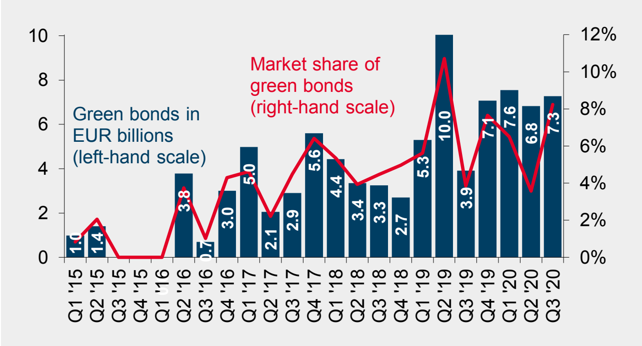
Hybrid segment: Volume in EUR billions or market share in %



Sources: Bloomberg, Helaba Research

… exceeds share of green bonds on primary market

Primary market for euro corporate bonds: Volume in EUR bn or market share in %



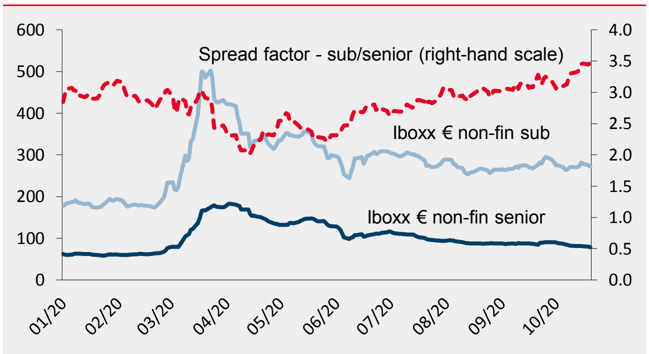
Sources: Bloomberg, Helaba Research

Cost of capital declines sharply in recent years

The outbreak of the Covid-19 pandemic also had a significant impact on the spreads of subordinated bonds in the first half of 2020. Although risk premiums on hybrid bonds fell markedly in the subsequent market recovery, senior bonds performed much better thanks to the ECB's emergency asset purchases. As a result, the difference between the yield spreads of subordinated and senior notes widened to 3.5x.

Recent increase in spread relative to senior bonds

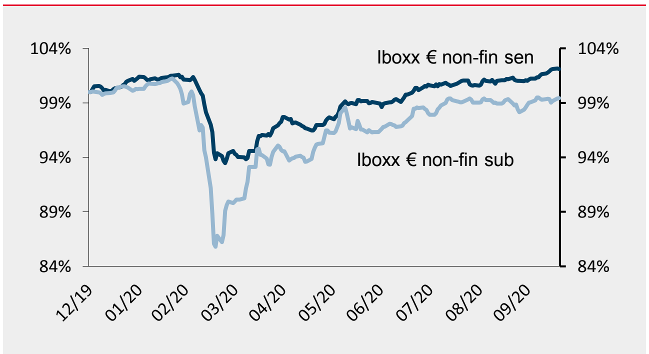
ASW (left-hand scale in bp) or spread factor (right-hand scale, x-times)



Sources: Datastream, Helaba Research

ECB ensures higher total return for seniors

Total return (adjusted to 100)

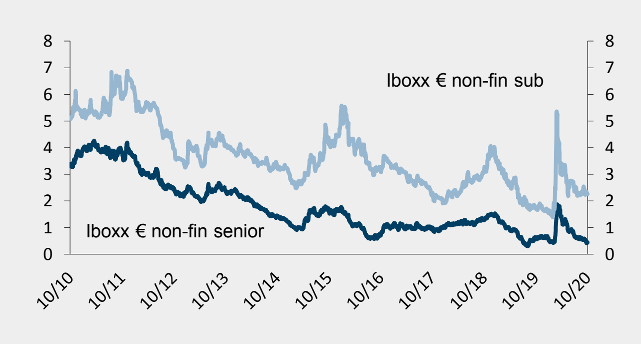


Sources: Datastream, Helaba Research

While the tendency towards a continuing distortion in spreads in favour of the senior unsecured segment is likely to be supported by the ECB's ongoing asset purchase programmes, on balance the more expansionary monetary policy will also result in significantly lower refinancing costs for hybrid bonds. The latter had already become noticeably cheaper due to falling base rates in previous years. What is more, a glance at historical patterns tell us that, despite the recent increase, the current relationship between the risk premiums of hybrid capital and senior bonds is not particularly high. The average multiple over the last 10 years was 3.6x.

