BARCLAYS

Credit Research

10 October 2019

Hybrid Capital
Seeking Value down the Capital Structure

- **With the rally in Treasuries driving long corporate yields to near all-time lows, we believe the hybrid capital instruments of investment grade issuers offer an attractive way to enhance the yield of credit portfolios. Our house view calls for a modest but positive US growth backdrop, which should be sufficient to keep corporate fundamentals robust and support moving down the capital structure of high-quality issuers.**
- **Total returns across the preferred/hybrid market (bank preferred, corporate, and insurance hybrids) have exceeded 14%, which represents significant outperformance versus BBs and the intermediate BBB index.**
- **Despite the outperformance, hybrid valuations look attractive versus senior debt. Across the different hybrid segments, median spreads are 250-350bp with a BBB/BBB- rating.**
- **Hybrids offer a significant pickup over senior debt. Bank preferred spreads to call are about 3.5-4.0x senior debt (of similar maturity), while the ratio for insurance/corporate hybrids is about 3.0x, meaningfully wider than our "fair" estimate of 1.5-2.0x.**
- **While they appear cheap in terms of yield/spread to call, hybrids face significant extension risk if spreads widen. The risk is exacerbated in the current environment given the potential discontinuation of Libor in 2021, which could freeze Libor at the last available level.**
- **Across the different segments of the hybrid/preferred market, we screen for securities that offer attractive pickup over senior debt, have limited extension risk – either due to a high reset spread or because they lose equity credit after the first call date – and have supportive underlying credit fundamentals.**
- **Among bank preferreds, we believe PNC 4.85s, USB 5.3s, STT 5.625s, and C 5s appear cheap, while the GS 5.3s look rich. Within the corporate/insurance hybrid sector, MPLX 6.875s, ALL 5.7s, EMACN 6.75s, ENCBN 6s, TRPCN 5.875s, and select PRU hybrids screen as cheap. Conversely, GM preferreds appear rich.**

Credit Strategy
Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com
BCI, US

Fundamental Credit Research
Brian Monteleone
+1 212 412 5184
brian.monteleone@barclays.com
BCI, US

Harry Mateer
+1 212 412 7903
harry.mateer@barclays.com
BCI, US

Peter Troisi
+1 212 412 3695
peter.troisi@barclays.com
BCI, US

Srinjoy Banerjee, CFA
+1 212 526 3521
srinjoy.banerjee@barclays.com
BCI, US

www.barclays.com

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Assessing the Hybrid Capital Landscape

As Treasuries have rallied, sending long corporate index yields to near all-time lows, meeting yield targets has become increasingly challenging. Moving down the quality spectrum, especially into BBB/BBB- credit, is one way to enhance yields, a strategy that we believe is attractive given valuations in that part of the market. However, concerns about elevated leverage and downgrade risk in lower-rated BBB credits has limited the extent of this migration. These worries have been exacerbated recently by a worsening US and global macroeconomic backdrop.

Another way for investors to pick up yield is to stay in higher-quality credits but move down their capital structure, specifically preferred and hybrids of A/high BBB issuers. As detailed in our Global Outlook, while our house view is for a growth slowdown, we do not think there will be a US or a global recession in 2020 given still-healthy labor markets and consumption and accommodative central bank policy. For investment grade credit, a modest but positive US growth backdrop should be sufficient to keep corporate fundamentals robust and support moving down the capital structure of higher quality issuers.

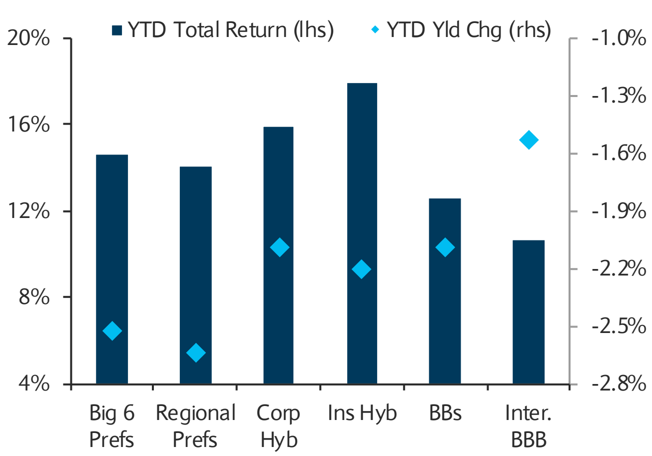
Specifically, we focus on three sub-segments of the hybrid/preferred universe: $1000-par US bank preferreds (split between big 6 and regional banks) and insurance and corporate hybrids. Within each universe, we focus on the more liquid segments of the market.[1] In total, we include about $50bn of bank preferreds, $35bn of corporate hybrids, and $20bn of insurance hybrids.

