Hybrid bond issuance bounces back in Europe, helped by M&A, low interest rates

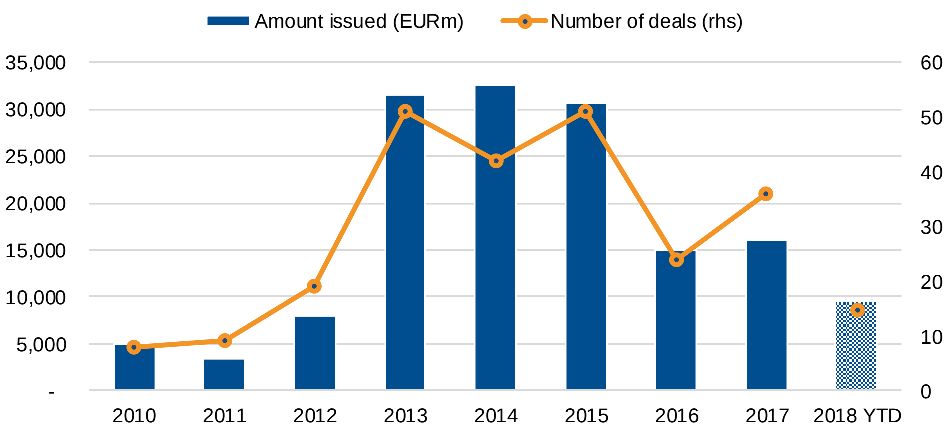
European issuance of hybrid bonds—securities which blend the characteristics of debt and equity—from non-financial corporates is on course to exceed EUR 20bn this year, with almost EUR 10bn issued in just the first four months, equivalent to more than half of 2017's total. Scope Ratings believes there is impetus behind more issuance this year, even allowing for the sensitivity of the hybrid debt market to overall investor sentiment. The recent surge in mergers and acquisitions by companies typically well suited to issuing hybrid bonds—namely those in capital-intensive sectors such as utilities, telecommunication and increasingly real estate—is underpinning supply this year. Hybrid bonds are go-to securities for a growing number of CFOs wanting to fund M&A without jeopardising their firm's credit rating while also minimising dilution of shareholders for the "equity portion" in any deal. Secondly, there is the considerable stock of hybrid bonds issued since 2013. As they come up for refinancing in the quarters ahead, the simplest solution for CFOs is to replace the old hybrids with new ones while interest rates remain so low.

New interim peak in issuance volume expected in 2018

Hybrid debt placement volumes this year should exceed the comparatively meagre EUR 15bn placed in 2016 and in 2017 while interest rates remain so low and BBB-rated companies are eager to maintain their investment-grade status. Even though issuance is unlikely to match the record yearly volume of more than EUR 30bn in 2013 and 2015, investor appetite for high-yield subordinated debt by financially solid corporates should remain healthy—unless investors' risk aversion increases significantly which would deter issuance of hybrid bonds. Scope believes that two main forces should continue to drive hybrid-debt supply this year:

- financing for M&A deals, many of which have taken place at the highest transaction multiples since 2007 which would put pressure on credit ratios if funded only through conventional debt;
- low interest rates remain an incentive for corporates to replace maturing hybrids on first call dates in the months and increasingly years ahead with new hybrid issues.

Figure 1: Hybrid debt issuance of European corporates



Source: Bloomberg, Scope

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Excursus: What is hybrid debt?

Case by case analysis of equity character

Bonds classified as "hybrid" blend the characteristics of debt and equity securities. Indeed, some of their characteristics make the bearer partially take on the risk of the business and bring the instruments closer to equity than to standard corporate debt. Although widely standardised in their documentation, the features of hybrid debt (see Figure 2) may significantly deviate from one issue to another. From Scope's perspective, the most important features which would qualify a hybrid bond for equity-credit are i) subordination, ii) mandatory or optional deferability of principal and coupons and iii) maturity and convertibility into equity at the discretion of the issuer. Hence, case-by-case analysis of every hybrid bond is required to determine the degree of equity content.

