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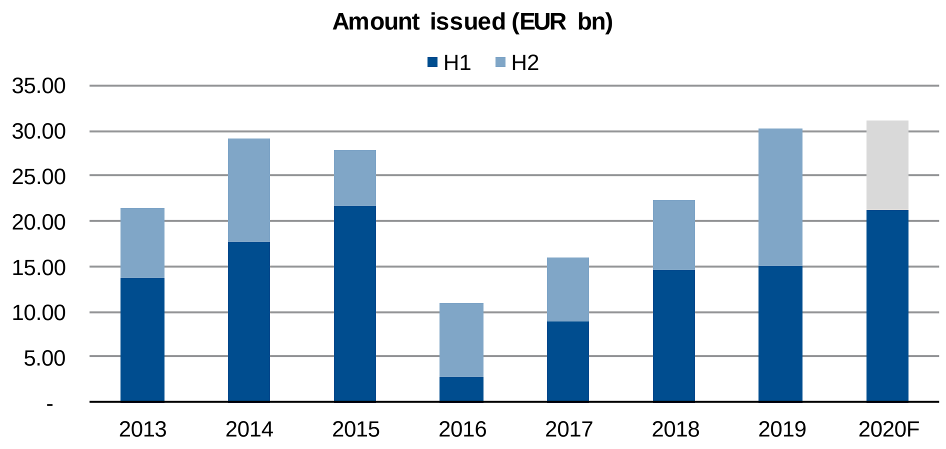
Europe's hybrid bond market recovers fast after Covid-19 shock to capital markets

Hybrid bond issuance in Europe snapped back at the end of the second quarter helped by the European Central Bank's stimulus package and a jumbo issue from BP PLC, putting the market on course to match last year's volume in 2020 despite a pandemic-induced first-quarter slump. Volume rose around 44% to EUR 21.4bn in H1 from EUR 14.9bn in the same period last year though the UK's BP contributed nearly half of the total with a EUR 10.6bn five-tranche jumbo issue.

Without BP's dramatic entry to the market, H1 volumes would have shown more clearly the near absence of new issues between mid-February and mid-May when the impact of the Covid-19 shock reduced deal-making activity. We expect full-year hybrid volumes to match or exceed the EUR 30bn issued in 2019. Several issuers are likely to seek early refinancing of callable hybrids. We expect other issuers will tap the market as loose ECB monetary policy and bond-buying programmes are underpinning investor demand for hybrid securities – assuming no further market shocks such as a second Covid-19 wave in Europe.

The hybrid bond market is inherently sensitive to changes in overall investor sentiment given the securities' subordination to other debt instruments. Consequently, a more-abrupt-than-expected economic slowdown – our baseline forecast is for a 4.5% contraction in the global economy in 2020 (see Scope's Sovereign Outlook Q3 Update) - could quickly thin the ranks of companies coming to market with new issues. That said, the rapid recovery in the hybrid segment after the initial Covid-19 shock show how eager companies are to take advantage of the equity-like features of the instruments and the ability to defer coupons, confirming how the hybrid market is growing in popularity especially among investment-grade issuers.

Figure 1: European corporate hybrid bonds issuance



Source: Bloomberg, Scope

New entrants, returning issuers boost Q2 hybrid deals

The slump in economic activity caused by the lockdowns and other physical distancing measures in response to Covid-19 has inevitably strained the finances of companies in many sectors, enhancing the appeal of issuing hybrid securities which credit rating agencies typically assign a 50% equity weighting. This year's dramatic slide in crude oil prices has put extra pressure on integrated oil and gas companies (IOCs), hence our negative outlook for the sector.

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European IOCs such Austria’s OMV AG, Spain’s Repsol SA and France’s Total SA have long tapped the hybrid segment, but BP’s Q2 entry into the market was dramatic. The British company’s deal is the largest in the history of Europe’s hybrid market with a total value of EUR 10.6bn in five tranches, three currencies, with first call dates in five to 10 years.

German auto maker Volkswagen AG re-entered the hybrid bond market for the first time since June 2018 with a EUR 1.8bn dual-tranche hybrid deal to refinance a EUR 1.25bn hybrid bond with a first call date in March 2021 and to bolster corporate creditworthiness.

Most issuers continue to use hybrid proceeds to refinance upcoming calls on existing bonds and replace earlier, more expensive issues. Investment grade corporates still dominate the market.

Capital-intensive sectors like utilities, real estate and telecom continue to be among the leading issuers, such as power company Energias de Portugal. Among Europe’s regions, Nordic issuers are increasingly active such as Akelius Residential Property AB and Telia AB.

One thing to remember is that once a company enters the hybrid bond market, it is difficult to exit as the callable hybrid bond needs to be refinanced with another similar issue to preserve the equity weighting granted by rating agencies and avoid taking on extra debt.

ESG-related financing through the hybrid segment continues to be noteworthy, growing beyond utilities and government-linked companies to telecom operators such as Telia and Telefonica SA.

