Making the most of hybrids

Andrew Readinger of Morgan Stanley Dean Witter finds out what makes the hybrid capital market tick.

Hybrid capital is a generic term for non-dilutive financial instruments that incorporate particular features of equity while offering significantly lower financing costs. In general, hybrid capital instruments are effectively subordinated debt, which have a long-dated or perpetual maturity. To achieve the greatest cost advantage to the issuer, hybrid capital instruments are typically structured to be tax-deductible.

Financial institutions have been the most frequent issuers of hybrid capital. Both banks and insurance companies can include such instruments in their regulatory capital base. As the regulator explicitly allows such instruments to be used within the given guidelines, financial institutions pay less attention to the accounting treatment. In contrast to banks, insurance companies not only issue hybrid capital for regulatory purposes, but they also increasingly use such instruments to bolster their capital for rating agency purposes. Ratings agency requirements can differ from regulatory requirements (for example, long-dated versus perpetual structures).

Corporate borrowers

As corporate borrowers are not regulated in the same manner as financial institutions, there are no minimum capital requirements to be fulfilled. Nevertheless, ratings agencies or banks/investors effectively regulates businesses. Maintaining a minimum rating is one of the key objectives of any corporate management. This places a constraint on the types of financing available to the company; for example, increased leverage can potentially result in a rating downgrade. In addition to the rating constraint, covenants often limit the use of additional senior debt/loans, so that alternative sources of funding have to be tapped. Such restrictive covenants can also exist in outstanding debt, which is of particular relevance for the high-yield market. Hybrid capital also allows corporate borrowers to raise 'equity-like' capital without changing the ownership structure, since such instruments usually do not carry voting rights. This feature is particularly appealing to businesses that do not have access to the equity markets. They can improve their capital base through 'supplementary equity'. As an additional benefit, hybrid capital instruments can be structured to qualify as equity under the relevant accounting principles.

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Rating considerations

The ratings agencies consider a firm's capital structure in assessing its credit fundamentals, but capitalisation is by no means the sole criterion and it is probably not the most important factor. The ability of a company to generate sufficient cashflow on a continuing basis to cover its financial obligations is a key determinant. Consequently, the agencies focus on the effect that a hybrid security will have on a company's cashflow when it evaluates the potential benefits that the organisation may obtain from using the hybrid.

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Ratings agencies grant hybrid capital instruments 'equity credit'. The concept intends to illustrate to what extent one security is better or worse than an alternative financing. An 'equity credit' of, for example, 50% means the impact of issuing that security is half as good as the impact of issuing common stock. To understand the concept of equity credit, it is necessary to take common stock, the purest form of equity, and define its core characteristics. By analysing these characteristics and by understanding why they give an issuer financial flexibility, the closer that individual hybrids replicate equity, and the better they can be compared to equity:

- **No continuing payments.** An issuer can reduce or eliminate dividend payments on common stock;
- **No maturity (no principal repayment).** Common stock does not have to be repaid; and
- **Significant loss absorption.** Common stock provides the highest loss absorption characteristics of any class of security because its holders are the last to receive distributions in liquidation. In addition, common equity may provide a cushion sufficient to maintain the company as a going concern.

While hybrids seek to replicate the above three characteristics, equity has a fundamentally different value dynamic

than debt. Equity represents ownership of the business, and so theoretically offers unlimited appreciation, as well as depreciation, instead of the fixed value that debt offers. The ratings agencies look at the evolution of the capital structure over time. They are most concerned with whether or not the capital structure provides adequate cushion to support the responses to a rapidly changing competitive environment that are necessary to preserve and/or enhance the issuer's cash generating capabilities. The agencies also consider the hybrid security's role in the long-term financial strategy of the issuer, the management's rationale for the transaction and the use of proceeds.