Figure 2: Common key features of corporate hybrid bonds

Benefits for issuers

- Potential suspension of coupon and principal payment
- Potential accounting as equity under IFRS
- Potential equity recognition from CRAs
- Tax-shield

Benefits for investors

- Investment in 'high-interest' debt from comparatively solid (mostly IG-rated) issuers

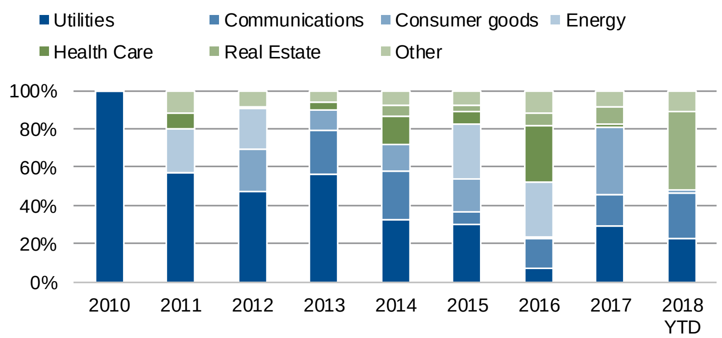
Source: Scope illustration; CRA = Credit Rating Agency

Capital-intensive sectors driving the volumes

Utilities, telcos and real estate corporates taking the lead

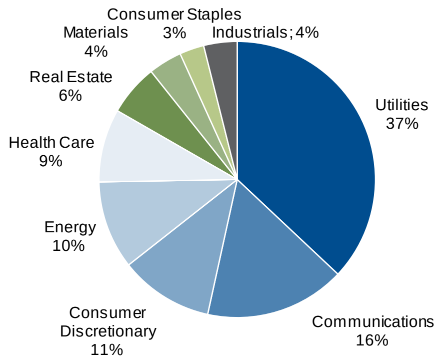
Scope notes that capital-intensive sectors such as utilities and telcos are usually among the biggest users of hybrid debt. Not only do companies in those sectors tend to be active in M&A, but also their debt-financed business models depend on maintaining investment-grade credit ratings to minimise their cost of capital. Hybrid bonds allow them to raise funds efficiently without putting pressure on the degree of indebtedness. A hybrid bond can be treated by rating agencies wholly or partly as equity given that coupon payments can be deferred or suspended. As Figure 4 shows, utilities and telcos made up more than 50% of total hybrid placements between 2010 and 2018 YTD (37% utilities, 16% telcos). Real estate companies have also used more hybrid debt since 2016, now accounting for 6% of overall placement volumes, however, almost 40% so far this year.

Figure 3: Total segment split between 2010 and 2018 YTD (measured by number of issues)



Source: Bloomberg, Scope

Figure 4: Total segment split between 2010 and 2018 YTD (measured by issued volume)



Source: Bloomberg, Scope

Hybrid bond issuance bounces back in Europe, helped by M&A, low interest rates

Utilities, telcos and real estate taking the lead

Utilities and real estate firms have been busy deal-makers in recent months, partly reflecting their improved credit profiles. Hybrid bonds should enable them to maintain their credit ratings despite the comparatively expensive M&A they have undertaken.

Most recent M&A deals financed through hybrids

Scope expects further large hybrid placements over the next few months considering how recent M&A has been financed. Belgian Elia decided to finance the acquisition of another 20% in German grid operator 50Hertz with a large portion of hybrid debt in 2018. Finnish utility Fortum might also swap some of the volume drawn from credit lines for the acquisition of a 47% stake in German Uniper with a hybrid bond. Danish TDC opted for a hybrid issue when acquiring Norwegian Get AS in 2014. Vodafone is planning to partly finance its latest acquisition, a EUR 18.4bn deal for some of Liberty Global's European assets, with hybrid debt. Real estate company Unibail-Rodamco has opted for its first hybrid in 2018 for the acquisition of Westfield Corp. The same has applied to corporates from other sectors with large M&A deals such as Repsol for the acquisition of Talisman Energy, Merck's (rated A-/Stable by Scope) integration of SigmaAldrich in 2014 or the takeover of Chemtura by Lanxess (rated BBB/Stable by Scope) in 2017.

Utilities and telcos particularly exposed to government shareholders, making it difficult to raise equity

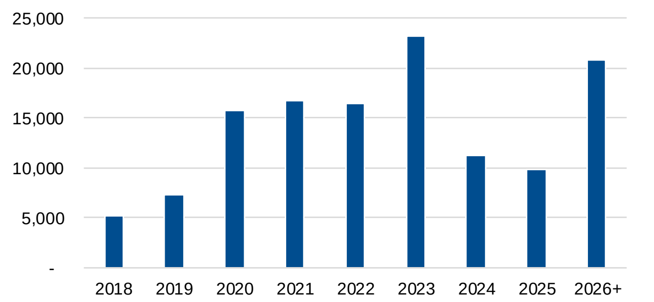
Scope points out that the ownership structure of utility and telco companies in Europe also lends itself to hybrid debt, either because as unlisted companies the options to raise equity are limited or because links to the state are close, so selling shares would dilute government ownership. Europe's utilities sector is a good example. Companies are often state-owned (e.g. Denmark's Ørsted, Sweden's Vattenfall, TenneT in the Netherlands or Norway's Trønder Energi) or have government on the shareholder roster (e.g. Italy's Enel, Germany's EnBW, the Netherlands' Alliander, or France's Engie). The same applies to former telco monopolies such as Spain's Telefonica, France's Orange, Telecom Italia or KPN in the Netherlands.

