Hybrid capital

Long-term fix or short-term story?

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Variations on a theme

Although corporate hybrid securities are the flavour of the year, they are not a particularly new concept. Various instruments have been used over the past 10 years in specific jurisdictions such as the US (trust preferred securities), Spain (preference shares sold to retail investors) or Germany (*Genusscheine*).

The significant development in 2005 was the emergence of an asset class in the euro institutional investors market. It was driven first by a clarification of the accounting and rating benefits of these instruments, and second by investors who see these products as a means to gain additional yield in the current low-interest rate and credit spreads environment. In the past 12 months more than 10 European corporates have used this new opportunity to issue equity-like debt instruments for a total amount in excess of €8bn, and debt capital market participants expect more to come.

STRUCTURE: A BALANCE BETWEEN EQUITY AND DEBT. The idea behind a hybrid instrument is to start with a debt-like security and to twist it into an equity security by playing on three main criteria: ranking, maturity and discretion on the remuneration. These three features affect the rating, tax and accounting of the issued securities.

- **Maturity/permanency of the funds within the balance sheet of the issuer** To replicate the absence of maturity of an equity security, a typical hybrid instrument targeting the euro institutional investor market has no maturity, a first call option for the issuer in year 10 (or longer) and a coupon step-up to create a incentive for the issuer to exercise the call. A replacement provision by which the issuer declares their intention to replace the qualifying hybrid by a new instrument with at least the same equity features before any redemption is also needed to mitigate the negative impact of the coupon step-up for rating agencies. The absence of legal maturity or an event which triggers an early redemption is key to attaining an equity accounting treatment, while rating agencies grant equity content of at least 50% to long-dated maturity issues (of more than 50 years).

- **Ranking** To optimise the equity content from rating agencies, the instrument needs to be junior to every other obligation of the issuer except common shareholders. At the same time, the choice of one instrument or another (deeply subordinated bond versus preference shares, for example) will be driven mainly by the necessity to ensure tax deductibility on interest payment and avoid any withholding tax. For each jurisdiction, various legal forms are used to comply with the local tax and legal system.

- **Interest payment mechanism** This is the area with the most diversity. Various interest payment mechanisms replicate the discretionary payment of the dividend on a common share, but the idea is always the same: to offer the issuer the possibility to differ coupon payments (on a cumulative or non-cumulative basis) while not altering the treatment of hybrid holders versus shareholders through dividend pusher or stopper mechanisms.

Executive summary

- In the past 12 months over €8bn has been raised by European corporates from this new opportunity.
- The building of a hybrid starts with a debt-like security that is twisted into an equity security.
- In the UK the biggest question over hybrids concerns the tax treatment, but careful planning could overcome this objection.

To date, two main interest payment mechanisms have been used. The first is a non cash-cumulative optional coupon payment in case of no dividend, which qualifies for a 50% equity content from the rating agencies. The second boosts equity content (up to 75% for Moody's) by setting a mandatory trigger deferral at a level which usually corresponds to a downgrade of the issuer below investment grade.

The trade-off whether to use a mandatory trigger deferral or not is that S&P's rating for the hybrid will be three notches below the corporate credit rating instead of two for the first option.

FRANCK ROBARD AND HIS COLLEAGUES LOOK AT THE THREE KEY CRITERIA OF HYBRID SECURITIES: RANKING, MATURITY, AND DISCRETION ON THE REMUNERATION.

BENEFITS HAVE BECOME CLEAR FOR ISSUERS Hybrid instruments are valuable financing tools for corporates and have many merits from a rating agency, accounting or shareholder perspective:

- **An equity treatment for accounting purposes** Most hybrids issued over the past 12 months have achieved an equity balance sheet treatment under International Financial Reporting Standards (IFRS) thanks to IAS 32 *Disclosure and Presentation,* which requires no defined maturity and an optional payment for all coupons. Nevertheless, some issues have received a debt treatment due to a fixed tenor. Here, the main trade-off is to have an equity treatment or the hedge accounting benefit for the associated swap as any hedge of an equity-treated instrument will result in a mark to market (MTM) valuation of the swap in the profit and loss account.

