

# Europe's hybrid bond market cools down: Issuance volume should shrink to 2016/2017 levels



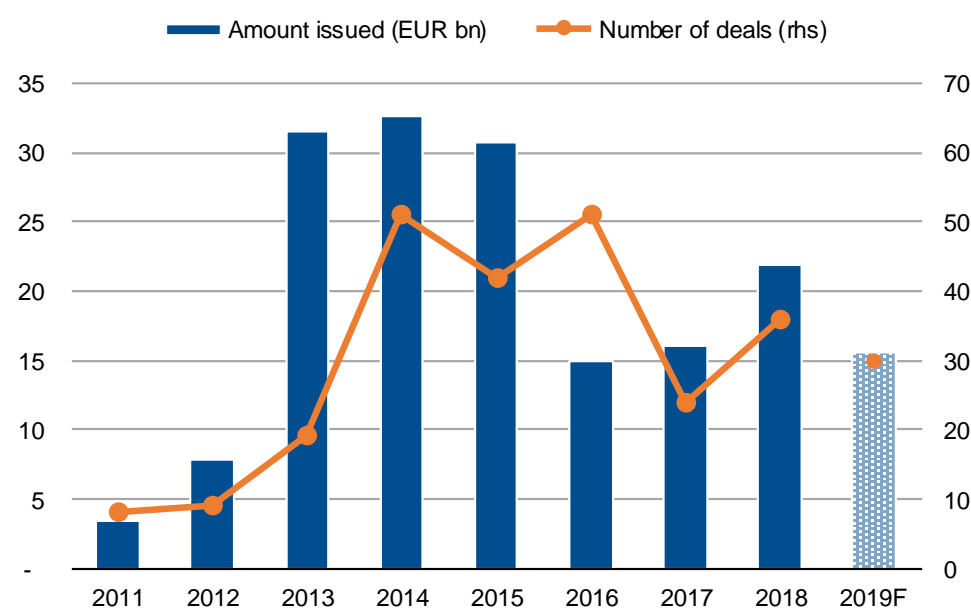
Scope  
Ratings

Europe's hybrid bond issuance rose 37% in 2018 to around EUR 22bn, after a strong first-half performance. Annual issuance, while much higher than in 2016 and 2017, fell short of volumes in the 2013-2015 period, as we had forecasted. Two thirds of issuance last year took place in H1, mostly by corporates seeking to refinance outstanding hybrids by exercising call options. The volume of hybrid bond transactions faded toward the end of year due to rising market volatility. We believe issuance volume should shrink to 2016/2017 levels in 2019 for several reasons: less hybrid debt with call dates this year which could need refinancing, a likely decline in M&A activity, continued market volatility and a potential increased risk premium for the subordinated debt instrument amid slowing economic growth and persistent geopolitical uncertainty. That said, a EUR 1bn hybrid bond from French utility Engie SA this month to refinance an existing issue does underscore underlying demand for hybrid issuance in Europe.

Several important trends were visible in Europe's hybrid bond market last year:

- New issuers came to market from diverse sectors seeking to benefit from the favorable yield environment and advantages of issuing hybrid rather than pure-debt securities.
- Investment grade companies continued to be the major issuers in terms of volume.
- Corporates from capital-intensive sectors—such as utilities, telecoms, and real estate—continued to dominate the asset class.
- Real estate issuers were increasingly active, responsible for more than EUR 4bn in hybrid volume compared with EUR 1.5bn in 2016 and less than 1bn in previous years.
- Vodafone was the biggest single issuer with triple-currency multiple tranches totaling around EUR 4bn, followed by Volkswagen with a EUR 2.75bn dual tranche and Telefonica with a EUR 2.25bn dual tranche. All other issues were of EUR 2bn or less.

**Figure 1: Evolution of hybrid debt issuance by European corporates**



Source: Scope, Bloomberg

## Analysts

Azza Chammem  
+49 30 27891 240  
[a.chammem@scoperatings.com](mailto:a.chammem@scoperatings.com)

Klaus Kobold  
+49 69 667738 23  
[k.kobold@scoperatings.com](mailto:k.kobold@scoperatings.com)

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## Scope Ratings GmbH

Lennéstraße 5  
10785 Berlin

Phone +49 30 27891 0  
Fax +49 30 27891 100

[info@scoperatings.com](mailto:info@scoperatings.com)  
[www.scoperatings.com](http://www.scoperatings.com)



Bloomberg: SCOP

## Capital intensive firms dominate the market

### 2018 highlights

Typically, capital intensive firms are keen to protect their credit ratings and diversify their financing beyond bank debt and corporate bonds by issuing hybrid debt.