Figure 2: European hybrid-bond issuance H1 2020:

Largest volume issuance by issuers	Sector	In EUR bn ~	Issuance purpose	Total hybrid issuance volume incl. called bonds
BP Capital Markets PLC	Oil & Gas	10.57	General corporate purpose	First issuance is in 2020
Volkswagen International Finance NV	Automotive	1.80	Refinancing and others	More than EUR 16.7bn
Repsol International Finance BV	Oil & Gas	1.50	Refinancing	Around EUR 3.5bn
EDP Energias de Portugal SA	Utilities	0.75	Refinancing	Around EUR 2.5bn
ELM BV for Firmenich International	Chemicals	0.75	M&A	First issuance is in 2020
Deutsche Boerse AG	Financial Services	0.60	Refinancing	Around EUR 1.2bn
Samhallsbyggnadsbolaget i Norden AB	Real Estate	0.50	General corporate purpose	More than EUR 1.16bn
Telefonica Europe BV	Telecom	0.50	ESG investing	More than EUR 11.6bn
Telia Co AB	Telecom	0.50	ESG investing	More than EUR 2bn
Akelius Residential Property AB	Real Estate	0.50	General corporate purpose	Around EUR 1bn
British Telecommunications PLC	Telecom	0.50	General corporate purpose	First issuance is in 2020
EnBW Energie Baden-Wuerttemberg AG	Utilities	0.50	ESG investing	More than EUR 4.7bn
Top EUR 0.5bn plus hybrid issues	subtotal (EUR bn)	18.97	Total 2020H1 hybrid issuance = EUR 21.1bn	

Monetary policy context supportive of hybrid issuance

For the hybrid segment, the ECB’s rapid response to the coronavirus crisis was crucial for restoring confidence. Following the rapid rise in spreads after the initial Covid-19 shock in Q1, the central bank’s enlarged bond-buying programme brought doubt down investment grade spreads by 200 basis points and encouraged issuers and investors to return to Europe’s capital markets in general.

For issuers, hybrids remain attractive as a way of raising funds without diluting shareholders while subsequently reducing a company's cost of capital. The equity buffer can also help bolster a company's creditworthiness and protect an investment-grade credit rating. Typically, companies have an important incentive to call on the first date possible to avoid the coupon step-up that would otherwise occur following that date.

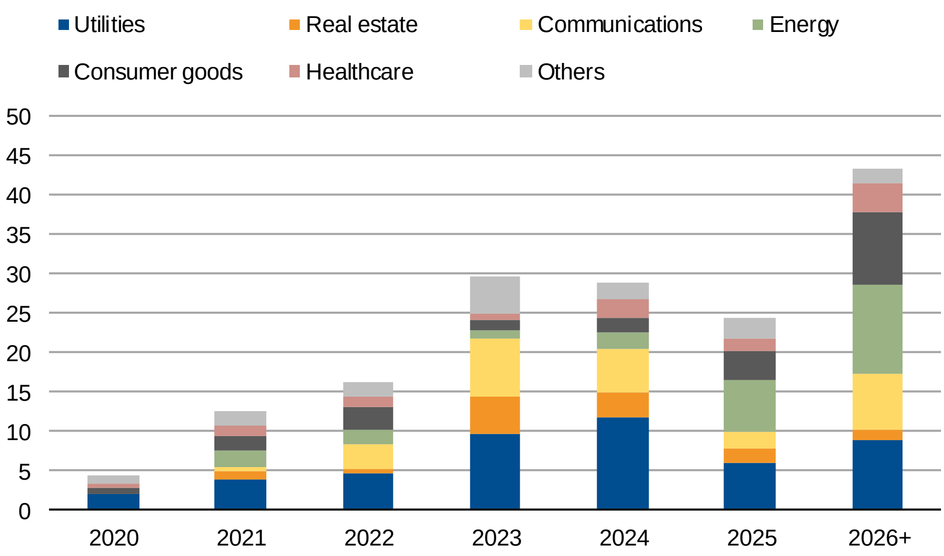
However, the circumstances of Covid-19 might change some corporate strategies in that there may be a premium on preserving cash reserves instead. Companies facing severe liquidity issues and highly impacted by the crisis such as airlines like Deutsche Lufthansa AG (BBB-/Negative) may opt to defer coupon payments or not call existing hybrid.

Looking forward: strong H2 pipeline

Issuers will continue to tap the hybrid market through the rest of 2020 to refinance callable bonds whose coupons look expensive compared with current potential low yields assuming there is no repeat of the Q1 pandemic-related economic disruption and that monetary and fiscal policy remain loose and stable in 2020. Utilities SSE PLC and TenneT Holding BV have raised EUR 1.1bn and EUR 1bn respectively this month.

We estimate that there are outstanding hybrids worth EUR 4bn with a call date in 2020 in addition to more than EUR 12bn with call dates in 2021 that could be refinanced early. Early refinancing tends to be driven by market volatility - faced with rising uncertainty, issuers prefer to tap the market as early as possible – so we expect that that issuance this year may match or surpass 2019's volumes.

Figure 3: Outstanding hybrid issues according to the next call date (EUR bn)



Source: Scope, Bloomberg

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