Aligning the stars

THE ACT'S HYBRID BREAKFAST SYMPOSIUM, HELD IN SEPTEMBER, HEARD THAT AN ENTIRE CONSTELLATION OF FACTORS HAD TO BE RIGHT TO BRING OFF A HYBRID TRANSACTION. **PETER WILLIAMS** REPORTS

There is a broad spectrum of capital market instruments ranging from senior debt to common equity, Khalid Krim, Head of European Hybrid Capital at Barclays Capital, told the ACT's symposium on hybrids.

Hybrid capital instruments incorporate elements of both debt and equity but always include a perpetual or long-dated tenor, deep subordination and deferrable coupons. Corporates issue them to finance acquisitions, avoid or limit dilution, strengthen the balance sheet, fund pension deficits and share buybacks, and optimise capital structure. Hybrids support credit ratings, raise non-dilutive equity, are tax-deductible and may reduce a corporate's weighted average cost of capital.

The value of hybrids issued in US dollars, sterling and euro combined rose from €1.4bn in 2003 to €12.6bn in 2006, and even more is expected in 2007. So far, 55% of the issuance has been in euros, 35% in dollars and 10% in sterling.

European hybrid capital investors are looking for extra yield and to diversify their holdings between senior corporate bonds, bank and insurance subordinated debt and hybrid capital. The relative value between senior and hybrid spreads offers arbitrage opportunities. Asset managers represent 45% of investors, banks 20%, insurance and pension funds 15%, and hedge funds 10%.

But questions remain over the impact of changes in market conditions on the corporate hybrid market: will other corporate issuers access it and will investors continue to believe and invest in this asset class?

Debbie Keat, Hybrid Specialist at Citi's Global New Products Group, argued that hybrid capital was a delicate balance between rating agency requirements, accounting and tax considerations, and marketability. The rating agencies assign equity credit by assessing how closely hybrid securities resemble equity in terms of permanence, periodic payment flexibility and subordination.

But any desire to resemble equity to please the rating agencies has to be balanced with the need to ensure interest is tax-deductible. Keat said UK hybrid issuers could balance these competing requirements – for example, through an alternative settlement mechanism (ASM) and principal subordination provision. Interest that is dependent on results or linked to revenues is a dividend (and therefore not deductible), and non-cumulative interest may also be considered results-dependent by the UK tax authorities. On the other hand, Moody's requires interest to be non-cumulative or non-cash-cumulative and settled by an ASM. Deferred interest in excess of 25% of the principal should be cancelled or subordinated to the level of ordinary equity in a liquidation.

Issuers of hybrids also have to ensure the accounting treatment is correct. Under IAS 32 *Financial Instruments: Presentation* an instrument that creates an obligation for an issuer to deliver cash or another financial asset should be classified as a liability on the issuer's balance sheet. While rating agency equity credit is unaffected, hybrids may be structured as liabilities or equity under IFRS.

Jon Drown, Director of Group Treasury at Rexam, made treasury history when the FTSE 100 packaging company became the first UK corporate to issue a hybrid. The rationale came in the form of two potential acquisitions and competing financing objectives. Rexam saw the funding package including a hybrid as appealing to shareholders, debt holders and management. For shareholders, there was limited dilution from a smaller equity issue, the maintenance of investment-grade rating and a demonstration of access to alternative funding sources. For debt holders, it maintained investment-grade rating and offered an attractive debt instrument. And management was attracted by the cost-effective funding mix.

In structuring the hybrid, the key hot points were flexibility, the tax treatment and attracting investors. Rexam wanted protection from changes in treatment from tax authorities, rating agencies and accounting standard setters, plus an any-time ability to exit the hybrid. It completed the transaction in under two weeks from announcement. But looking back, Drown suggested the stars had to be in alignment to achieve a hybrid. This alignment includes an event (such as a share buyback or M&A), a strong desire to maintain current ratings, a senior management that is open to innovation and benign market conditions.

A hybrid is a bespoke product and there were at least 10 new features in Rexam's. Selecting banking partners with the right experience and intellectual capital is vital. Companies need to be open internally about the appropriateness of a hybrid and if red-flag issues arise be prepared to be flexible or admit the transaction is not possible. Rexam achieved what it wanted because it had clear objectives from the outset and stuck to them.

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