As shown in figure 3, Real estate companies emerged last year as increasingly active participants in the market, with nine companies issuing more than EUR 4.1bn of Hybrid debt. In 2018, six corporates (see figure 2) issued EUR 13.75bn in outstanding hybrid debt out of the full-year total of EUR 21.9bn, mainly refinancing maturing issues. Utilities, real estate and telecom companies remain the major actors in the hybrid market followed by chemicals companies. Telecom issuers led the way, with EUR 6.4bn in combined issuance from the UK's Vodafone and Spain's Telefonica followed by utilities with EUR 5.6bn and real estate EUR 4.1 bn all out of EUR 22 bn.

The financing arm of auto maker Volkswagen, already a major issuer of corporate bonds, was again active in 2018.

## Low interest rates continued to lure investors

In addition to diversification of financial portfolio and the equity features of hybrid securities, it was low interest rates that continued to lure issuers to the market. For example, Austrian-based energy firm OMV AG placed EUR 500m hybrid debt at about 2.8%, which is considerably lower than its previous hybrid bond offerings for an instrument with similar features.

**Figure 2: Largest hybrid bond issuance in 2018**

Issuer by most recent issuance date	Sector	> EUR 1bn	Issuance type	Issuance purpose
Electricité de France	Utilities	EUR 1.25bn	Single tranche	Hybrid refinancing
Vodafone Group	Telecom	EUR 4bn	Quadruple tranche-triple currency	M&A
Volkswagen International Finance	Automotive	EUR 2.75bn	Dual-tranche	Hybrid refinancing
Enel	Utilities	EUR 1.5bn	Dual-tranche	Hybrid refinancing
Unibail-Rodamco-Westfield	Real estate	EUR 2bn	Dual-tranche	M&A
Telefonica Europe	Telecom	EUR 2.25bn	Dual-tranche	Hybrid refinancing
		EUR 13.75bn		

Source: Scope, Companies

## M&A continues to be a major driver

Financing M&A remained an important reason behind hybrid debt issuance. Vodafone's jumbo issue was aimed at financing its acquisition of Liberty Global asset's in Germany and Eastern Europe for about USD 21.8bn. Additionally, Belgian-based power-grid operator Elia System Operator used proceeds to refinance a bridge loan for its purchase of a further 20% stake in Eurogrid, the holding company of Germany's 50Hertz Transmission. Unibail-Rodamco-Westfield priced the highest hybrid transaction for a real estate company to partly finance the Westfield acquisition.

## Refinancing via execution of call option is preferred

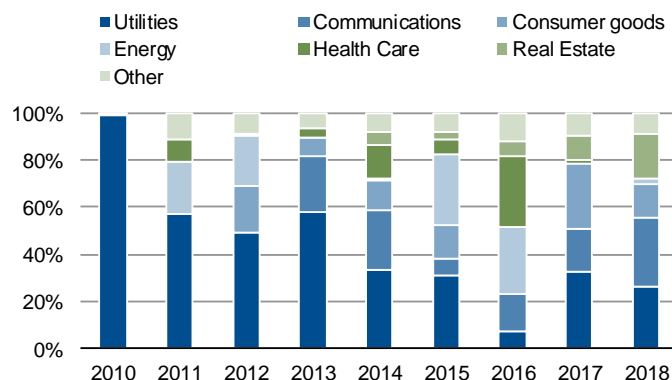
Many issuers decided to exercise call options to allow them to refinance at lower rates. We point out that exercising call options is often a shrewder approach than redeeming securities, as execution risk involved in finding new investors is much lower, offering more security at a lower cost. For example, Italian utility Enel missed the date for exercising its EUR 1.25bn; 6.5%; January 2074 hybrid bond. The subsequent tender offer to redeem the hybrid debt is subject to higher costs and execution risk, as current Investors have to accept the tender offer for it to succeed.

## French and German companies dominate market

Issuers based in France and Germany were the most active participants in the market in 2018, followed by Austria- and Sweden-based firms.

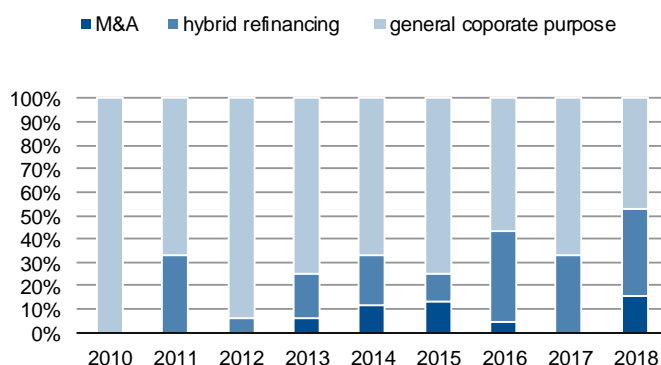
The euro continues to be the main currency of issuance with the tendency of some issuers to offer dollar tranches. For instance, the UK-based Doosan Power Systems placement of about USD 264m.

