Hybrid bonds: European market flourishes After 2020 record, new issuance still on a roll

Europe's hybrid bond market came into its own in 2020 amid the corporate dash for cash to survive the Covid-19 crisis. Volumes rose nearly 80% to a record EUR 53bn from EUR 29bn in 2019. Strong deal flow continues this year.

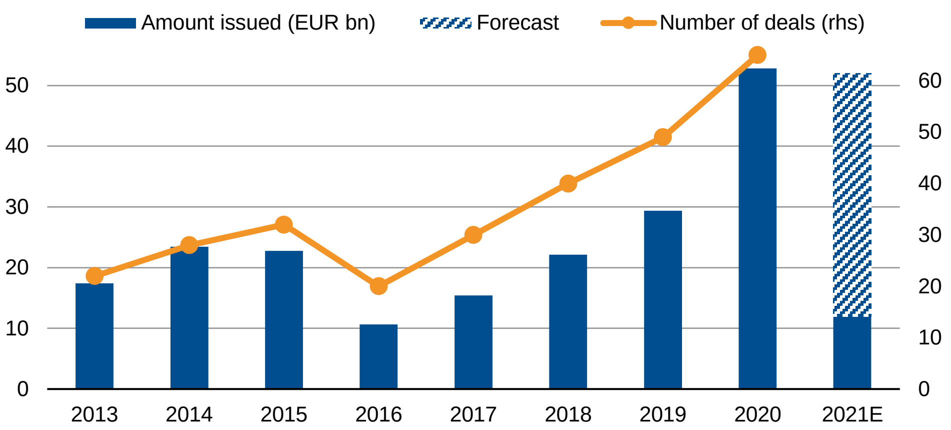
The rapid growth in the hybrid segment suggests that this part of the European capital market has matured some more. Hybrids are becoming an increasingly reliable source of funds for issuers – even in a time of crisis. The equity-like securities provide corporate treasurers flexibility in seeking to protect credit quality – hybrid bonds typically receive a 50% equity-weighting from credit rating agencies - and protect liquidity, in part through the option to defer coupons. Low yields in the senior bond market and higher risk in high-yield bond market also ensure that the segment continues to attract the attention of yield-hungry investors looking for a more balanced combination of risk and return.

The lengthening list of highly rated issuers willing to tap the hybrid segment is also a sign of its growing maturity. Integrated oil and gas companies (IOCs) have joined telecommunications operators, utilities and real estate companies - all capital-intensive sectors – as active users of hybrids.

We see further longer-term growth for the segment for several reasons even if hybrid volumes this year may not quite match 2020's record issuance despite a five-fold increase in the first six weeks of 2021 compared with the same period last year:

- High volume of outstanding hybrid bonds with upcoming first call between 2021-2023 implies considerable refinancing ahead.
- The increasing vigilance of some corporates toward preserving credit ratings amid uncertainty about recovery in revenue and cash flow to pre-pandemic levels.
- Issuers are increasingly comfortable with using the asset class to pro-actively diversify funding rather than using it just as a defensive financing tool.
- With interest rates set to remain low for some time, the search for yield by investors is ensuring hybrid issuers can tap a broad pool of capital. Hybrid bonds can offer a more attractive risk-reward ratio than investment grade and high-yield bonds.

Figure 1: European corporate hybrid bonds annual issuance



Source: Bloomberg, Scope Ratings

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Pressure for corporate debt reduction might weigh on market

If hybrid issuance proves more subdued in 2021, it will likely reflect the shift in focus among European companies to reducing costs and reducing leverage.

For now, conditions for the segment look favourable. In general, there is a correlation between demand and spreads, reflecting the hybrid market's sensitivity to overall investor sentiment, with the higher the demand for hybrids, the narrower the average spread between hybrid bond market yields and benchmark yields. As Figure 1 and 2 shows, supply of hybrid bonds from issuers dropped significantly in 2016 as hybrid bond spreads widened. We saw the similar phenomenon at the beginning of the pandemic in 2020 where the hybrid transactions were scarce to non-existent between February and April. Investors were very cautious leading to lower demand and higher spreads even for senior investment grade rated debt.

The spread of European corporate hybrid bonds, represented in Figure 2 by the iBoxx non-financial subordinated index, narrowed sharply with the resurgence in issuance as central banks flooded markets with liquidity last spring in response to the Covid-19 shock.

