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Hybrid bonds:
Growth bucks the trend

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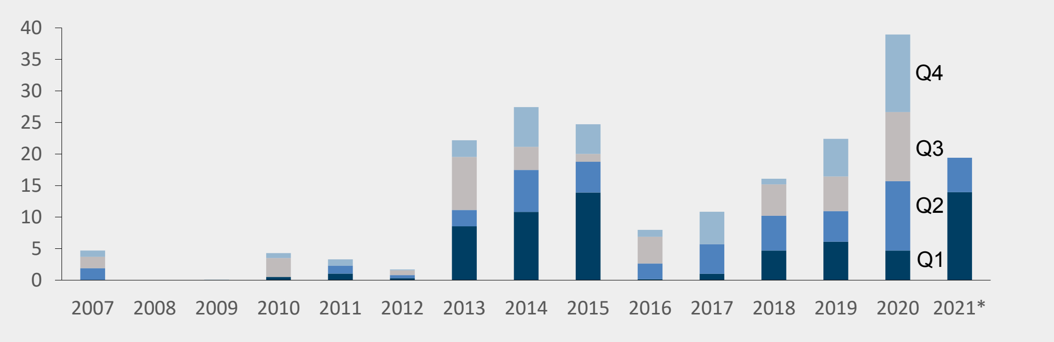
Although the overall EU corporate bond market has been in decline this year, hybrid bonds have seen a record level of issuance in the first five months. More and more companies regard this subordinated instrument as an effective and comparatively inexpensive means of bolstering their equity position. Companies that have been particularly active hybrid bond issuers include utilities, oil companies and telcos. What is more, green instruments have become more popular than in any other segment of the capital market, with almost one third of bonds issued this year having a sustainability component. Among the latter was a debut issue from the construction sector. Maintaining a healthy financial profile is likely to remain on the agenda of many companies for the near future, in large part due to the fallout from the Covid-19 crisis. At the same time, the cost of refinancing subordinated debt continues to be rather low. Consequently, we expect the primary market for hybrid bonds to maintain its strong momentum in the second half of the year and achieve a new record volume. The popularity of ESG bonds is also likely to persist.

Hybrid bonds on course for record-breaking growth

The brisk pace of EUR corporate hybrid bond issuance continued in the first five months of 2021. By the end of May, almost EUR 20 billion had been issued in 19 transactions, equal to EUR 3.7 billion more than in the entire first half of 2020. The average issue size, at EUR 1 billion, was slightly smaller than in 2020 (EUR 1.2 billion). The share of hybrids as a proportion of the total volume issued in a shrinking EUR corporate bond market rose from 8.4 % to just under 11 %. The economic downturn in the wake of the pandemic is likely to have been a significant factor in putting pressure on the financial position of many companies. In this respect, hybrid bonds provide a comparatively attractive option to expand corporate equity bases, particularly when it comes to improving balance sheet structures and enhancing credit ratings (cf. Credit Special - "Hybrid bonds: Shoring up defences in good time" of 11 November 2020). It appears that an increasing number of companies appreciate the advantages that subordinated debt offers. Just as in previous years, the majority of bonds were issued as perpetuals with no fixed maturity date - a crucial prerequisite for full recognition as equity on the balance sheet in accordance with IFRS accounting rules.

Further growth ahead in 2021

Issuance volume (in EUR billions)



*includes issues until end of May 2021.
Sources: Bloomberg, Helaba Research & Advisory

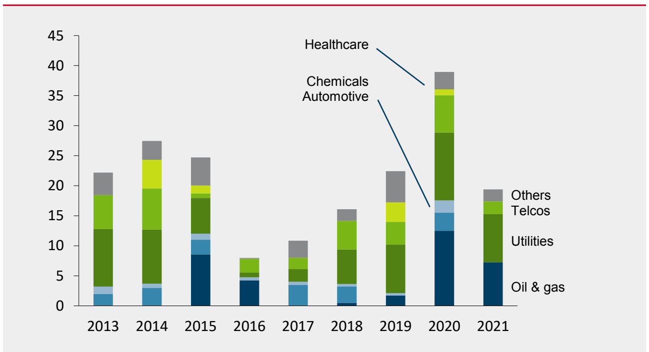
Capital-intensive industries drive the market

However, the greater use of hybrid financing has not yet led to a wider range of companies within this segment. Although issuers from five sectors have been active in the hybrid market since the beginning of the year, which is indeed more than at the same time last year - with the retail sector making a rare appearance on the market in the shape of a bond from the Japanese online retailer Rakuten - the largest volumes are still generated by utilities (EUR 8 billion), oil & gas companies (EUR 7.25 billion) and telcos (EUR 2.1 billion). Taken together, these sectors so far account for almost 90 % of market volume in 2021. One explanation for this is arguably the capital-intensive business model of all three sectors, with the average total gross debt of hybrid issuers in these industries currently exceeding EUR 20 billion. For this reason, these companies attach considerable importance to measures designed to protect their credit profiles.

