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Corporate Hybrids

Executive Summary

- The corporate hybrid market has increased by 60% since the end of 2012.
- Corporate hybrids lie somewhere between senior unsecured debt and equity in the company's capital structure.
- Structures' evolution has been largely driven by the credit rating agencies' methodologies changes.
- We believe that the extension risk is one of the key factors to assess corporate hybrids' value.
- At Western Asset, we only invest in those issues in which we are confident of the issuers' credit profile, understand the management's proposed use of the hybrids' proceeds and when there is clear relative value to less subordinated debt.

The term ***corporate hybrid*** covers a range of debt instruments that lie somewhere between senior unsecured debt and equity in a company's capital structure. Depending on the structure of the hybrid and how a company performs, an investor could end up with a finite maturity coupon paying bond, or a heavily subordinated perpetual, similar to zero dividend equity. From a credit rating perspective, hybrid capital counts partly as debt and partly as equity. This is advantageous for a company in that hybrids lower its cost of capital through the debt funding aspect but support its senior credit rating because of the increase in the equity buffer they imply. Hybrids thus improve the flexibility of a corporate balance sheet at a lower cost of finance, with coupon payments that are tax deductible (unlike dividends) and with no diminution of existing equity holders' voting rights.

Corporate hybrids have enjoyed a renaissance in recent months with issuance increasing the total size of the European corporate hybrid market by 60% since the end of 2012. Now standing at over €40 billion, the market is developing both away from the traditional utility issuers and into non-euro currencies. With issuance likely to increase further and returns attractive in the current low yield world, should hybrids be a part of every fixed-income portfolio? Some of the key features of European corporate hybrids include:

- **Coupon deferral option**, with any coupons deferred potentially being cumulative and compounding;
- **Dividend pusher and stopper**, which either force coupon payment on the hybrid or limit any coupon or dividend payment on instruments ranking *pari passu* or subordinated to the hybrid debt in the event of coupon cancellation on this debt;
- **Replacement Capital Covenant** (RCC), or the obligation or intent to replace the hybrid debt with capital of similar or better quality;
- **Change of control**, which protects investors in the event of takeover of the parent company, with a 5% coupon step-up in most cases;
- **Early redemption risk**, allowing the issuer to redeem all of its debt in certain situations (changes in accounting, methodology of rating agencies, taxation, etc.) with a redemption price that is fixed (in some cases at 101%) or based on a make-whole price;
- **Alternative Coupon Satisfaction Mechanism** (ACSM), an option offering compensation (most often in shares) for investors at the time of coupon cancellation.

Hybrid structures have developed significantly since inception in 2005, driven largely by the changes in credit rating agencies' methodologies. This has resulted in a more standardised structure. With the obvious desire by companies to garner the highest equity credit from the rating agencies at the lowest possible cost, standardisation has led the vast majority of hybrid issuance to satisfy the rating agencies criteria that qualifies for a 50% equity credit. The main requirements that need to be satisfied to qualify are detailed below.

Moody's, S&P and Fitch generally rate corporate hybrids two to three notches below the senior unsecured debt from the same issuer, with the notching going wider if the credit is high-yield. The lower notching reflects the hybrids' more "equity-like" features with two key elements:

1) Subordination, whereby the agencies reduce the senior credit rating by one notch for the subordination, and

2) Coupon deferral, since the issuer's option to defer coupon also warrants lower ratings. Securities with optional deferral are rated one notch lower in addition to the lower rating applied due to the subordination risk, i.e., two notches below senior unsecured. Mandatory deferral is seen as potentially riskier still, with these securities rated an additional notch lower compared to those with optional deferral, i.e., three notches lower below senior unsecured bonds.

Clearly, by investing in a corporate hybrid an investor is moving down the capital structure of a company. As a result, we believe that beyond normal fundamental credit analysis, bond investors should also take the following factors into account before investing in corporate hybrids:

- **Relative spread pick-up versus the senior debt of the same issuer**: How much extra yield do investors need to be adequately compensated for the additional risk of moving down the capital structure?
- **Size of the hybrid coupon relative to annual dividend**: How material are hybrids within an issuer's capital structure? What has been the trend in dividend payments on the stock? What are the consequences of deferring coupons on the ability of the issuer to pay dividends? Is there an adequate defense mechanism built in the structure to stop dividend payments on the stock if the coupon on the hybrids is not paid?
- **Interest deferral language**: Under what conditions can the coupon be deferred? How will the deferred coupon be paid in the future?
- **Incentives to call at the first call date**: What would drive the issuer to call the hybrids at the first call date? Economic incentives versus the need to maintain access to markets might need to be considered by the issuer in deciding when to call the hybrids.
- **Credit rating considerations**: Ratings are normally a key consideration when assessing deferral, extension and subordination risks. How has the rating agencies' methodology evolved for rating these instruments?

At Western Asset, we believe that the extension risk inherent in hybrids is key to assessing their value. The economics of call will be driven by the structural features of the bond and broader fundamentals. However, other factors are likely to be part of the issuer's decision making, in particular the reputational risk of not calling. Coupon deferral risk is also an important consideration.

Ultimately, an investor must always remember that a hybrid is a high beta play on the underlying credit and that the severity of loss is high in the event of a default. However, this is not to say that hybrids should not be part of a fixed-income portfolio. The credit team at Western Asset uses the extensive fundamental credit research and analysis capabilities at its disposal to assess the characteristics and risks inherent in these securities. We only invest in those issues in which we are confident of the issuers' credit profile. Additionally, we must understand the management's proposed use of the proceeds from the hybrid and be able to determine when there is clear relative value to less subordinated debt.

Hybrid Features Required for 50% Equity Credit

	S&P (March 2011)	Moody's (July 2010)	Fitch (July 2011)
Maturity	Over 20 years[1] remaining to effective maturity[2]	Over 60 years at issuance and over 10 years remaining	Over 5 years remaining
Callability / Step-up	Step-up <25 bps or Step-up<=100 bps with RCC[3]	Step-up <=100 bps starting after year 10 (from the issue date)	Step-up <=100 bps with replacement language (statement of intent is sufficient)
	No more than 5 years non-call after call		
	Intent-based replacement language		
Deferrability	Coupons deferrable for at least 5 years	Fully optional deferral	Coupons deferrable for at least 5 years
	Cumulative allowed	Cumulative allowed	Cumulative allowed
	Divi stopper/pusher with <1 year lookback allowed	Divi pusher lookback <=6 months allowed	Lookbacks allowed

[1] 20 years for BBB and higher-rated issuers, 15 years for BB and 10 years for B rated issuers
[2] Effective maturity: A call date on which the issuer faces a particularly strong incentive to call (e.g. coupon step-up)
[3] RCC (Replacement Capital Covenant): This clause obliges (or may be intentional only) the issuer to replace its hybrid with capital of similar or better quality.