

An era of customisation

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OF SOCIÉTÉ GÉNÉRALE CORPORATE AND
INVESTMENT BANKING LOOK AT ALTERNATIVE
FUNDING: HYBRIDS AND THEIR DERIVATIVES.



More than €15bn equivalent of corporate hybrid bonds has been issued by companies in the past two years. This is thanks to a combination of factors coming from different market participants such as regulators, rating agencies and accountants, who have all refined their own criteria and methodologies on the subject.

While the product started as a pure instrument to raise regulatory capital for financial institutions, the enhancement of rating agencies' methodologies lifted the market to new technical heights. As a result, we are seeing customisation coming to the market rather than standardisation, allowing issuers and investors to find better solutions. This has led to an increasing complexity of instrument features in order to achieve 'best of' structures able to provide equity benefit to issuers and a fairly priced risk-return for investors.

CORPORATES HYBRIDS: WHAT'S NEW? Starting with the two initial structures (one with optional non-cumulative interest and the other with trigger-based mandatory deferral), the past year has been a period of innovation driven by investor behaviour and confidence in the various features and evolution of the position of the rating agencies on some technicalities.

Among these advances, there has been innovation in interest payment mechanisms with the introduction of optional deferral on a non-cash cumulative basis where deferred coupons can only be settled with the proceeds of selling shares or new hybrid securities in the market.

A further benefit to investors has also appeared as rating agencies

have softened their requirements on final maturity of the instrument to 50 years beyond the first call date.

Last but not least, 'early redemption events' have been at the forefront of the innovation, with the inclusion of additional call options in hybrids which allow issuers to redeem their hybrids in various scenarios. For example:

- If the issuer has a convertible bond outstanding and it converts into ordinary shares;
- If the equity value given by rating agencies is less favourable than it was at issuance; or
- If an acquisition, which has been announced and for which the hybrid is part of the financing package, does not close favourably for the issuer.

These calls have been used recently by Linde and Siemens in their hybrid funding exercises. They have become more and more common as they increase financial flexibility from a management point of view without any negative impact on the investor base or pricing as these options are priced with no intrinsic value.

DERIVATIVES OF STRUCTURES Market participants have become more and more sophisticated as the complexity of hybrid instruments has developed and a number of new ideas have arisen with the aim of being less costly, broadening the investor base, or allowing for further flexibility in the use of the instrument for the issuer. This has led to the emergence of 'derivatives' of corporate hybrids.

Table 1. Differences between standard hybrids and senior perpetuals

INSTRUMENT	STANDARD HYBRID	SENIOR PERPETUAL	STANDARD SENIOR
Ranking	Senior to shares only, subordinated to all debt, including all ordinary subordinated debt	Pari passu with senior unsecured debt	
Interest mechanism	Payment may be deferred on a non-cash cumulative basis	Payment may be deferred, and cumulated	Payment must be made to avoid default
Maturity/Redemption	Perpetual/long-dated security with call and step-up earlier to materialise maturity	Perpetual security with call and step-up earlier to materialise maturity	Fixed maturity
Cross-default	No		Yes
Negative pledge	No	Yes	

Executive summary

- Tremendous innovation has been seen in the debt to equity continuum recently and this trend means the market is more and more in a position to offer each company a structure which fits perfectly with its own specifics and requirements.
- More than €15bn equivalent of corporate hybrid bonds has been issued by companies in the past two years. Market participants have become more sophisticated as the complexity of hybrid instruments has developed and customisation of the product has led to increasing complexity.

1. Senior perpetual Although the hybrid instrument was originally designed for regulated issuers (mainly banks and insurance companies) to support their regulatory financial ratios, it has migrated to become an effective tool for corporate issuers.

Corporate hybrid securities, of course, do not suffer from these regulatory capital constraints.

For corporates, hybrid technology has been targeted towards providing the best possible products for investors and to select from the various benefits surrounding the product.