Nevertheless, there were also some newcomers who took advantage of the opportunity to raise a total of EUR 3.4 billion on the market. At 17.5 %, the share of first-time issuers in the first 5 months of 2021 was below the very high level of the previous year, yet significantly above that of 2019. The largest debut issue, with a volume of EUR 1.5 billion, came from the oil & gas producer Wintershall Dea.

Few sectors still dominate

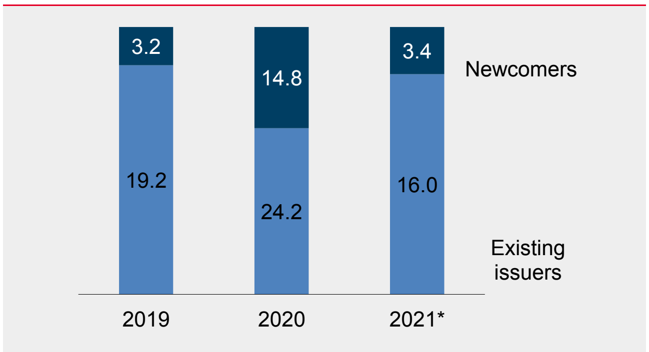
Volumes (in EUR billions)*



*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

Debut issuers support market growth

Volumes (in EUR billions)*

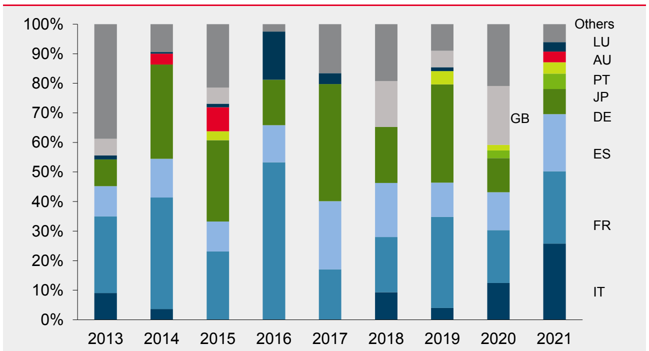


*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

In our opinion, the increasing regional diversification of issuers also indicates keen interest in hybrid bonds. Although 70 % of issues in 2021 have originated from Italy, France and Spain, the remaining third comprises a rather diverse range of countries, including Australia and Japan - regions that are rarely seen on the hybrid bond market.

2021 already a kaleidoscope of countries

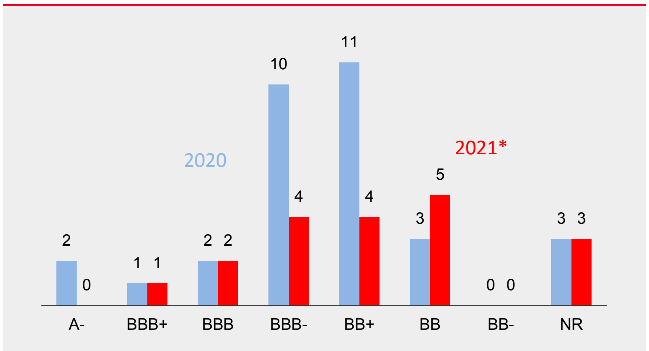
Volumes (in EUR billions)*



*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

Credit ratings slightly weaker on average

Volumes (in EUR billions)*



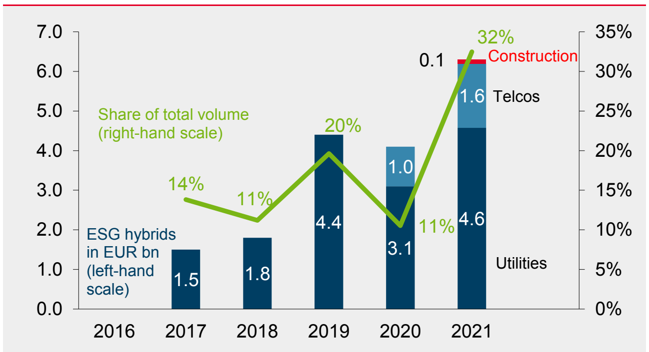
*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