Bank preferreds: This includes big 6 and regionals banks. Most securities in the universe we consider have the same structure: they are perpetual and, after an initial non-call fixed-coupon period, become callable either continuously or every coupon date. Coupons are non-cumulative, are fixed initially, and turn into floating after the first call date. The call dates, reset spreads, and, for some recent deals, benchmark floating rates differ across securities. Preferreds continue to receive Tier 1 treatment after their call dates; therefore, the call/extension decision is driven primarily by reset spread.

Corporate hybrids: Corporate hybrids are much less homogeneous than bank preferreds. Some of the securities (especially those issued by MLPs) are perpetual, while others have long-dated maturities. Most pay cumulative coupons that switch to floating after the first call date, but some have non-cumulative coupons (including the recently issued AerCap

FIGURE 1

Year-to-Date Hybrid Performance



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 2

Hybrid Capital Valuations

	Price	Yield to Call	Spread to Call	Years to Call	Reset Spread	Rating
Big 6 Bank Prefs	$106.5	4.2%	271bp	4.7	347bp	BBB-
Reg Bank Prefs	$102.8	4.6%	315bp	4.7	314bp	BBB-
Corp Hybrids	$102.8	5.0%	336bp	5.3	364bp	BBB-
Insurance Hybrids	$112.0	4.5%	266bp	9.5	303bp	BBB
Intermediate BBB*	$105.6	2.7%	119bp	5.0**	NA	BBB
BB*	$103.4	4.2%	249bp	4.7**	NA	BB

* Yield metrics to worst. For spread, we use OAS. ** Years to maturity for BBBs and years to workout date for BBs.

Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

[1] We also exclude securities callable in the next two years given that their yields to call are very sensitive to small moves in price.

5.875s). Given their structure – long maturities and no coupon steps – these hybrids generally continue to hold equity credit past the call date, although there are some exceptions. Securities with shorter final maturities partially lose equity treatment 20 years prior to maturity (often on or near the first call date). Furthermore, many European corporate hybrids have coupon steps, designed so that the securities lose S&P equity credit on the first call date. As discussed in detail below, all else equal, hybrids that lose equity credit on the first call date are more likely to be redeemed early.

Insurance hybrids: Similar to the corporate hybrid universe, there are different structures in the insurance hybrid sector. Many securities have a 30-year effective maturity,[2] which means they lose S&P equity credit on or around the first call date. At the other extreme, MetLife and Voya have perpetual non-cumulative preferred stocks similar to the structures issued by banks.

Strong Year-to-Date Returns; Current Valuations Still Attractive

Total returns across the hybrid universe have exceeded 14% (Figure 1), which represents significant outperformance versus BBs and the intermediate BBB index (the duration of intermediate corporates is closer to the duration of the hybrid space). Bank preferred yields have compressed more than 2.5%, well in excess of BBs and intermediate BBBs. Figure 2 shows the median statistics across the different preferred/hybrid groups. Although differences in structure affect the likelihood of call and make comparisons across different segments of the market challenging, this provides a sense of the potential opportunity set in each market. A few things stand out:

- Despite the compression in hybrid yields year-to-date, valuations still look attractive versus senior debt. Across the four hybrid segments, median spreads are 250-350bp with a BBB/BBB- rating. This compares favorably with intermediate BBB debt, as well as BBs, which trade at 119bp and 249bp spreads, respectively.