Figure 2: Non-financial corporate Hybrid Index Spread performance over time

Source: Markit iBoxx, creditmarketdaily.com

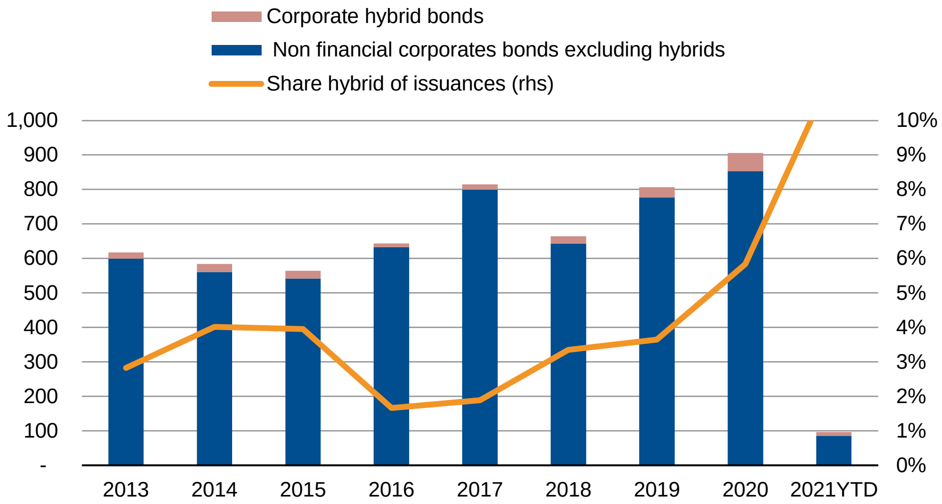
Favourable monetary-policy context for hybrid issuers, investors

Tightening spreads trigger more issuance of hybrid bonds

The European Central Bank and other monetary authorities reacted emphatically to avoid a liquidity crisis when measures to contain the pandemic temporarily shut down much of global economic activity in the first half of 2020. The central banks worked hard to maximise near- and medium-term liquidity in financial markets through emergency monetary support, importantly in the form of extended and expanded asset purchase programmes which, in the case of the ECB, increased overall exposure to corporate bonds by around 50% to around EUR 270bn.

Hybrid bonds are not eligible for the ECB purchasing programs: the extended corporate sector purchase programme (CSPP) and the pandemic emergency purchase programme (PEPP). However, the hybrid market benefited indirectly from the cheaper cost of borrowing for issuers, due to tightening spreads, and investors' search for yield in the low interest-rate environment. The hybrid proportion of non-financial corporate debt issues has grown every year since 2017 and will continue to do so in 2021.

Figure 3: Hybrids issues in comparison to total bond issues of European non-financial corporates (in EUR bn)



Source: Bloomberg, Scope

Sustainable investment trend boosts hybrid segment

Green hybrid bond volumes rise amid ESG-investing boom

An important tailwind for the hybrid market is the rapid growth in the market for sustainability-linked securities, driven by tightening regulations, investor demand and corporate supply as policy makers focus more intently on the transition to "carbon neutral" economies and more sustainable growth.

Hybrid-bond issuance so far this year has confirmed the burgeoning market for environmental-, social- and governance-linked securities, particularly from the utilities sector. Hefty capital spending programmes linked to Europe's energy transition have to be managed carefully by treasurers but also offer an opportunity for green-bond issuance (See Scope's European Utilities Outlook 2021).

Spanish utility Iberdrola SA issued Europe's largest green hybrid bond to date in January with a EUR 2bn deal. For investors, green hybrids from defensive sectors like utilities are attractive given the relatively limited opportunities to pick up yield while investing in ESG-linked bonds. Other utilities such as Energias de Portugal SA and Denmark's Ørsted A/S have also issued green hybrids, with oil and gas companies possibly ready to follow suit.

Strong start to 2021: record hybrid-bond issuance in January, February

Capital-intensive companies race to market in early 2021

By mid-February, non-financial corporates in Europe had issued around EUR 11bn in hybrid bonds compared with around EUR 2bn in the same period last year and EUR 4.4bn in early 2019. Utilities continue to lead the way, given the sector's significant capital expenditure requirements which require complex funding if treasurers are to protect credit quality. Oil and gas companies continue to steal the limelight: France's Total SE is the biggest single issuer to date with a dual tranche EUR 3bn hybrid bond.

