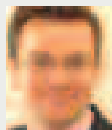
Ask the experts:

Finding the right balance between equity and debt

Is hybrid capital the flavour of the month for European corporates or is it here to stay?



Vincent Allilaire, Associate Director, Standard & Poor's Ratings Service

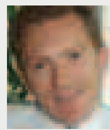
Market conditions, such as low interest rates and credit spreads, are clearly one factor driving investor appetite for this asset class. But given that these instruments benefit issuer credit quality when compared to senior debt, we do expect the incentive to issue to remain in place. The way in which Standard & Poor's ratings process treats hybrid capital has been, and will remain, consistent over the long term, though we do also adapt it to the rapid evolution of hybrid features.

Standard & Poor's analyses a hybrid along the three main attributes of common equity: subordination, permanence and deferability of cash payments. Strong equity features favourably impact our assessment of credit quality.

Recent European corporate hybrid issuers (over €5bn in June-July alone) have improved their financial headroom at their current rating level, which provides a strong incentive for others to follow. But we may, over time, also see hybrid issues being used for non-credit-related purposes, such as raising additional equity-like capital without diluting a controlling stake.

The terms of recent issues are likely to prompt further issuance over the long term. Hybrid instruments need to present a high degree of permanence. Although European hybrids may traditionally be called 10 years out, the terms and conditions in their documentation now typically includes a statement of intention from the issuer to replace them with another hybrid issue whose equity-like features are already predetermined or with equity.

These replacement features are likely to sustain the level of issuance in the asset class over the long term. Replacement features might also develop further into covenants with senior debt holders, which would significantly strengthen their analytical value.



Jean-Francois Mazaud, Head of Debt Capital Markets Origination for Corporates, SG Corporate and Investment Banking (SG CIB)

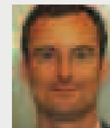
We believe this is a product that will remain part of the market for the foreseeable future, particularly in the current environment of low credit spreads and interest rates.

From an investor perspective, the product offers good yield (higher than for senior debt) and is a booster to the profitability of a portfolio at a rate of risk that is considered remote in the current environment.

For issuers, hybrid capital has many merits that encourage them to favour this type of financing. From an accounting point of view, it is treated as equity and has equity credit from ratings agencies, which is a clear benefit. Because you do not dilute the earnings per share when the instrument is issued, it is non-diluted equity. In addition, it enhances the cost of equity of the company, with a lower cost of equity than a straight equity.

Any change in interest rates or credit spreads could have an impact on hybrid capital products. This situation could lead to a narrower investor base and higher prices, but with the current market environment in Europe, we do not believe this is likely to happen at this time.

There is clear evidence of increased demand for these transactions. SG CIB believes this is a good product for corporates that are investment grade or above. The market is interesting and sophisticated and fits well with today's corporates, which want growth, but with the correct balance between equity and debt and as few dilutions as possible for shareholders.



Henryk Wuppermann, Head of Capital Markets, Bayer AG

In February, Moody's issued its new methodology for hybrid capital. This made the implications for corporate ratings far clearer and was the starting point for many companies to seriously consider taking advantage of hybrid capital – as financial institutions have for some time. But what are the benefits of hybrid capital for a company? The answer is simple: if companies have little or no access to equity markets, hybrid capital is the only way to improve their capital base.

However, issuing hybrid capital also makes sense for listed companies such as Bayer. In our case, Moody's treats our hybrid instrument as 75% equity while S&P determined an intermediate equity content. Consequently, this transaction, which was combined with a tender for existing bonds, clearly supported our credit rating.

Issuing hybrid capital rather than an equivalent amount of straight equity and debt meant we did not dilute stockholders' equity. Moreover, the after-tax cost of capital is much lower because investors require a far higher return on straight equity and, in addition, the coupon on hybrid bonds (in our case 5%) is tax-deductible.

Given that investors' demand for hybrids also seems to increase with each new transaction, I am confident that they will become more than just the flavour of the month.