Share of sustainability bonds reaches all-time high

Sustainable financing is also making inroads into the hybrid bond market as well. By the end of May, the issuance of hybrid bonds with an ESG component had topped EUR 6 billion. This corresponds to a share of total volume exceeding 30 % - the highest level ever in the hybrid market. At the same time, the first signs of a sector diversification were also noticeable in this segment over the first five months of the year. Despite the fact that utilities are still responsible for the overwhelming majority of green issues, in addition to the telecommunication sector the construction industry entered the sustainable hybrid segment for the first time. There has also been a slight change in specific structure of the instruments, with green bonds increasingly being joined in the market by sustainable and social bonds.

One third of hybrid bonds have ESG component, …

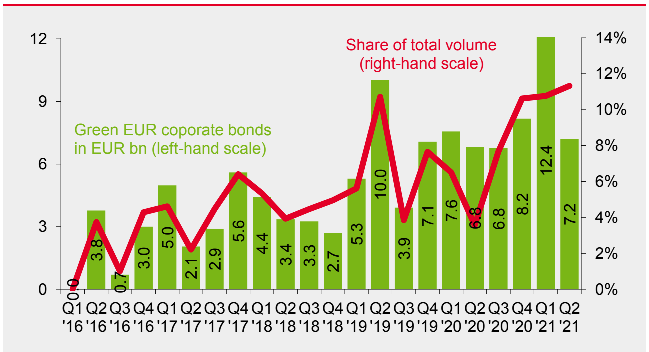
Hybrid segment: volume in EUR billions or market share in %*



*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

… but significantly smaller share of overall market

Primary market for EUR corporates: volume in EUR billions or market share in %*



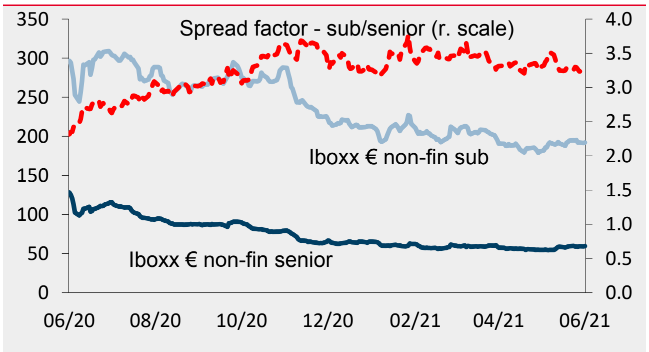
*includes issues until end of May 2021
Sources: Bloomberg, Helaba Research & Advisory

Cost of capital remains low

The ECB's purchase programmes are a major reason why the risk premiums for corporate bonds are still at a very low level. Since the beginning of the year, the iBoxx indices for both subordinated as well as senior bonds have essentially trended sideways. The spread ratio of the two segments has been fluctuating between 3.2x and 3.8x and at the end of May was at the lower end of the spectrum. As such, the risk premium ratio of hybrid capital to senior bonds remains below its long-term 10-year average of 3.6x. Even in absolute terms, the rather favourable funding costs for hybrid bonds are reflected in the persistently low yield of the iBoxx EUR Non-Financials Subordinated: at a current level of 1.7%, the index is a long way from its crisis levels in Q2 2020.

Recent sideways trend in corporate spreads

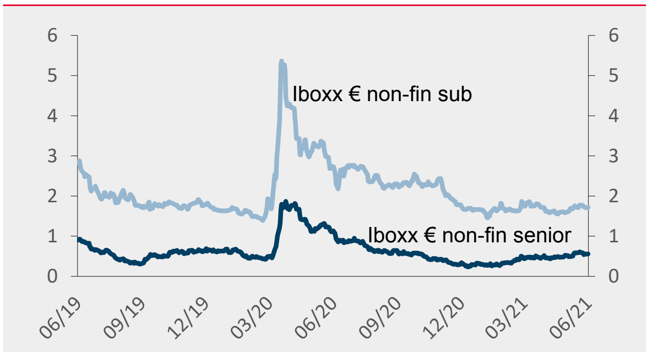
ASW (left-hand scale, in bps) or spread factor (right-hand scale, x-times)



Sources: Datastream, Helaba Research & Advisory

Index yields indicate low cost of capital

Yield (in %)



