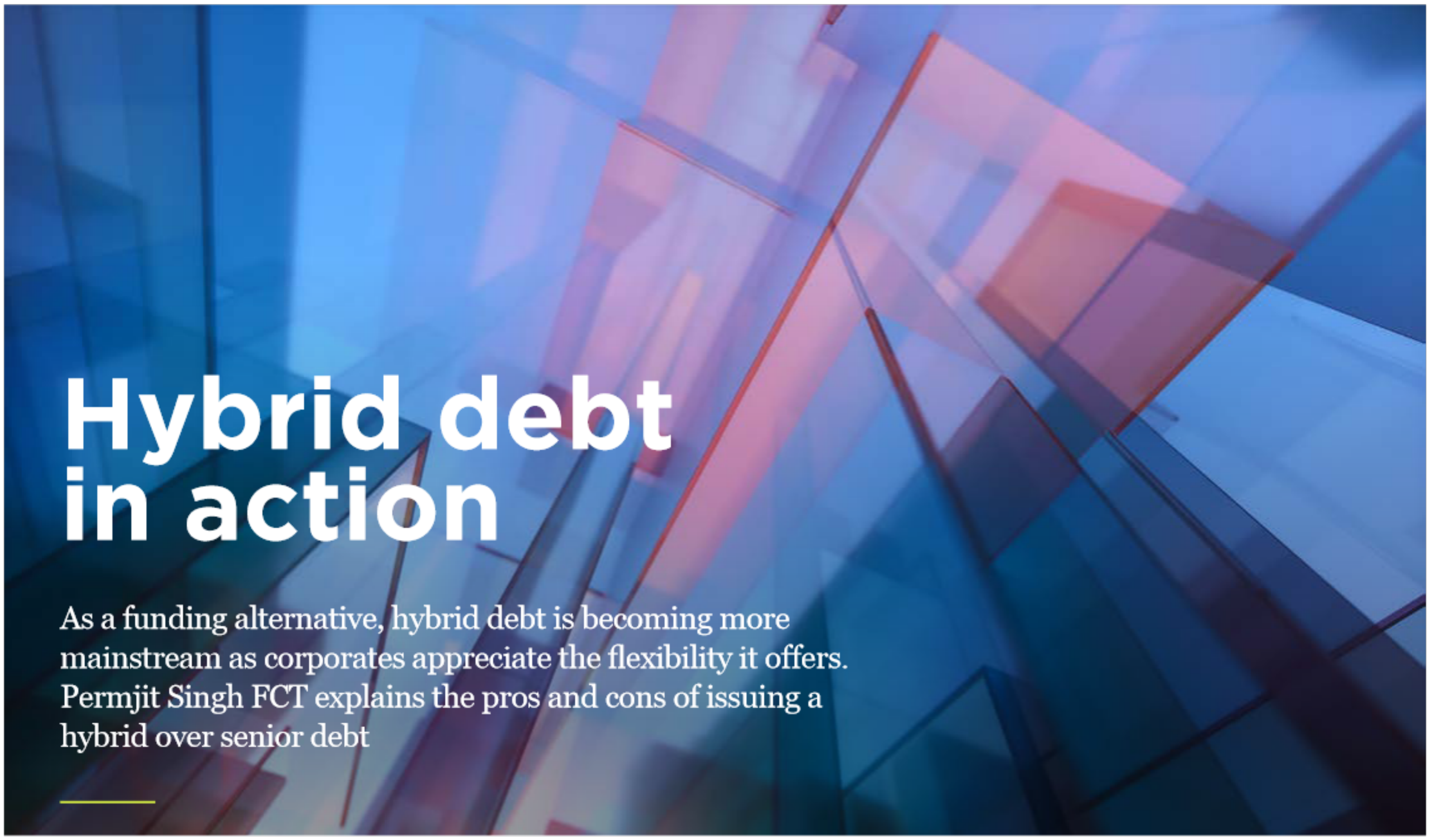

Hybrid debt in action

As a funding alternative, hybrid debt is becoming more mainstream as corporates appreciate the flexibility it offers. Permjit Singh FCT explains the pros and cons of issuing a hybrid over senior debt

Subordinated to senior debt yet senior to ordinary shares, hybrids are the mezzanine layer in a company's capital structure. Hybrids may be reported on the balance sheet as equity and treated as such by auditors and credit rating agencies. The effect is lower gearing, credit risk, and weighted average cost of capital (WACC), and so a higher company value.

Like straight debt, and unlike ordinary shares, hybrids won't dilute equity ownership and compromise corporate control.

Because unlisted companies lack the public profile and market reach to raise conventional equity, hybrids are an alternative source of equity for them.

The ability to defer hybrid coupon and/or principal payments (like ordinary share capital and dividends) gives the company options and flexibility to conserve cash in a liquidity crisis.

Raising debt is not an option for highly geared companies because it increases their financial risk and WACC. Nor is it an option for companies at the limit of their debt capacity. In those circumstances, such companies would have no option but to raise relatively expensive equity, but the astute treasurer will know there is a third option, issuing hybrids.