- **An equity credit from rating agencies** Rating agencies have clarified their methodologies and given equity value to hybrids. Moody's opened the ball in 2004, and S&P and Fitch followed suit in 2005. All recent hybrids have received a 50% to 75% equity credit from Moody's and 40% to 60% from S&P. Greater transparency from the rating agencies has been important in driving issuance as market participants know the level of equity replication achievable with a specific instrument. Higher equity value can theoretically be achieved but has not been tested because of the extra constraints imposed on issuers or investors, such as legally binding replacement language or mandatory interest deferral triggers with a higher probability of occurrence.

- **Shareholder value** Hybrids strengthen the capital base by putting a buffer between senior creditors and shareholders. At the same time, they are tax-deductible equity-like products, and so enhance the cost of equity of the issuer. Last but not least, coupons on hybrids treated as equity for balance sheet purposes are not accounted as a financial charge and so have a positive impact in the net income when used instead of or to replace senior debt instruments while they remain non-dilutive under IFRS.

Management of the risks associated with hybrid capital

The principal motive for the issue of hybrid debt is optimisation of capital structure. While credit rating agencies and investor requirements are key criteria in capital structuring, an accurate assessment of the risks associated with hybrid instruments is vital. The issuer is therefore ultimately confronted with the management of these risks, which essentially depend on the evolution of the fixed-income and credit markets. Whether assessed before or after issue, solutions for managing hybrid debt risk can be constructed using a range of ad hoc derivative instruments.

As with plain-vanilla bonds, an issuer is exposed to interest rate and credit risks as soon as they decide to issue a hybrid instrument. To hedge this risk, the issuer can implement standard pre-hedging solutions. For the credit spread, a company may decide to protect itself either against systemic market risk or against sector-specific risk. The advantage of hedging systemic market risk is that it can be used to cover very large amounts, in optimal liquidity conditions. The objective is to offset the risk of a generalised credit market event that is beyond the control of the issuer and that the issuer does not wish to experience.

Once the instrument has been issued, the issuer can seek greater flexibility in the management of the associated financial risks and of the redemption clauses. If the instrument is classified as debt for accounting purposes, then rate management risk is implemented in the standard way. Variability can be an interesting solution for cyclical companies whose activities depend on economic growth. In effect, when the economy starts to decelerate sharply, interest rates generally plummet just as cyclical businesses are experiencing a simultaneous fall in sales revenue. In these circumstances, a reduction in financial cost and weighted average cost of capital (WACC) can be particularly welcome.

If, on the other hand, a firm's hybrid issue is classified as shareholder equity, then under international accounting standards (IAS), instruments for managing rate risk are not considered fair-value hedges of the associated risk. In that case, a system for monitoring and controlling the market value of the management instruments must be implemented. These systems must be defined and set up in accordance with companies' limitations, particularly with respect to acceptable levels of volatility.

In short, the issue of hybrid capital is not just a question of optimising capital structures. As with any other financial instrument, the risk associated with hybrids must be studied, and effective solutions for the management of these risks must be implemented.

Inès de Dinechin

Table 1. Analysis of several structures for the Vinci perpetual

Market spread over benchmark	Spread with cumulative deferral	Spread with no deferral	Spread with 10-year maturity after call date	Spread with no extension
295bp	276bp	260bp	203bp	149bp

Source: SG CIB Credit Research

STRONG RATIONALE As long as investor appetite remains strong, hybrids are in every treasurer's toolbox. There is a market consensus to consider hybrids as a form of capital with many merits, and when talking to potential issuers the question often crops up: what rationale can I sell internally and externally which justifies issuing a hybrid instrument?

The merits listed earlier theoretically justify an issue, but such instruments should not be seen as purely opportunistic funding as a strong rationale has to exist to justify the premium paid over senior debt and to convince investors of this choice.

Among these specific situations, the most appropriate seem to be acquisition-related funding, a strengthening of rating credit metrics (and therefore increasing the financial flexibility within a rating category) for an issuer with a stable business profile, and pre-funding of pension deficits. All have been well understood by investors.

WHAT IS THE FAIR PRICE? Issuers and investors face a relatively new asset class with different and complex structures and not enough outstanding issues yet to conduct a pure relative value analysis. Therefore, after choosing the right instrument, the next question is: what is the fair value of this instrument?

Even if at the end of the day the credit spread at launch remains a matter of bargaining between investors and issuers, bankers have developed sophisticated pricing methodologies. SG CIB computes a fair price for a hybrid issue based on the senior spreads of the company. This fair price calculation depends on the specific characteristics of the hybrid issue in terms of coupon deferral and extension mechanisms.