Busy refinancing schedule for hybrid debt

First call dates of many utility, telco hybrids approaching between 2018-2020

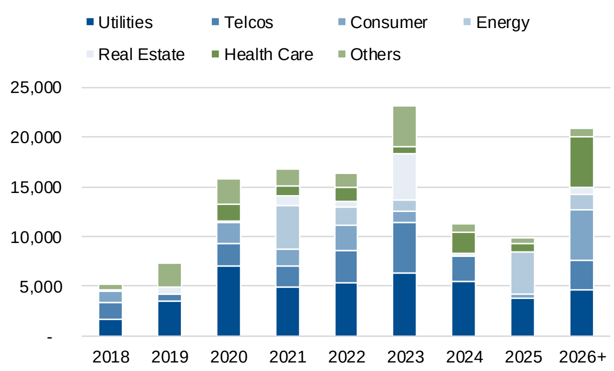
Looking at the upcoming first call dates of outstanding hybrids, utilities and telcos are also among the most prominent issuers set to seek refinancing over the next few years (see Figures 5 and 6) and so likely to continue to drive hybrid issuance[1]. Unless a hybrid-debt issuer has significantly strengthened its balance sheet since the original placement of the securities, the issuer typically replaces the called and redeemed instrument to maintain the level of equity within the capital structure, just as Telefonica, Iberdrola, Alliander and Ørsted have done recently in 2017/18.

Figure 5: Currently outstanding hybrids issues according to their first call date (in EURm)



Source: Bloomberg, Scope

Figure 6: Industry breakdown of currently outstanding hybrids according to their first call date (in EURm)



Source: Bloomberg, Scope

[1] It is also noteworthy that many hybrids feature the requirement to redeem the existing hybrid only with funds from newly issued hybrid or common stock. As an equity raise often is the second-best option considering this depends on achievable prices, the likelihood of a hybrid succeeding is rather high.

Potential hybrid redemption and refinancing volume staggers up to EUR 15bn by 2020

Scope assumes that the expected refinancing of outstanding hybrids with first call dates from 2018 onwards will boost primary market activity. While potential hybrid replacements in 2018 amount to EUR 5bn (outstanding hybrids between May and December 2018), the potential redemption and refinancing volume rises to more than EUR 15bn within two years, around the total yearly placement volume in 2016 and 2017.

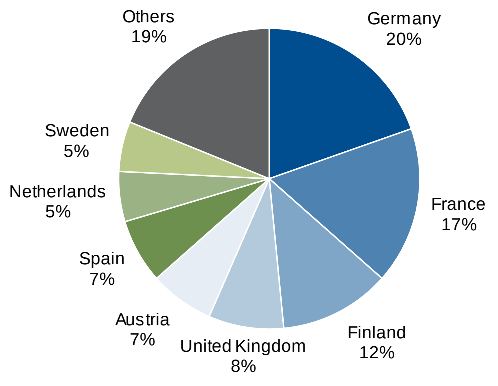
Increasingly important role of hybrids in financing mix

Hybrids still play a subordinated role in capital market debt financing

Hybrids have become a well-accepted, fairly standardised source of funding for many corporates, across all European jurisdictions (Figure 7), with German, French and Finnish corporates being most active. Still, hybrids make up only between 0-5% of debt capital market instruments (see Figure 8). Scope believes that hybrids will grow in importance in the financing mix for many companies. Overall, we expect that hybrid instruments will be even more frequently used as a standard financing tool by various corporates, rising closer to 5% and even beyond of total corporate bond supply from non-financial corporates. For that to happen, the market will need the following stimulus:

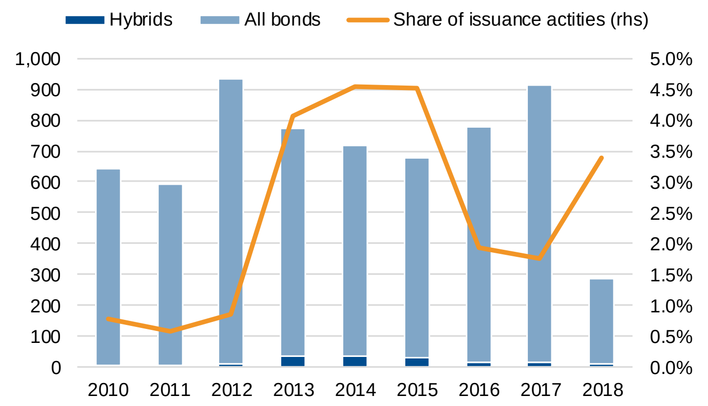
- Wider outreach and more frequent usage by experienced hybrid debt issuers;
- Greater visibility on the treatment of hybrid debt by rating agencies;
- Decreasing coupon gap ('sub-senior spread') to conventional debt as a result of demand overhang for debt instruments with higher yield[2];
- Persistently high M&A activity and comparatively expensive M&A valuations which require funding through either equity or hybrid debt to not put credit ratings at risk;
- Potential end of ECB's tapering policy (CSPP) which favoured issuance of conventional debt instruments over hybrids, particularly in 2016/17.

Figure 7: Country of risks of hybrid issuers from 2008-2018YTD (measured by number of instruments issued)



Source: Bloomberg, Scope

Figure 8: Hybrids issues in comparison to debt issues of European non-financial corporates (in EURbn)



Source: Bloomberg, Scope

[2] According to arrangers the gap between senior and subordinated debt has narrowed over the past few years, down from highs of 300 basis points on average in 2016 to ranging from 125 to 175 basis points recently. France's Engie set the record for the lowest yield on a corporate hybrid in 2018, when it priced a perpetual bond with a non-call 5.25 year structure at 1.5%. Another recent example is Grand City Properties which lowered the coupon on its new 2018 hybrid to 2.5% against 3.75% in 2016. Telefonica saved more than 200 basis points on its new 2018 hybrids which refinanced the 2013 instrument.

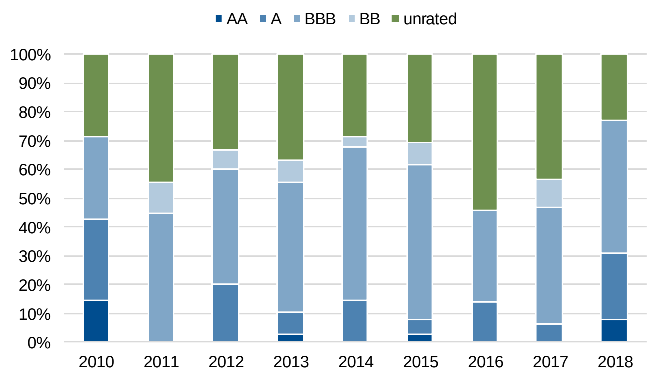
Good market sentiment required for hybrids

Scope stresses that hybrids are more popular when market sentiment is benign. At times of turbulence, investors tend to refrain from taking the risks of buying subordinated debt instruments where payment of coupons and even the principal can be deferred at the discretion of the issuer. Hybrid bond yields are quick to reflect this extra risk when market sentiment sours, making it more sensible for companies to issue corporate bonds if they need extra capital-market financing.

Hybrid issuers predominantly rated in the BBB category

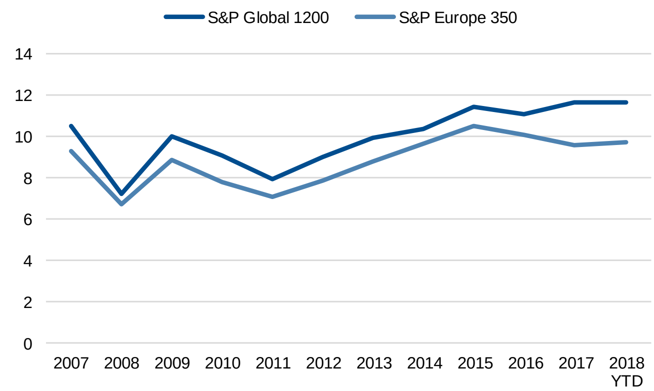
Hybrids usually come from issuers with a strong visibility on their cash flows, as mirrored by the rating category distribution in Figure 8. Although a large remaining share of hybrid issuers, standing at around 35% on average, is unrated at the time of the issue, the largest proportion of issuers is rated in the BBB or A. Scope suspects that it is issuers in the BBB category (~70% of rated issuers over the last 10 years) which have the strongest incentive for the issuing of hybrid debt as the potential equity treatment may protect their creditworthiness from being downgraded to high yield. This logic is likely to be most compelling at a time of large M&A deals, recently done at historically high valuation multiples. Funding deals using hybrids may be the most appealing way to preserve existing an IG-rating.

Figure 9: Issuer rating categories



Source: Bloomberg, Scope

Figure 10: EV/EBITDA multiples – global and Europe



Source: Bloomberg, Scope

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