

Europe's hybrid bond market booms

Robust outlook for 2020 after record year



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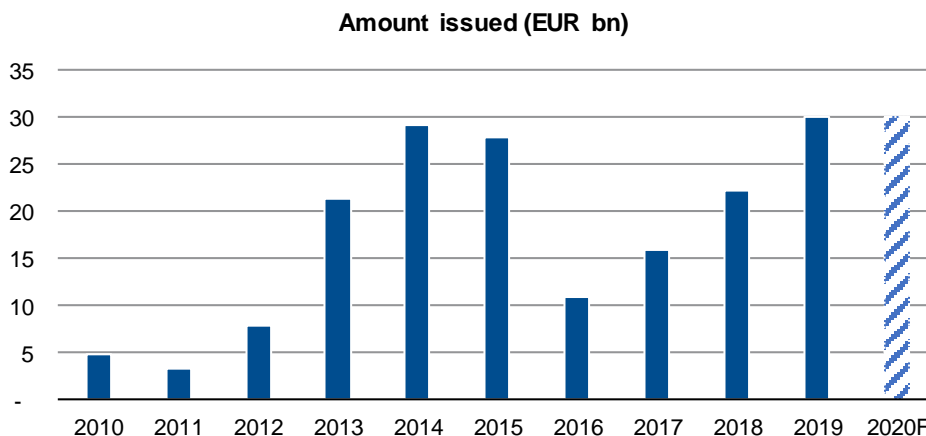
A diverse range of companies issued a record EUR 30.2bn in hybrid bonds in Europe in 2019, with ultra-loose monetary policy and buoyant market conditions set to support activity this year assuming there is no abrupt economic slowdown.

We expect volumes from non-financial corporates to be around the same level this year – after a near 50% jump in 2019 from EUR 22.2bn in 2018 – as more companies beyond capital-intensive sectors such as utilities and telecommunications, historically the most active users of hybrids, tap the segment.

Much of the outlook for the hybrid market depends on how loose monetary policy remains in Europe amid sluggish economic growth in many countries, including Germany. A soft landing for the European economy would help keep the pipeline full.

The hybrid bond market remains inherently sensitive to changes in overall investor and, particularly, stock market sentiment. Consequently, a more-abrupt-than-expected economic slowdown in 2020 or possible financial and/or political shocks could quickly thin the ranks of companies coming to market with new issues.

Figure 1: European corporate hybrid bonds issuance hits new record in 2019



Source: Bloomberg, Scope

The issuance volume in 2018 and 2019 shows that the hybrid market is becoming more mature. New entrants are coming from a more diverse range of industrial sectors and even non-rated companies are seeking to benefit from the equity features of the debt instrument amid historically low bond-market yields. Some issuers tapped the market more than once.

Growth in the hybrid bond market has tracked growth in Europe's much larger and deeper corporate bond market (see Figure 2.). Issuance is booming with extra impetus from the ECB's commitment to ultra-loose monetary policy, including the rates cut which has kept yields at record lows and the restarting of the central bank's corporate bond purchasing programme (CSPP).

The primary corporate bond market in Europe had a record year with an issuance volume, including the hybrid segment, of almost EUR 800bn in 2019. Activity has remained buoyant in January.

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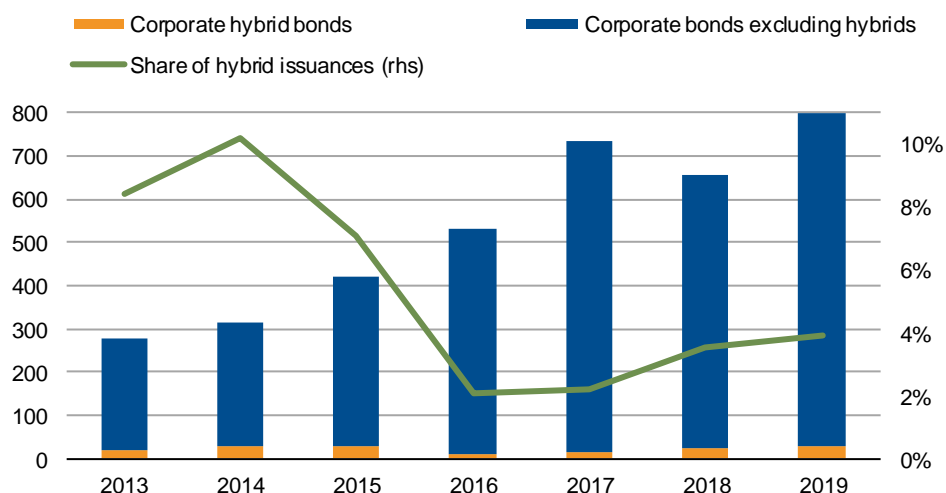
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Figure 2: Hybrids issues in comparison to debt issues of European non-financial corporates (in EUR bn)



Source: Scope, Bloomberg

Main hybrid bonds market trends in 2019

Investors' insatiable appetite for corporate bonds spills over to hybrid segment

For investors faced with highly priced bond markets – some European corporate bonds offered negative yields in 2019 – hybrid bonds from investment-grade issuers remain an attractive alternative to searching for higher yields among bonds issued by non-investment-grade companies.