- Within the hybrid universe, bank preferreds (big 6 and regional) and corporate hybrids are similar rated and have similar time to first call of about five years. Corporate hybrids trade the widest at nearly 5% yield. Among banks, big 6 paper trades about 40bp tighter than regional preferreds, but the former has a better structure with meaningfully higher back-end spreads (347bp versus 314bp).

- The hybrid insurance sector stands out with a much higher median dollar price, tighter spread to call, longer time to call, and low back-end reset spread. However, the richer valuations are justified in part by better quality (the median rating is one notch higher) and better structures. As discussed above, many insurance hybrids lose rating agency credit after the first call date, limiting their extension risk.

Although corporate hybrids offer the highest yields/widest spreads among the different segments of the hybrid universe, the underlying senior debt of the issuers is also meaningfully wider than bank/insurance paper. In Figure 3, we adjust for this by looking at the hybrid/senior spread ratio (using a senior bond maturing close to the hybrid call date). Bank preferred spreads to call are about 3.5-4.0x senior debt (of similar maturity), while the ratio is about 3.0x for insurance/corporate hybrids (Figure 3). This is meaningfully wider than our "fair" estimate. Assuming zero recovery for hybrids and 40% recovery for senior debt implies a hybrid/senior ratio of 1.7x. Other considerations, such as coupon deferral risk, longer maturities, and the tax-advantaged nature of coupons (for preferreds) could drive the ratio wider or tighter. Overall we believe a "fair" hybrid/senior ratio is 1.5-2.0x.

[2] In some cases, the securities have a legal final maturity that is longer than the maturity date that S&P deems to be the "effective" one.

FIGURE 3
Hybrid Valuations Compared with Senior Spreads

	Hybrid Spread to Call/ Senior Spread	Reset Spread/ Senior Spread
Big 6 Banks	3.5x	2.1x
Regional Banks	4.1x	2.2x
Corps	3.0x	1.5x
Insurance	2.9x	1.6x

Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

Another factor to consider is longer term spread volatility. For banks and regulated issuers, the ability to increase leverage significantly is generally limited by regulation, which, all else equal, should lower spread volatility. At the other extreme, energy sector revenues and valuations are more volatile, and investors should generally charge a higher premium for being short volatility (as hybrid instruments are) in these credits.

Importantly, while they appear cheap in terms of yield/spread to call, hybrids face significant extension risk if spreads widen. The risk is exacerbated in the current environment given the potential discontinuation of Libor in 2021, which could freeze Libor at the last available level (see *Libor Worries Afloat*). With Libor near 2% but likely to decline further (implied 1y forward 3m Libor is 1.4%), the downside could be substantial. Figure 3 shows the ratio of the reset spread to long-dated senior spread[3] (over swaps) of the issuer as a measure of extension risk. On average, bank preferreds have higher reset to senior spread ratios (of about 2x) than corporate and insurance hybrids, which are at 1.5-1.6x, although as we discuss later, there is significant variation across individual securities.

In addition to the reset spread, extension risk is driven by the capital treatment/equity credit of the security after the call date. We divide the hybrid universe into two buckets based on their capital treatment after the first call date.

Securities Continuing to Receive Capital Treatment after the First Call Date

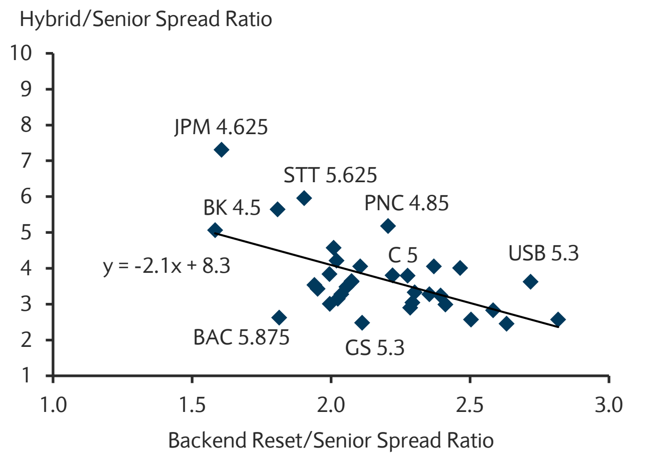
For securities that continue to receive the same treatment (all bank preferreds and many corporate hybrids), a reset spread to long-dated senior ratio of 1.5-2.0x is essentially at-the-money. Securities with resets meaningfully tighter than this range have very high extension risk, while those above the range have a higher likelihood of being redeemed on the first call date.