SG CIB's hybrid model uses a three-step approach to compute a fair price for a new structure:

- Simulate all possible scenarios on future spreads' financial ratios of the company. This first step depends heavily on the spread curve of the company, as this curve gives information about the market's perception of future spread dynamics.

- Determine the company's decision regarding coupon deferral and extension in each scenario and compute the price of the security in each case. This step takes into account the specifics of each structure, and differentiates between cumulative and non-cumulative mechanisms and between mandatory and optional deferral languages.

- Assign a probability to each scenario, and then compute the fair price of the structure by making a net present value of all scenarios weighted by their probability.

This three-step approach is a mathematically consistent way to price hybrid issues which takes into account all the options embedded in hybrid securities. Investors increasingly rely on this kind of pricing approach before making any investment decision. Having this kind of model is therefore key to ensure an accurate pricing and a successful distribution of these products.

The model enables a comparison of the fair value of each element of the structure, therefore optimising structures to minimise the cost of funding. For example, the fair spreads of some alternative structures for the Vinci hybrid are summarised in *Table 1*. The actual structure of the Vinci hybrid is perpetual with a non-cumulative deferral mechanism. Our model gives a 295bp spread for this structure (consistent with the market spread). Replacing it with a cumulative deferral mechanism would lead to a 276bp spread (19bp tighter). With no deferral at all, the fair spread of the hybrid would then be 260bp. If the maturity of the hybrid is set at 20 years, i.e. 10 years after the first call date, then the fair spread given by SG CIB's model is 203bp. Finally, with no extension at all (mandatory redemption at first call date), the fair spread is 149bp.

UPCOMING UK HYBRID ISSUES? Scottish Power issued one of the first hybrids of this type in 2003 with a convertible fixed-rate preferred security. Since the benefits and treatment of various instruments have been clarified, an increase in hybrid issuance volumes by UK corporates can be expected. For them, the main challenge is to ensure that coupon payments are tax-deductible. In the UK, tax law contains several provisions that challenge the tax deduction on interest paid on debt with 'excessive' equity characteristics. Accordingly, direct issuance of a hybrid by a UK company bears the risk of not being tax-efficient because the interest payment mechanism could contradict the tax framework.

An indirect issue using a vehicle would avoid these issues. An offshore finance vehicle could issue a perpetual instrument with all the features required to be efficient from a rating agency and accounting perspective. The issuance vehicle would then use the proceeds raised to make a subordinated loan to the UK's parent with an interest payment mechanism softer than the one existing in the hybrid sold to investors.

This route, among others, illustrates the fact that even if the tax environment is more challenging in the UK compared with continental European jurisdictions, structures can be put in place to ensure tax relief on interest payments. UK financial institutions have addressed this issue by issuing tax-deductible Tier 1 for years and we expect UK corporates to do the same in the near future.