Issuers mainly used hybrid proceeds to refinance upcoming calls on existing bonds and replace earlier, more expensive issuances. Germany's Bayer AG and France's Orange SA issued two of 2019's biggest hybrids to refinance earlier issues callable in 2020.

Figure 3: European hybrid-bond issuance 2019: top issuers (EUR 1bn plus)

Largest volume issuance by issuers	Sector according to Bloomberg classification	> EUR 1bn	Issuance purpose	Total hybrid issuance volume incl. called bonds
Deutsche Bahn Finance GMBH	Industrials	2.00	General corporate purpose	First issuance is in 2019
Telefonica Europe BV	Communication	1.80	Refinancing	More than EUR 10bn
Vodafone Group PLC	Communication	1.78	M&A	Around EUR 6bn
Bayer AG	Healthcare	1.75	Refinancing	More than EUR 8bn
Merck KGaA	Healthcare	1.5	M&A	EUR 3bn
Engie SA	Utilities	1.5	Refinancing	More than EUR 6bn
Total SA	Energy	1.5	Refinancing	More than EUR 10bn
Orange SA	Communication	1.5	Refinancing	More than EUR 7bn
National Grid Finance PLC	Utilities	1.25	Refinancing	More than EUR 3bn
Infineon Technologies AG	Technology	1.2	M&A	First issuance is in 2019
Sika AG	Materials	1.14	M&A	First issuance is in 2019
Heimstaden Bostad AB	Real estate	1.09	M&A	First issuance is in 2019
Top EUR 1bn plus hybrid issues subtotal (EUR bn)		18.01	Total 2019 hybrid issuance = EUR 30.2bn	

Issuers using bonds to finance upcoming calls and M&A

Merger-related financing was again a theme in 2019. Four of the 10 biggest issues in 2019 were by companies financing recent acquisitions. UK's Vodafone Group PLC was present again this year with a EUR 1.78bn hybrid to finance the Liberty Global assets after last year's EUR 4bn issuance for the same purpose. German pharmaceutical firm

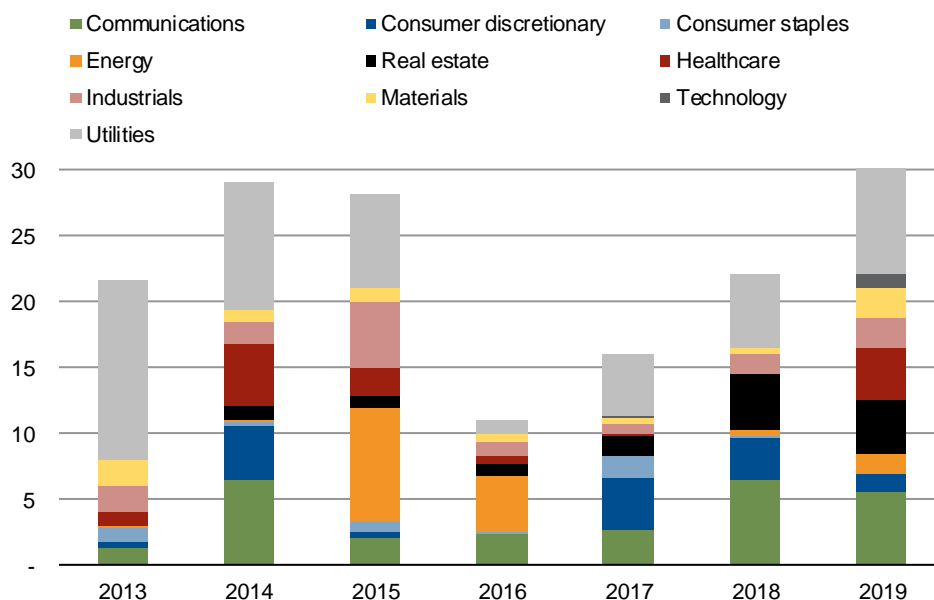
Merck KGaA (rated A-/Stable by Scope) tapped the hybrid market this year to partly finance the acquisition of Versum, having issued EUR 1.5bn in 2014 to finance its acquisition of Sigma Aldrich.

Hybrid issuance was quite diverse by industrial sector (Figure 4). Real estate and healthcare companies joined the capital-intensive utilities and telecommunications sectors as the most active participants. Automotive companies were notably absent as they grappled with weak demand and the challenge of meeting new, tougher emissions standards by increasing the number of electric cars in their line-ups.

The shifting make-up of the hybrid sector partly reflects how some of the rules of thumb that investors relied on in the past have lost their usefulness. Investors used to be very selective as regards sectors and individual companies, opting for defensive sectors such as healthcare to avoid risk. However, the line between defensive and cyclical sectors has become muddled. For example, the performance of once-defensive utilities has proved much more volatile in recent years, with the exposure of their conventional power-generation units to changing environmental policies and the consequences of growing supplies of renewable energy. Telecom companies have also struggled to accelerate growth and improve profitability faced with stiff competition from rival operators and other technology companies as technology itself has evolved fast.