Targeting the right investor base
Subordinated debt has become a well-known asset category in Europe, as issuance volumes have increased significantly since 1995. The most active issuers for both dated and perpetual instruments have been banks with dated structure most frequently used until 1998. Following the release of the BIS Hybrid Tier I guidelines in October 1998, more sophisticated structures via special purpose vehicles (SPVs) have become more common. This has resulted in a better understanding of different hybrid capital characteristics in the investor community. Therefore, larger transaction volumes can be achieved – in 2000 the average transaction size was €512m compared to €328m in 1999.

In principle, corporate issuers can target a variety of investors in Europe and the US. In both regions, there is a developed retail investor base offering potentially more attractive cost of funding. However, as issue size and pricing depend heavily on the name recognition of the issuer, only more established issuers should consider this option.

In addition, there are further limitations regarding transaction size. Following last year's activity in the European retail market, the current market depth has decreased significantly resulting in 'close to zero' issuance volumes.

To achieve greater transaction volumes, an issuer should consider the institutional investor base. In Europe and the US, institutional investors are familiar with hybrid capital instruments. As corporate hybrid capital is an only 100% BIS risk-weighted asset, the broadest range of investor can be tapped in such transactions. Therefore, not only 'traditional' hybrid capital investors such as insurance companies and pension funds can participate, but also banks are attracted by the additional yield pick-up. However, institutional-targeted transactions usually require a coupon step-up, as such investors prefer a fixed or 'synthetic' maturity. The step-up feature reduces the instrument's benefit for rating purposes, while it does not necessarily have an impact on the accounting treatment.

To overcome the disparity of the two financial objectives, shareholder and bondholder value, hybrid capital provides a bridge between the two different mindsets

So far, the corporate sector has been relatively inactive compared to banks. High-yield issuers have most frequently used dated instruments. Such companies have only limited access to senior debt, since their access to those funds is limited by covenants. In contrast to dated instruments, perpetual hybrid capital has been raised predominately by investment grade borrowers. Although only a limited number of businesses have accessed the hybrid capital market, past transactions were mainly in the A to BBB rating category.

As most issuers had some downgrade pressure from the ratings agencies, the main objective of corporate hybrid capital raising has been to get 'equity credit' from the ratings agencies. To achieve this objective, perpetual non-call five structures without step-up features have been most frequently used.

Expected developments
The European corporate landscape is changing rapidly. Managers are under increasing pressure from shareholders to focus on the corporate's share price performance, therefore creating an incentive to leverage further the capital structure. Also, corporate treasurers rely increasingly more on bond financing, because banks are less willing to lend money. With the increasing importance of the bond market, a greater focus on ratings becomes essential. If a corporate is not offering 'bondholder value' in addition to shareholder value, it is in great danger of being cut off from vital short-term and long-term funding sources. Recent developments in the European corporate debt market demonstrate that investors are becoming increasingly more sensitive toward ratings, resulting in a spread widening between the different ratings categories.

In addition, investors take potential future developments, for example, ratings downgrades, in their investments decision into account.

To overcome the disparity of the two financial objectives, shareholder and bondholder value, hybrid capital provides a bridge between the two different mindsets. Its ability to reduce leverage while being cost-efficient and non-dilutive appeals to both the equity and debt investor communities. In addition to 'pure' shareholder/ratings considerations, corporate treasurers must ensure they have the greatest financial flexibility through the right funding and capital mix. They are not only able to optimise their cost of capital, but they also less dependent on their existing funding sources through the diversification of the investor base.

Since many European corporates are already active issuers in the corporate debt market, their credit is well known to investors. As fixed income investors remain 'yield hungry', the yield pick-up, offered by hybrid capital, for a well-known credit is very attractive to them. Marketing efforts for a hybrid capital transaction can be focused rather on the transactions' characteristics than on the issuer's credit resulting in a much quicker and smoother execution process.

Corporate treasurers cannot afford to ignore hybrid capital options, to maintain decision flexibility and to be at the forefront of financial innovation – and the prospects for issuers have never been better. ■

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