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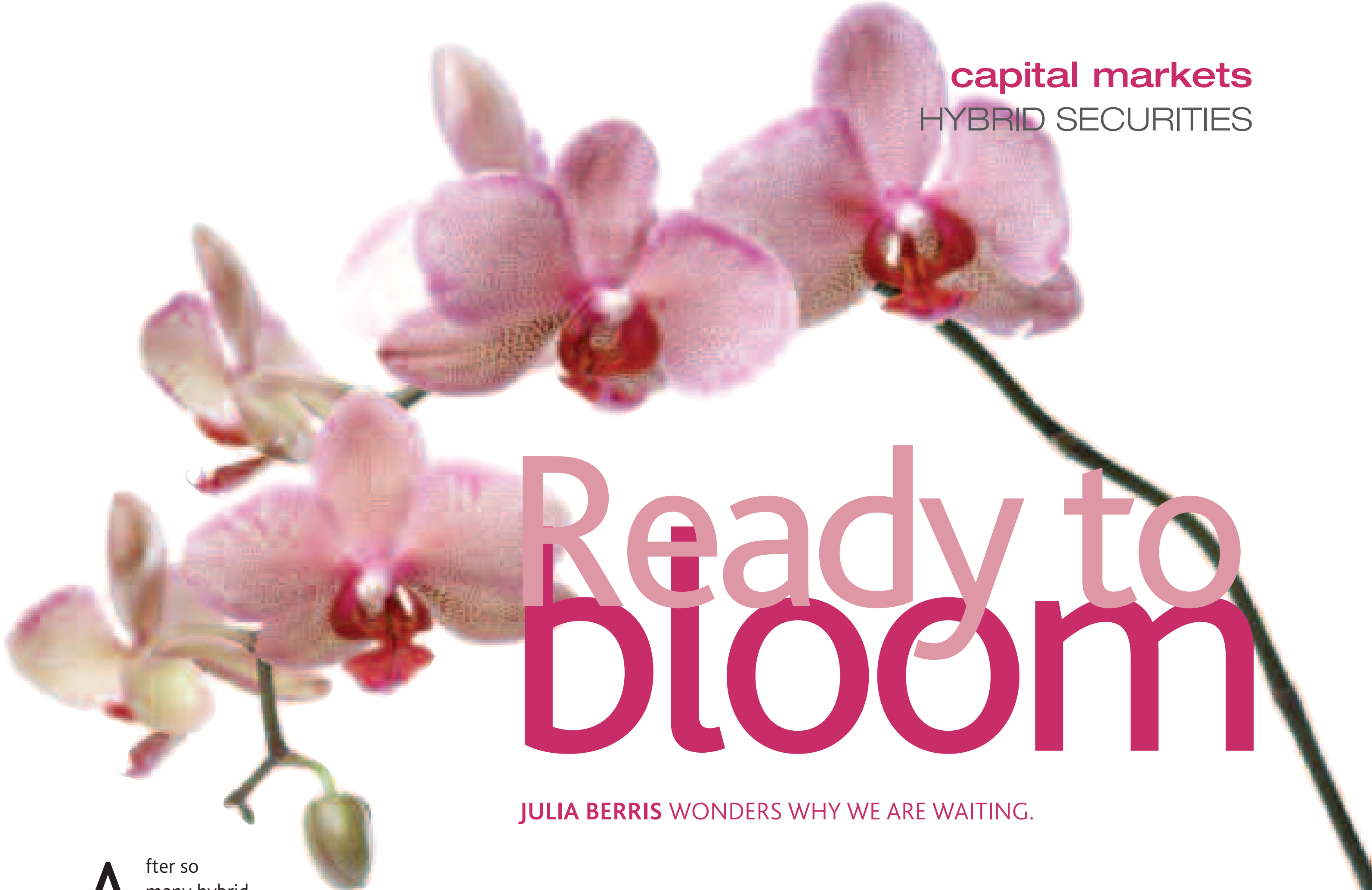


Ready to bloom

JULIA BERRIS WONDERS WHY WE ARE WAITING.

After so many hybrid bond issues in Europe last year, the UK is waiting with bated breath for the very first issuance on home turf. Because of the intriguing mix of debt and equity which hybrid capital provides, mainland Europe has really taken advantage of this revolutionary type of bond, with 10 companies storming the market with hybrid issues in 2005.

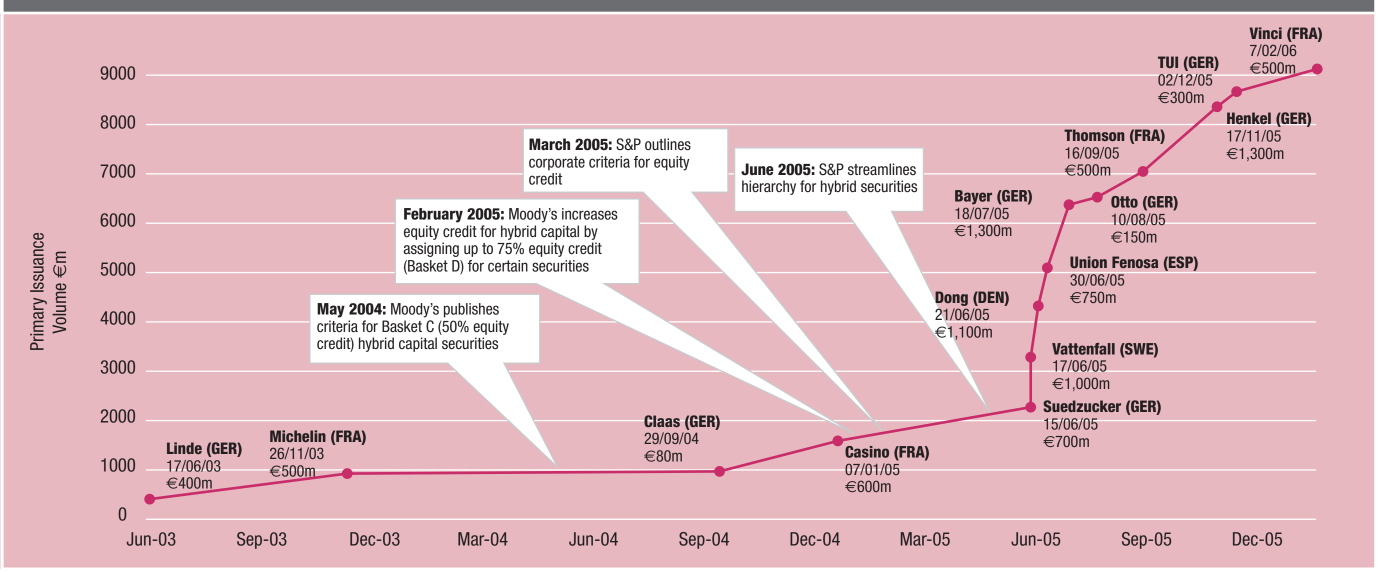
And Europe has continued the trend in 2006, with German carmaker Porsche motoring ahead with an issue of $1bn in January – the largest deal by a European borrower without a credit rating. This issuance was made at the same time as a Eurobond for €2bn.