**Figure 3: Aggregated sector split measured by issuance volume**



Source: Scope, Bloomberg

**Figure 4: Use of proceed split measure by number of transactions**



Source: Scope, Bloomberg

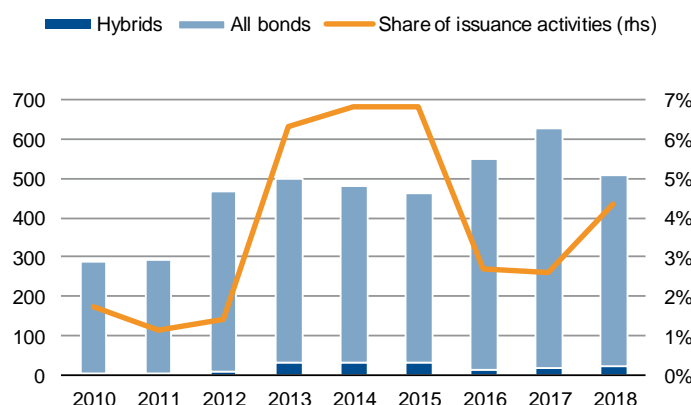
## The outlook for 2019

Geopolitical uncertainty, less frenetic M&A may curb appetite for hybrid bonds

Scope expects a decrease of issuance volume to 2016/2017 level for a number of reasons:

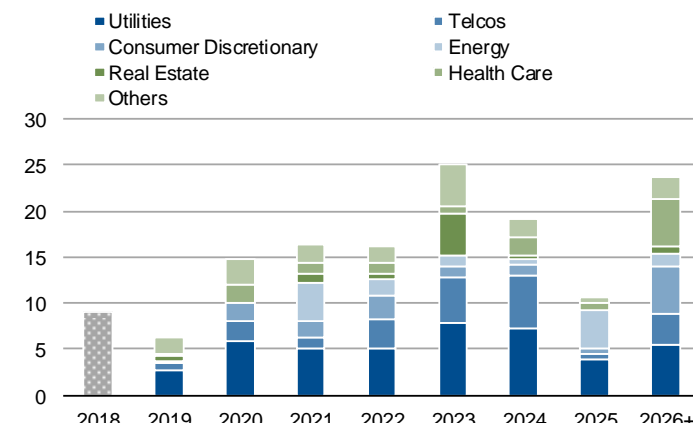
- The hybrid market is primarily correlated to the corporate bond market which experienced a decrease in volume in 2018 that is expected to continue in 2019 (see figure 5).
- The geopolitical uncertainty related to Brexit, escalation in trade disputes, and fresh concerns about euro area finances might all help curb issuer and investor interest and appetite in hybrid bonds.
- The numbers and size of M&A deals may fall from previous years given the more uncertain business outlook, diminishing one source of demand for hybrid-bond financing.
- The lack of incentive to issue hybrid will also come from the decreased volume of outstanding hybrid bonds with upcoming calls in 2019 (see figure 6).

**Figure 5: Hybrids issues in comparison to debt issues of European non-financial corporates (EUR bn)**



Source: Scope, Bloomberg

**Figure 6: Outstanding hybrids issues according to the next call date (EUR bn)**



Source: Scope, Bloomberg



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### Scope Ratings GmbH

#### Headquarters Berlin

Lennéstraße 5  
D-10785 Berlin

Phone +49 30 27891 0

#### London

Suite 301  
2 Angel Square  
London EC1V 1NY

Phone +44 203-457 0 4444

#### Oslo

Haakon VII's gate 6  
N-0161 Oslo

Phone +47 21 62 31 42

#### Frankfurt am Main

Neue Mainzer Straße 66-68  
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

#### Madrid

Paseo de la Castellana 95  
Edificio Torre Europa  
E-28046 Madrid

Phone +34 914 186 973

#### Paris

1 Cour du Havre  
F-75008 Paris

Phone +33 1 82 88 55 57

#### Milan

Via Paleocapa 7  
IT-20121 Milan

Phone +39 02 30315 814

[info@scoperatings.com](mailto:info@scoperatings.com)

[www.scoperatings.com](http://www.scoperatings.com)

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Torsten Hinrichs.