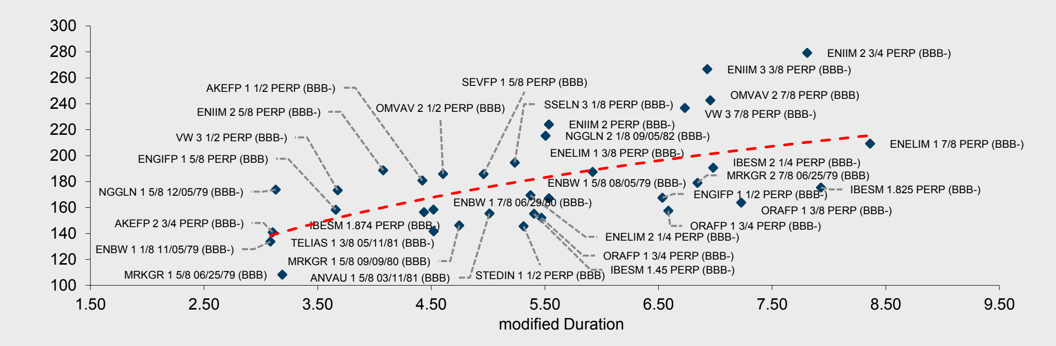
Sources: Datastream, Helaba Research & Advisory

Sector affiliation remains important factor in determining spreads

When looking at individual bonds, it becomes apparent that companies with defensive strategies are best placed to benefit from comparatively low refinancing conditions in the hybrid segment. Risk premiums for utilities, telcos and companies in the healthcare sector enjoy particularly low risk premiums. In contrast, cyclical industries such as the automotive and oil & gas sectors face higher premiums. However, spreads saw further narrowing in the last two months of 2020 and, as a result, the sector-based spread differential between issues in the same rating class also tightened somewhat. Meanwhile, it has fallen to barely 200 bps between bonds of similar duration, having previously reached up to 250 bps in November 2020. This is likely to have further added to the appeal of this instrument among corporates with cyclical business models.

Highest risk premiums still among cyclicals in 'BBB' and 'BBB-' classes

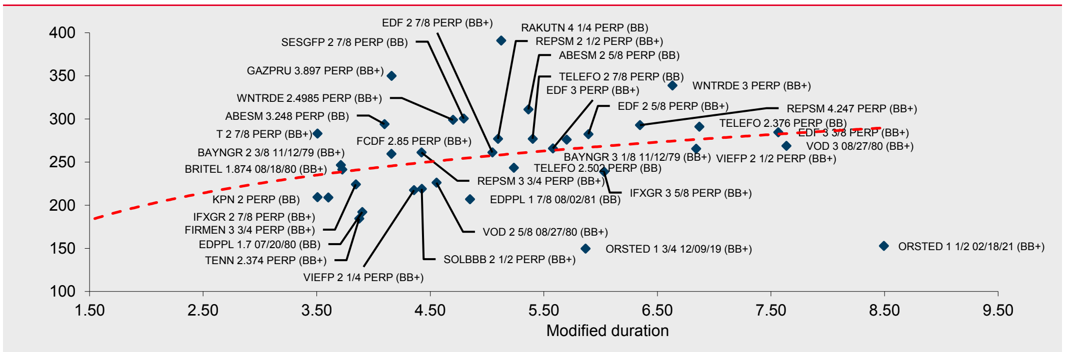
Hybrid bonds issued since May 2019, z-spread* (in bps)



*as of 2 June 2021. Sources: Bloomberg, Helaba Research & Advisory

Spread differential for non-investment grade bonds narrows to as little as 200 bps

Hybrid bonds issued since May 2019, z-spread* (in bps)



*as of 2 June 2021. Sources: Bloomberg, Helaba Research & Advisory

Market expected to sustain positive momentum

In the short term, there is unlikely to be any change to the low cost of capital in the corporate sector. The European Central Bank's purchases should stimulate enough demand to keep risk premiums low across the entire corporate bond universe over the quarters ahead. Consequently, hybrid bonds will continue to offer an exceptionally cheap way for companies to maintain healthy balance sheets. At the same time, there is likely to be a time lag before some corporates feel the financial impact of the pandemic. That is why we anticipate that the capital-strengthening effect of hybrids will draw additional issuers to the market as the year unfolds. For investors, hybrid bonds continue to offer a significant spread advantage over senior debt. Conditions are therefore ideal, both in terms of supply and demand, for the market to sustain its positive momentum over the coming months. ■