Figure 4: Hybrid bonds transactions 2021 year to date

Largest volume issuance by issuers since beg. 2021	Sector according to Bloomberg classification	Amount in EUR	Issuance purpose	Coupon rate
Total SA	Energy	3bn	Finance development	Dual tranche: 1.63% and 2.13%
Iberdrola International BV	Utilities	2bn	Finance green projects	Dual tranche: 1.83% and 1.45%
Wintershall Dea Finance BV	Energy	1.5bn	General corporate purpose	Dual tranche: 2.5% and 3%
Telefonica Europe BV	Communication	1bn	Finance sustainable projects	One tranche: 2.38%
Ørsted A/S	Utilities	˛1bn	Finance green project	Dual tranche: 2.5% and 1.5%
Heimstaden Bostad AB	Real estates	0.8bn	General corporate purpose	One tranche: 2.63%
Abertis Infrastructure Finance BV	Industrials	0.75bn	Financial policy framework	Dual tranche: 2.63% and 2.63%
Energia de Portugal SA	Utilities	0.75bn	Finance green projects	One tranche: 1.88%
Aroundtown SA	Real estates	0.6bn	General corporate purpose	One tranche: 1.63%
Total issuance as of mid-February :		**Around 11bn**		

New players in town: IOCs join utilities as big hybrid issuers

Hybrid market increasingly in demand by IOC issuers

IOCs tapped bond markets actively in 2020 to shore up their finances as oil prices crashed and demand plummeted, including debut issues of hybrid debt market most notably by BP PLC. We expect the companies to focus on deleveraging in 2021 though they will be ready to tap debt markets again if prices and margins do not live up to expectations and to fund the transition to more sustainable business (See Scope's Integrated Oil & Gas Outlook 2021).

The importance of diversified sources of funding in the sector is visible in the IOCs readiness to issue hybrid even though the cost of borrowing is more expensive than for issuing senior unsecured debt.

if prices and margins do not live up to expectations due to the likely slow and uneven global economic recovery – notably subdued demand for jet fuel, given the pandemic's disruption of the aviation sector (See Scope's Airlines Outlook 2021), in addition to petrol and diesel –IOC will be ready to tap the debt market again.

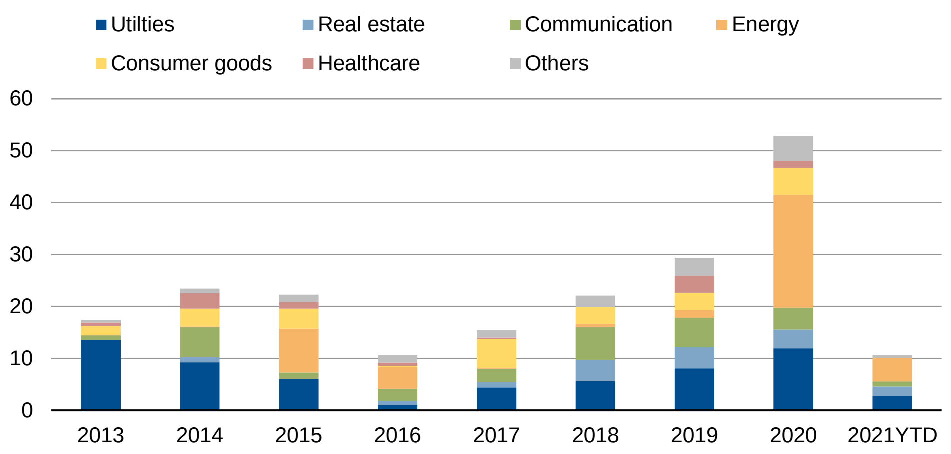
Defensive sectors trading at relatively tight spreads

Defensive sectors remain well-suited for hybrid issuance

Utilities' share of the hybrid market has fallen as IOCs have become bigger issuers, but they remain heavy borrowers. Other capital-intensive sectors such as telecoms and real estate will continue to be sources of hybrid issuance as treasurers juggle the needs of meeting capex requirements and protecting credit ratings.

However, it is not only capital intensity that distinguishes the most active users of hybrid securities. The equity characteristics and favourable features are increasingly attracting medium-sized issuers belonging to the non-investment grade category or even non-rated companies. However, most corporate issuers of hybrid bonds are rated investment grade. Investors are more comfortable investing in subordinated debt when it is issued by companies with strong balance sheets and resilient business models capable of withstanding possible shocks. This phenomenon helps explain why it is companies in non-cyclical, or defensive, sectors that dominate the hybrid segment.

