Hybrids bloom

THIBAUT ADAM EXAMINES WHAT IS DRIVING THE CURRENT ACTIVITY IN THE CORPORATE HYBRID MARKET.

The corporate hybrid capital market revival is well under way. The favourable environment has been driven by multiple factors. Ratings agency Moody's published its new equity credit methodology for hybrid capital on 1 July 2010, which takes into consideration hybrid performance through the financial crisis. Low swap rates are leading to low absolute returns. There is a lack of competing supply since banks, faced with a shifting regulatory environment, are not issuing. And there is significant investor appetite for higher-yielding assets in the current environment.

Moody's methodology revamp, in particular, has cleared the way for greater issuer activity. Its principles-based approach has resulted in greater transparency and a deeper investor base as structural complexity is reduced, significantly enhancing the investor marketability of hybrid structures. Meanwhile, the Standard & Poor's criteria have been relatively stable since they were put in place in 2003, aside from a change in replacement provision in 2007. The stability of the rating agency framework is key for corporate issuers.

Why have the four transactions to date all been utilities (Tennet, SSE, Suez Environnement and RWE)? The market is not restricted to just these entities. Investors naturally feel more comfortable with companies that rely on the bond market for refinancing and that offer stable and predictable cashflows. We fully expect issuers from other industries to tap the market.

What has changed since the corporate hybrid market kicked off five years ago? There has been a fundamental shift in market dynamics: those banks that dominated issuance now issue only a fraction of what they used to. Meanwhile, investors are keen to buy higher-yielding assets from well-known names, resulting in the potential for much larger transactions than could be previously considered. Furthermore, the market is now more mature. Investors' experience of extreme stress with subordinated bank debt means they understand better the risks associated with the instrument.

Does the relative risk aversion towards subordinated bank debt highlight the benefits of corporate hybrids? The hybrid instruments of blue chip corporates are rare enough to ensure outperformance over bank paper. Uncertainty over the regulatory treatment of bank securities has also led to a more cautious investor climate.

Box: How hybrids work

WHAT IS HYBRID CAPITAL?

Corporate hybrid capital has characteristics of both debt and equity: it comes in long-dated/perpetual format, has a fixed coupon with varying degrees of deferrability/cancellation, and is subordinated to all senior debt obligations, being senior only to common equity.

A cost-effective financing tool, hybrid capital offers a number of advantages. It is issued in a form of debt and placed with fixed income investors. Its remuneration is tax-deductible. It is viewed as equity-like by rating agencies. It is non-dilutive from a shareholder's perspective (unlike other equity and equity-linked securities). It costs less than equivalent debt and equity packages. And its principal can be accounted for as "equity-like" under IFRS.

THE FOUR MAIN ADVANTAGES OF ISSUING HYBRID CAPITAL

- **Bolsters ratings** Hybrid capital has been established as an effective way to access a cheap equity substitute while bolstering ratings. Rating agencies value the equity-like features of hybrid instruments

What are the key drivers for pricing in today's market? Corporate hybrid performance has fared well since the beginning of the financial crisis. The increase in beta during this time was more gradual for corporate hybrids compared to financial subordinated debt, helping corporates to outperform over the period. In the current low-yield environment, some investors are finding hybrids especially attractive, with an average yield pick-up of about 2.5% over senior debt. Versus equities, corporate hybrids on average provide a yield of 5.4%, compared with a dividend yield of 3.3% for the DJ Stoxx 600 index. Even at the individual bond hybrid level, the bond yield surpasses the equity stock yield.

Rating agencies have revamped their frameworks over the past two years. How are issuers or investors affected? In the past, each deal was different, so significant due diligence was required for each transaction. Convergent new rating frameworks mean instruments are now more standardised, which provides transparency to investors.

For issuers, there has been a simplification of some clauses – for example, the use of the complicated alternative coupon settlement mechanism (ACSM) to pay a deferred coupon is no longer necessary, allowing for cumulative payments of interest, which in turn leads to best pricing. Features linking hybrid payments with ordinary share payments are generally included to ensure payment discipline, e.g. dividend pushers/stoppers and interest on interest.

The recent Moody's and S&P changes can be seen as an indication that the instruments are now mature. The new frameworks take account of several years of issuance as well as evolving technology, while the financial crisis has provided a real-life stress test for hybrids. As all instruments incorporate capital disqualification language, providing the issuer with the option to redeem or vary/substitute the securities if the equity credit is weakened, issuers may mitigate the cost of any future changes – which are less likely than before.

Rating defence is a key preoccupation for CFOs. Where do corporate hybrids fit into the picture? A hybrid is an attractive instrument in the chief financial officer's toolbox: it can be considered, for example, as a highly effective way to rebalance the capital structure following an acquisition. However, it cannot address all rating pressure matters: if the source of rating weakness stems from operational rather than financial structure issues, what it will achieve is limited.

How does the low absolute swap rate influence an issuer's decision? A number of corporates seek investment opportunities on the basis of their absolute return. They would then look at the best capital mix to optimise shareholder value within various rating constraints. In this context, a tax-deductible hybrid priced today in the current very low interest rate environment will reveal a favourable after-tax cost.

Figure 1: Hybrids vs banks Tier 1

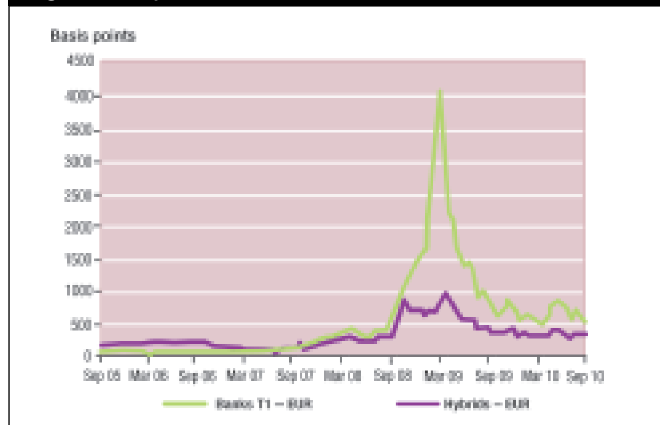

Figure 2: Hybrids vs banks LT2

and award up to 100% equity treatment. Precedent hybrid deals, including Henkel, Vattenfall and Solvay, resulted in a favourable rating agency outlook or rating upgrade.

- **Cost-effective** Hybrids are considered highly cost-effective. Coupons are tax-deductible and determined by reference to bond pricing, while the hybrid capital is a valuable substitute for common equity. The securities don't dilute existing shareholdings.
- **Acquisition financing** Acquisitions have traditionally been financed through shares, debt or the disposal of assets. Hybrids have let European corporates raise cost-effective equity capital to finance acquisitions. Of acquisitions financed with hybrid capital and equity, hybrids traditionally comprise between 20% and 50% of the package.
- **Equity access** Hybrid capital is an important financing tool for companies without access to the traditional equity capital markets. This may be as a result of government or family ownership, or where majority owners do not wish to be diluted. Hybrid capital may then be utilised as a substitute to strengthen the balance sheet.

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