The growing diversity of hybrid issuers also suggests that securities are gaining the trust of investors looking for extra returns and issuers looking for a broader mix of financing than plain debt or equity.

Figure 4: Hybrid bond issuance by sector



Source: Scope, Bloomberg

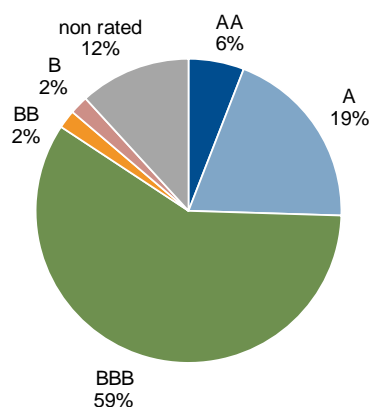
BBB rated companies favour hybrid bonds

Investment-grade companies, particularly those in the borderline BBB category, were the most frequent issuers of hybrids last year as CFOs sought to preserve their investment grade ratings as slower economic growth threatened to pinch revenues.

Green hybrid bonds were also a feature of last year's issuance. Investors across capital markets clamoured for more ESG-related securities, leading to a flurry of ESG-related fundraising activity. The EU's newly approved ESG taxonomy – a set of guidelines on what counts as a sustainable investment – should help spur more sustainability-linked

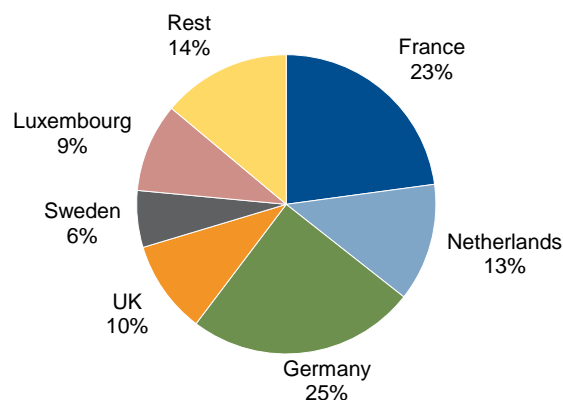
fundraising. Engie SA and fellow utilities Energias de Portugal SA, EnBW Energie AG and Iberdrola SA issued green hybrids in 2019.

Figure 5: Hybrid bond issuance by rating category in 2019



Source: Scope, Bloomberg

Figure 6: Hybrid bond issuance volume by country of incorporation (% of total)



Source: Scope, Bloomberg

French and German companies dominate the hybrid market

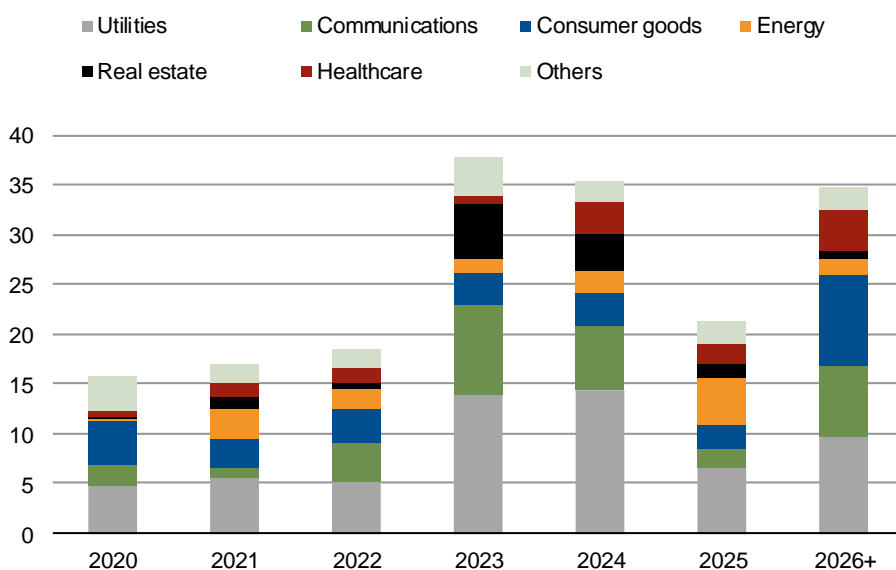
Of this year's hybrid bond issuers, French and German companies were the dominant players in the market by volume, though Dutch, UK and increasingly Nordic companies were also active.

Looking forward – the 2020 outlook

If broad monetary and economic conditions remain stable in 2020, issuers will continue to tap the hybrid market to refinance callable bonds whose coupons look expensive compared with current coupon rates.

We estimate that EUR 15bn in hybrids will reach their first call date in 2020, in addition to more than EUR 15bn in 2021. The vast majority of these will be replaced with new hybrids. Early financing has already taken place in 2019 for hybrid bonds callable in 2020. The same will happen to the hybrid bonds callable in 2021 as issuers take the opportunity of low rates to refinance earlier issuance more cheaply.

Figure 7: Outstanding hybrid issues according to the next call date (EUR bn)



Source: Scope, Bloomberg



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