"The new bonds not only optimise our structural liquidity, they also guarantee – totally in line with our conservative financing strategy – a consistent, comfortable liquidity cushion for the company," says Chief Financial Officer at Porsche, Holger P Harter.

The issue was priced at par to yield, down from guidance of about 7.5%, after about 300 investors placed orders worth more than $4bn for the bonds, which can be bought back after five years. The deal saw support from Asian investors and European retail accounts as well as significant interest from institutional investors, which meant the bonds were widely distributed to a variety of investor types. Porsche said the dollar-denominated bond would be a natural hedge for its dollar receivables.

Porsche says it will use the proceeds to increase its cash liquidity

Hybrid capital: the story so far



position, after spending about $3bn on buying an 18.5% stake in Volkswagen last year.

With such an explosion of interest in hybrid securities within mainland Europe last year, it is hard to predict what the future holds for hybrids in the UK. City analysts are perplexed as to the lack of hybrid activity in the UK. There are mixed feelings among equity investors, who suspect that UK organisations are waiting for another company to take a risk and go for a new type of bond before they work up the courage to do so themselves.

Matthew Hurn, Group Treasurer at DSG international, says: "There are significant benefits with hybrids but explaining this to senior non-financial people can be complicated. This could be why we haven't seen a UK hybrid yet. However, I think this is likely to change within the next year. I expect that companies with large pension deficits may see this type of transaction as attractive."

Henryk Wuppermann, Head of Capital Markets at Bayer, says: "I don't know why there has not been a UK hybrid bond. If you believe something is a good move and will have a positive outcome, then you should do it and not wait for someone else to move first."

In July 2005, Bayer issued a hybrid bond to the value of €1.3bn to help strengthen Bayer's credit rating. "We issued the hybrid because we wanted to improve our credit metrics with the agencies," Wuppermann explains. "We put two things together: tendering existing bonds, and financing that via the issuance of the hybrid."

Issuing a hybrid bond is a popular way for companies to strengthen their credit rating. The methodology of the rating agencies themselves has been a driving force in this market and certainly helps explain the increased number of hybrids last year.

The ratings agencies are becoming more transparent in the treatment of these instruments. In May 2005 Moody's changed its approach in this area. The revision of the methodology enabled it to provide higher equity credit for certain instruments.

In November 2005 German company Henkel issued a €300m hybrid bond to help finance a large part of its pension deficit. This allowed the pensions offering to remain unchanged without the controlling family having to dilute its 52% stake. City analysts argue that this is a smart way of solving a pension deficit issue and pleasing the equity market.

As well as funding pension deficits and improving credit ratings, hybrid bonds have the ability to perform all kinds of functions for an organisation, such as financing acquisitions and refinancing existing borrowing.

However, this versatile instrument is not without its drawbacks. From an investor's perspective, the equity features of a hybrid generate risk: the securities are subordinate, the coupons are deferred, and a corporate may not be able to effect the call. There is also a suspicion in the market that the banks' enthusiasm for this instrument stems from the fees they are able to charge, which are much higher than for a straight bond.