Figure 5: Hybrid bond issuance by sector

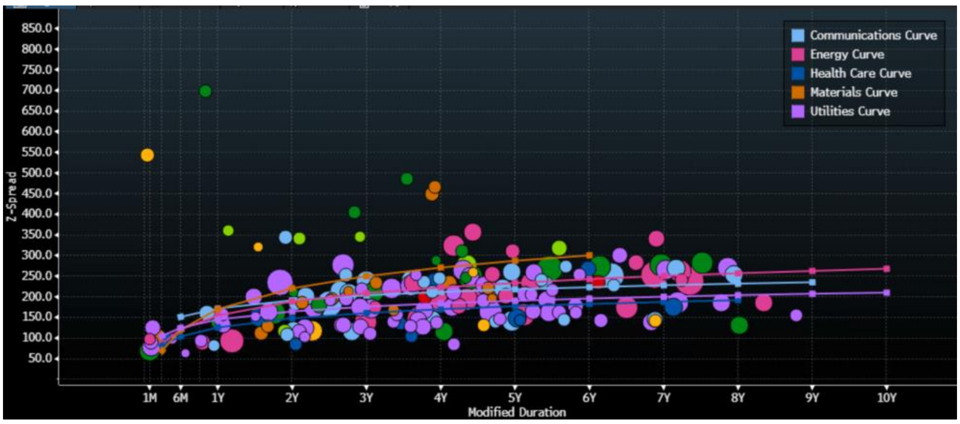


Source: Bloomberg, Scope

Narrow hybrid-bond spreads for utilities, healthcare, IOCs

Indeed, if we look at the European spread curves of non-financial companies, it is the hybrid bonds issued by European utilities, healthcare companies, and IOCs that are trading at the narrowest spreads relative to the rest, according to Bloomberg data. Spreads on hybrid bonds particularly in the investment grade rating category reflect the lower risk. Hybrids trading at high spreads reflect the greater risk of deferrals of coupon payments, extensions and postponement of calls. Examples include issues by Deutsche Lufthansa AG and Accor SA (among the outliers in the chart in **Figure 6**), leading companies in two of the sectors worst hit by the economic disruption from the pandemic: air travel and hotels-entertainment. Lufthansa has decided not to call its 2020 hybrid issue.

Figure 6: Hybrid yields curve by sector



Source: Bloomberg

Liability management, refinancing to determine activity in 2021

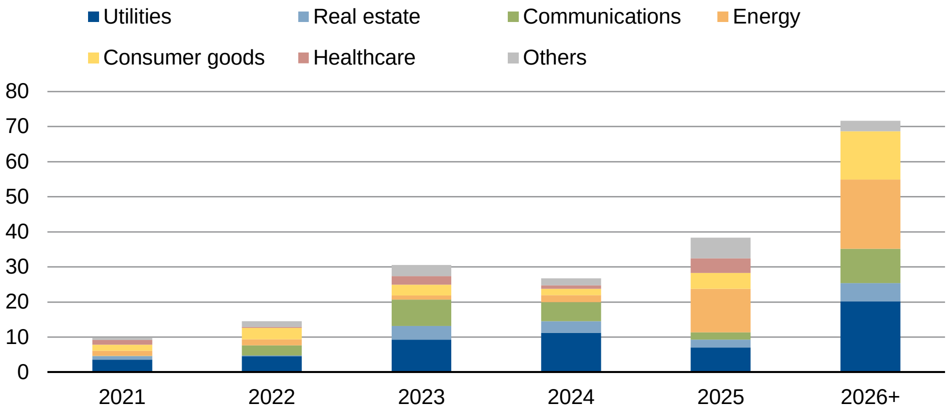
Lower interest rates will trigger early refinancing

With continuing economic uncertainty related to the pace of the economic recovery, we expect European companies to focus tightly in the year ahead on lowering the cost of borrowing where they can by replacing existing debt and extending maturities – hybrid bonds included. Rather than issue a new hybrid bond, a number of issuers have approached bond holders and proposed exchanging existing bonds that are nearing maturity (2022-2023) with longer-dated issues.

At least EUR 9bn in hybrids face first call in 2021

The majority of hybrid securities callable in 2021 have already been refinanced, with half of those with a call date in 2022 also refinanced. However, there is at least EUR 9bn in hybrid bonds that face their first call this year, with more than EUR 15bn falling due in 2022 and around EUR 28bn in 2023 – equivalent to at least EUR 50bn in total in the next three years. This pent-up issuance should ensure that 2021 will be another good year for Europe's hybrid bond market.

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



Source: Bloomberg, Scope

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