Falling refinancing costs

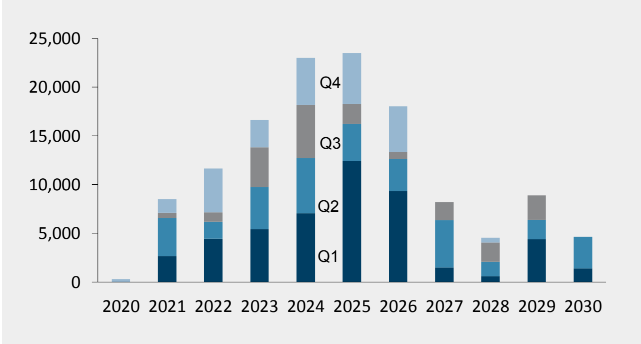
Yield (in %)



Sources: Datastream, Helaba Research

Bulk of maturities in 2024 / 2025*

Volume according to first call date (in EUR millions)



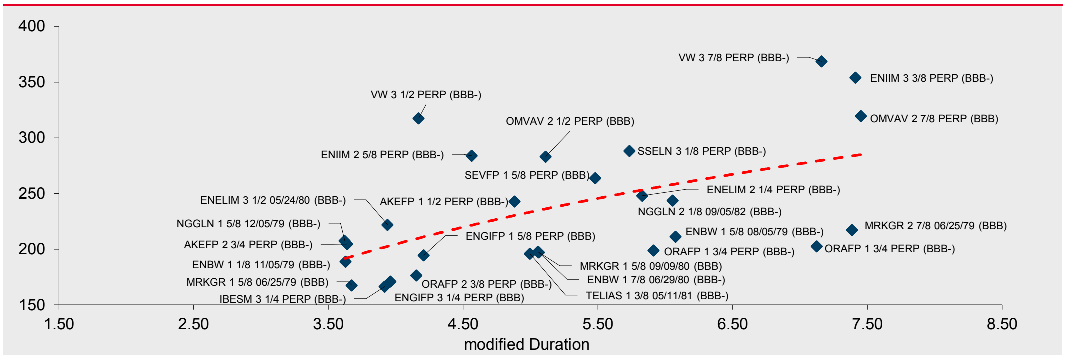
*excl. banks, financial service providers, insurance and real estate companies
Sources: Bloomberg, Helaba Research

Sector currently most important factor determining spread

At the moment, companies with defensive business models, in particular, are able to refinance themselves on relatively favourable terms in the hybrid sector. Bonds issued by utilities carry the lowest risk premiums, whereas those issued by companies in cyclical sectors such as the automotive industry or the oil & gas sector are priced at significantly higher spreads. The spread differential between issues of the same rating category with similar duration may amount to as much as 250 bps. This phenomenon can be observed across the entire credit rating spectrum.

Cyclicals in 'BBB' and 'BBB-' segments with highest risk premiums

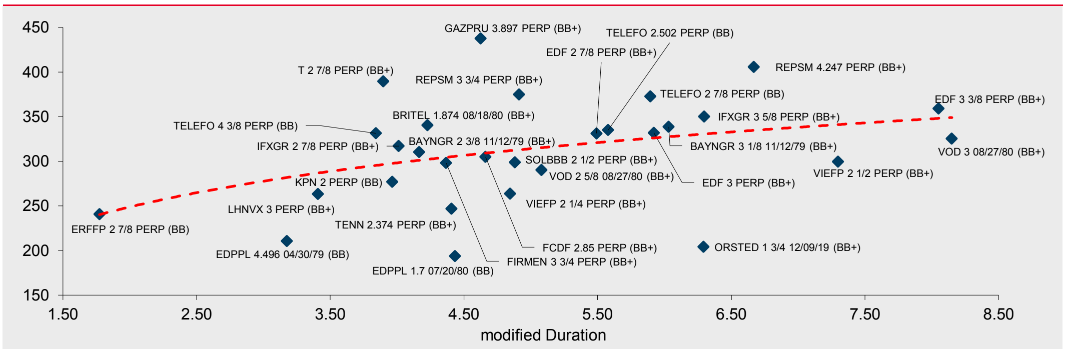
Hybrid bonds issued since early 2019, z-spread* (in bp)



*as of 6 November 2020. Sources: Bloomberg, Helaba Research

Similar sector pattern for non-IG notes

Hybrid bonds issued since early 2019, z-spread* (in bp)



*as of 6 November 2020. Sources: Bloomberg, Helaba Research

Economic environment points to buoyant market growth

The typical euro-denominated hybrid bond is issued by investment grade companies and has an average volume of EUR 1.2 billion. It is issued as a perpetual but can be called for the first time after at least 5 years. Usually, rating agencies recognise 50 % of a hybrid bond as equity and give it a rating two notches lower than senior unsecured notes. Hybrids then usually represent almost one fifth of an issuer's debt or equity capital. Although the bond has been priced at around 3.5 times the spread of senior bonds in recent years, it is a relatively inexpensive form of funding that helps to preserve a company's credit rating - compared, for example, with an increase of share capital.

Overall, we therefore expect hybrid capital to remain an attractive refinancing option for many corporates in the quarters ahead - all the more so if the emphasis in respect of financing increasingly shifts to shoring up balance sheets in view of a persistently hostile economic climate. In particular, this is likely to apply to issuers in economically vulnerable sectors, even though they currently have to pay significantly higher risk premiums than defensive companies. In equal measure, we expect hybrid bonds to be replaced by new notes, additional debut issuers to enter the market as well as established issuers to place additional bonds. In conclusion, we anticipate that the market for hybrid capital will remain buoyant going forward.