"Overall, while more expensive than senior bonds, hybrids diversify the long-term capital structure, are supportive to credit metrics... and further strengthen the liquidity position," said Credit Suisse analyst Thomas Adolff, about BP's $12bn of multi-currency hybrid bonds issued during the COVID crisis in H1 2020.

In addition to plugging the funding gap, hybrids diversify funding, and being a cheaper form of equity than ordinary shares, they'll lower the WACC and so increase company value. If allowed by tax authorities, company value can further increase because of the tax shield of debt.

SSE's March 2017 hybrid bonds had a fixed redemption date and were therefore treated as debt, but its 2020 and 2022 hybrids were perpetuals and were therefore treated as equity, for accounting purposes.

"Hybrids diversify funding, and being a cheaper form of equity than ordinary shares, they'll lower the WACC"

In Europe, the hybrid bond market has grown by 1,000% in the last decade to around €200bn. Issuance is expected to pick up from the slump over the last two years caused by a deteriorating economic environment and heightened interest rates, if only because of around €50bn of bonds with call dates in the next two years.

Hybrids are a favourite of capital-intensive companies, such as utilities and telcos, and they, along with energy companies, account for more than half of European non-financial company issuance. Other candidates for hybrids are companies that need to finance large acquisitions. Typical issue size starts at €500m.

So, what's the catch with hybrids?

Hybrids are relatively expensive. Utility Enel paid 2.5% extra interest margin on its hybrids compared with its senior debt; no wonder its €1.75bn hybrid offer in January this year was nine times over-subscribed. Most hybrid issuers are investment-grade, so can the extra cost be justified, especially when spreads for hybrids have outpaced spreads on alternative debt?

For the issuer with a strong balance sheet, ample debt capacity and stable cashflow, hybrids are not the optimum choice of finance in the current environment.

Hybrids can be volatile and so difficult to manage because of their embedded call option. Investors anxious about extension risk (that issuers will not follow market convention of exercising their call option and redeeming their bonds), and will be tempted to sell, which will lower the bonds' market price and raise the company's WACC.

The *Financial Times* reported in October 2022: "[The] price of [Naturgy's hybrid] had fallen to 97.55 cents [over market fears it would not call its bond] but shot back to face value after the news [that it would call], offering reassurance to investors." Naturgy's was not the only hybrid experiencing volatility. "Hybrids at risk of not being called have traded well below face value in recent months."

With market interest rates now much higher, and hybrid yield spreads outpacing spreads on alternative debt, treasurers might hesitate to redeem their hybrids. Property company Aroundtown skipped its first call due in January 2023 on its €369m hybrid, saying it was cheaper to extend the issue than call it and replace it with a new hybrid bond.

At the same time, treasurers need to meet investors' expectations: "[not redeeming would] certainly annoy investors... and put pressure on the ability of that credit [issuer] to come back into the hybrid market in the future," said James Vokins at Aviva Investors.

"Corporate hybrid bonds are higher beta and noticeably more volatile compared to traditional investment grade bonds," said Ziling Jiang of Neuberger Berman, so capital intensive and interest-rate sensitive issuers, such as property investment companies, should think twice about issuing hybrids.

Hybrids' correlation with equity market prices, and with volumes in the wider bond market, means hybrids are not a funding alternative when conventional markets are contracting. Jiang added: "The corporate hybrid bond universe is still a relatively concentrated and less liquid space compared to the broader investment grade credit universe." The illiquidity premium might be negligible for established repeat hybrid issuers.

So, in conclusion, hybrid debt occupies a unique tier of a company's capital structure, simultaneously supporting senior debt and ordinary shares, reducing financial risk, lowering WACC, diversifying funding, and offering flexibility during financial distress. On the other hand, volatility, relative illiquidity, and optionality means hybrids are not a panacea for issuers and investors sensitive to interest rates, extension risk, and equity ownership.

But as SSE PLC reported in May this year, "hybrid bonds are a valuable part of SSE's capital structure, helping to diversify SSE's investor base and most importantly to support credit rating ratios."

VOLKSWAGEN: A CASE STUDY

In June 2020, Volkswagen AG placed two unsecured subordinated hybrid notes with an aggregate principal amount of €3.0bn via a subsidiary, Volkswagen International Finance N.V., Amsterdam, the Netherlands (VIF). The hybrid notes are perpetual, but may be called unilaterally by VIF. The first possible call date for the first note (€1.5bn and a coupon of 3.500%) is after five years, and the first possible call date for the second note (€1.5bn and a coupon of 3.875%) is after nine years. This resulted in an inflow of cash funds amounting to €2,984m, less transaction costs of €16m. Additionally, there were non-cash effects from the deferral of taxes amounting to €5m.

Interest may be accumulated depending on whether a dividend is paid to Volkswagen AG shareholders. Under IAS 32, these hybrid notes must be classified in their entirety as equity. The capital raised was recognised in equity, less a discount and transaction costs and net of deferred taxes. The interest payments payable to the noteholders will be recognised directly in equity. IAS 32 only allows these hybrid notes to be classified as debt once the respective hybrid note is called.

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