For an issuer the balancing act of getting the right result from the ratings agencies, accountants and tax advisers can be a complicated task and is a lengthier process than straight debt issuance. Even so, City analysts predict activity in this area in the UK over the next few years and a continuing stream of hybrid deals in Europe. With the low interest rates and low yield currently prevailing in the market, analysts argue that now would be the perfect time for the UK's first hybrid bond. Who will be first to take the plunge?

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Vinci issued a €500m 6.25% Baa3/BBB perpetual hybrid transaction with the first call date in year 10. In the event of the bonds not being redeemed in year 10, the coupon will step up by 1%. SG CIB was one of the two joint bookrunners on the issue.

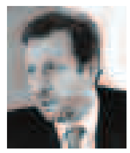
What influenced your decision to issue a hybrid rather than straight debt/equity?
The main reason we chose a hybrid over cheaper instruments is the attached equity content, which either may not materialise (in the case of a convertible bond) or does not exist (in the case of a standard senior bond). In addition, we should not directly compare hybrid and senior cost but rather compare the hybrid to a mix of 50% straight equity (non-tax-deductible) and 50% senior bond. Looked at this way, we took the right decision for Vinci from a cost perspective. Moreover, this product doesn't bear any dilutionary effect.

What will the proceeds be used for?
Vinci issued a euro benchmark-sized hybrid bond to initiate at a very early stage in the year the refinancing of the ASF acquisition and create additional financial flexibility in its balance sheet.

How did you manage the ratings process?
Rating agencies were kept informed as soon as we decided to issue this instrument. S&P said it would enhance our financial flexibility and headroom for small to moderate acquisitions. Moody's said it would give additional flexibility in its assessment of our financial profile, which could prove helpful in supporting rating stability.

Did the board have any concerns over the transaction?
The board was consulted ahead of launch and gave its full support. A

Look closely



CHRISTIAN LABEYRIE, DEPUTY CEO AND CFO OF CONSTRUCTION COMPANY VINCI, ANSWERS QUESTIONS FROM **PETER WILLIAMS** ON HIS COMPANY'S RECENT €500M HYBRID.

detailed presentation of the product and its specifics was made to the board on 9 January 2006.

How long did the process take?
Around five weeks all together including discussions with rating agencies, lawyers, auditors as well as the roadshow and all the syndication procedures (launch, pricing and settlement).

What lessons were learnt, and what would you do differently?
The credit story is paramount for a solid and stable investor base. We had to dedicate time to explain the business, and answer questions from investors. A quick and clear execution was then needed for the deal to succeed on the primary market and the bond to perform on the secondary one.

What are your next priorities?
To complete the acquisition of ASF. This means proceeding with a tender offer to buy out minority shareholders.

Did the auditors need a lot of time to understand the transaction?
Not really. The instrument was relatively standard and well known by auditors, rating agencies and investors, which was essential to proceed quickly with the preparation and the placement of the issue.

Were you pleased with the distribution of investors?
The issue was subscribed by very high-quality European institutions including fund managers (65%), insurance companies (16%) and central banks (5%). The geographical breakdown showed a stronger interest from domestic investors, with France representing 42%, followed by the UK with 23%. The final placement was well spread all over Europe and we are satisfied by the breakdown achieved.

How significant were the costs in deciding what to issue?
We were first concerned by the equity and accounting treatments of the instrument. As for the costs associated to the issue, they are in line with the equity-like features of the instrument. The coupon paid is is some 400bp below our cost of equity which is very satisfactory.

How comfortable were you over being able to set the right issue yield and the whole mechanics of pricing?
At the end of the roadshow, we got a clear view as to what investors wanted to achieve in terms of minimum yield and what would be needed to ensure a successful placement on the primary market as well a smooth aftermarket. This enabled us to go for a very short bookbuilding of only three hours with a set spread of 275bp and a fixed size of €500m.

Can a hybrid's early maturity date and commitment to 'replacement language' be seen to be too inflexible?
Our intention is effectively to call the bond in November 2015 and to replace it with a new instrument that has at least the same equity content. The replacement language is a necessary concession to get the equity treatment from rating agencies.

What are the main drivers in setting your policy for capital?
We are guided by three key principles: first, to keep a sound balance sheet structure with a solid BBB+/Baa1 rating to ensure a sustainable and profitable growth over the long term; second, to diversify our sources of funding to be able to catch the best financing opportunities available and optimise our cost of funding; and third, ultimately to favour financing policies that can positively affect on shareholder value. Our hybrid issue perfectly met these three criteria.

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