In addition, unrated and highly leveraged corporates have been looking to remove rating agencies' considerations to benefit from the positive accounting and fiscal treatment of these instruments only:

- accounting treatment: equity under IFRS;
- tax treatment: coupons of the hybrid instrument are deductible for tax purposes; and
- rating agency treatment: none, the hybrids are seen as debt.

The differences between standard hybrids and this last structure, often called senior perpetuals, are clearly highlighted in *Table 1*:

The trade-off is in the pricing of the instrument arising from a wider investor base for unsubordinated securities, and also for rated issuers, in the rating. Indeed, on the pricing, the issuer will benefit from the subtraction of recovery risk on the instrument where the fair value of the instrument can be defined as:

- senior spread;
- plus coupon deferral risk spread;
- plus extension of maturity risk spread.

From a rating point of view, issuers will benefit from a higher rating on the instrument: the notching down for subordination that rating agencies apply to standard hybrid structures (one notch if the senior rating is investment grade for S&P and is at least Ba2 for Moody's; two notches otherwise) will not be taken into account and the instrument will therefore attract a higher rating.

Between December 2006 and January 2007, the Mexican cement group Cemex returned to the international bond market with a security which some market participants described as "half hybrid and half something else". The perpetual non-call five-year, eight-year and 10-

year for a total of \$2bn over that period offered the same characteristics:

- Senior indebtedness, secured on the dual currency notes issued by a wholly owned subsidiary of Cemex, no cross-default;
- Perpetual with no fixed maturity date; and
- If remuneration is declared or paid on any 'qualifying equity security', the issuer may not defer payment; any unpaid interest will constitute arrears of interest, which will not bear interest.

The instruments were well received on both sides of the Atlantic, with an order book rumoured to have reached \$5bn for the \$1.25bn on offer at the initial launch in December 2006. The deal carried a BBB- rating from Standard & Poor's and a BBB rating from Fitch – above the non-investment grade rating which a standard hybrid would have attracted.

Aside from rating agency-compliant instruments, senior perpetuals can be a valid alternative as they seem to fit perfectly with the requirements and constraints of medium capitalisation companies which are often unrated and can be interested in taking advantage of the other benefits of hybrid-like instruments.

2. Hybrid convertible Another example of a derived product is the hybrid convertible. Behind the instrument is the will to have an instrument ultimately convert into a core form of capital, therefore responding to demand from treasurers and rating agencies for permanent capital formation from these instruments.

The most obvious advantage of incorporating a call option on the company's own shares is to monetise the value of the option into an instrument and hence lower the coupon and cost of funding. The issue also targets another investor base – for example, equity-linked investors.

A number of transactions were already structured around this principle at the dawn of the hybrids age, and are still coming to the market:

- Fortis €1.25bn floating rate equity-linked subordinated hybrid (FRESH) in April 2002;
- Scottish Power \$700m 4% perpetual subordinated guaranteed convertible bonds in July 2003;
- Monte dei Paschi di Siena €400m FRESH in December 2003;
- MOL's Magnolia Funding €610m 4% exchangeable hybrids in March 2006; and
- OTP's Opus Securities €514m 3.95% exchangeable hybrids in October 2006.

Figure 1. PIK notes

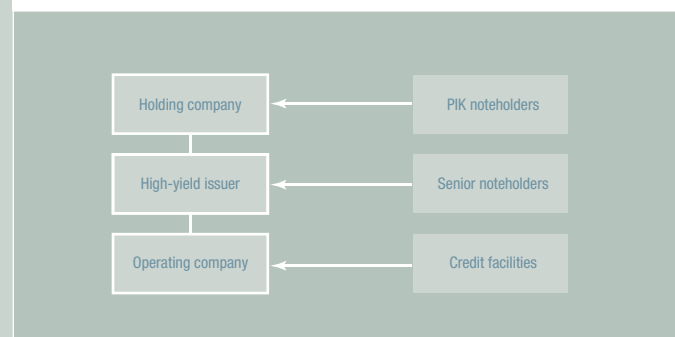


Table 2. When would a company use one or the other?

INSTRUMENT	STRAIGHT HYBRID	PERPETUAL SENIOR	HYBRID CONVERTIBLE	PIK NOTE
Regulatory capital-efficient	+	-	+	-
Treated as IFRS equity	+	+	+	-
Treated as equity for rating agencies	+	-	+	-
Non-dilutive	+	+	-	+
Tax-efficient	+	+	+	+
Leverage-efficient	+	+	+	+

These examples show a different approach on the instrument: the FRESH and Scottish Power structures allow for a call option to be exercised throughout the life of the securities, while the recent transactions from MOL and OTP, completed in 2006, show a call option which matures at the first call (and step-up) date. The FRESH even makes the calls automatic!

How does a contemporary hybrid convertible work? A convertible bond is a bond allowing the holder to convert, at his election and at any time, the instrument into ordinary shares of the issuer. Bondholders normally wait until maturity to choose between:

- the conversion of the bonds if the share price is above the conversion price (also called strike price in the options world); and
- redemption of the bonds in cash if the share price is below the conversion price.

For a hybrid convertible bond, the option's mechanics are the same. However, after the first call date, if the bonds have not been converted or called, bondholders will no longer have the ability to convert the bonds into shares. In theory, bondholders will wait until year 10 to exercise or not their conversion option.

- If at year 10 the issuer chooses to call and redeem the instrument, depending on the share price level, bondholders will either choose to convert the bonds or receive cash.
- On the other hand, if at maturity the issuer chooses not to call the bonds at the first call date, the bonds will live on but bondholders will no longer be able to convert them into ordinary shares.

To illustrate how this works, consider the Opus Securities bond, which was issued by OTP on the back of the recent acquisitions of Investsberbank in Russia and JSCB Raiffeisen in Ukraine. OTP was able to collateralise Opus, a fully controlled issuer, with treasury shares. Opus then issued hybrid exchangeables into the shares, therefore lowering cost of capital for OTP and preparing for further buyback of shares. Moreover, the hybrid exchangeables were structured to be compliant with Tier 1, as defined by Basle's 1998 press release.

Market participants expect more hybrids to be launched in a convertible format.

3. PIK notes issued by holding companies: another form of subordinated securities? Another type of deeply subordinated instrument has developed recently in the high-yield market. Payment-in-kind (PIK) notes bear structural subordination risk as they are issued by an entity positioned well above the operating company which generates the cashflows.

PIK notes have become increasingly popular in Europe in the last two years and are mostly used to finance or refinance the equity of

sponsors in leveraged transactions. The proceeds are generally used to pay dividends to shareholders.

Payments in kind are also frequently used as a financing tool for leveraged buyouts as they enable the borrower to achieve higher leverage without paying cash interest on all of the funds raised (see *Figure 1*).

The features of PIKs are very different from hybrid instruments. They typically bear two main characteristics:

- They are unsecured and do not have any guarantee or support from any member of the group.
- Interest is paid in the form of additional bonds rather than cash. Like zero-coupon bonds, they give a company breathing room before having to make cash outlays. They offer in return rich yields as in most of the financing schemes, credit facilities and high-yield bonds that preclude or restrict the payment of dividends to the holding company.

Even if PIKs do not include all the embedded options and risks for investors in corporate hybrids securities such as extension risk, interest deferral risk and conventional subordination, they are issued at the riskiest end of the capital structure and their recovery prospects in the event of a default are not better than those of a typical hybrid.

Nevertheless, the buying driver for investors is similar. In the current context of low-yield markets, holding company PIK notes offer the highest yield available in the non-investment grade universe, with fixed coupons which can be well above 10%. In addition, there is currently an important investor demand for holding company PIK notes given the drop of returns in the high-yield market

According to *Table 2*, straight hybrid is the most beneficial instrument. Nevertheless, there has been a tremendous amount of innovation in the debt to equity continuum in the last months and thanks to this trend the market is more and more in a position to offer to each company a structure which fits perfectly with its own specificities and requirements.



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