Figures 4 and 5 compare the hybrid/senior spread ratio with the ratio of hybrid reset to senior (a measure of extension risk). Most bank preferred resets are wider than our “fair” range, which limits overall extension risk. Furthermore, bank preferreds generally offer much higher compensation for extension risk than corporate/insurance hybrids. Given the significant downside from extension, we generally prefer higher-reset securities, but this suggests that for investors less concerned about extension risk, bank preferreds offer better risk/reward than non-bank securities.

[3] Where available, we use 30y senior spreads. For banks with no 30y bonds available, we use a flat 10s30s Treasury OAS curve.

FIGURE 4

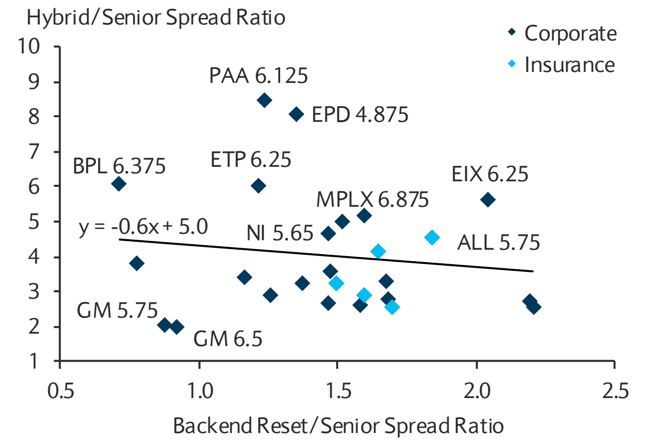
Bank Preferreds



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 5

Corporate and Insurance Hybrids



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

The following opportunities appear compelling:

- **Buy PNC 4.85s, USB 5.3s, and STT 5.625s**: PNC, US Bancorp (USB) and State Street (STT) are three of the highest quality US banks with the necessary scale and diversification to compete effectively with the larger banks and strong risk management cultures. While the reset rates on their preferreds may look low, when compared with senior spreads, the reset/senior spread ratio looks sufficiently high and the yield (4.2-4.6%) and spread compensation for moving down the capital structure is attractive.

- **Buy C 5s**: Many of the Citigroup (C) preferreds look attractive, but legacy securities that first become callable after 2021 carry elevated reset risk if Libor ends.[4] Therefore, we prefer C 5s, which are linked to SOFR and offer a 4.7% YTC with a solid reset spread of 381.3bp.

- **Sell GS 5.3s**: Goldman Sachs (GS) 5.3s offer one of the lower hybrid/senior spread ratios, and at a 4.3% YTC, we find better value elsewhere. While Bank of America 5.875s also have a relatively low hybrid/senior ratio, the high YTC of 4.6% should limit the downside, in our view.

- **Buy MPLX 6.875s**: The MPLX 6.875s screen as cheap compared with the overall corporate hybrid universe (Figure 5). The reset spread is only 1.6x the senior long bond spread, near the tighter end of our fair value range. That said, we are Overweight the credit and expect spreads to tighten, which should lower extension risk. Our constructive stance is driven by the view that management will be able to hold leverage around 4x through 2020, as well as the partnership's commentary about potential asset sales.

- **Sell GM 5.75s and 6.5s**: The GM preferreds screen as rich, offering relatively limited pickup over senior debt and with low reset coupons of L+3.598% and L+3.436%, respectively. Although we are Overweight GM and see value in its senior debt securities, the 5.75% and 6.5% preferreds are rich, in our view.

- **Buy ALL 5.75s**: Allstate (ALL) 5.75s offer an attractive pickup over senior debt, with a reset/senior ratio of 1.8x. We are Underweight the credit based on tight senior valuations – while we do not expect spreads to widen, there is little room for further upside, in our opinion. That said, the company is less sensitive to capital market volatility

[4] Many C preferreds will revert to Libor at time of issuance, which was typically very low.

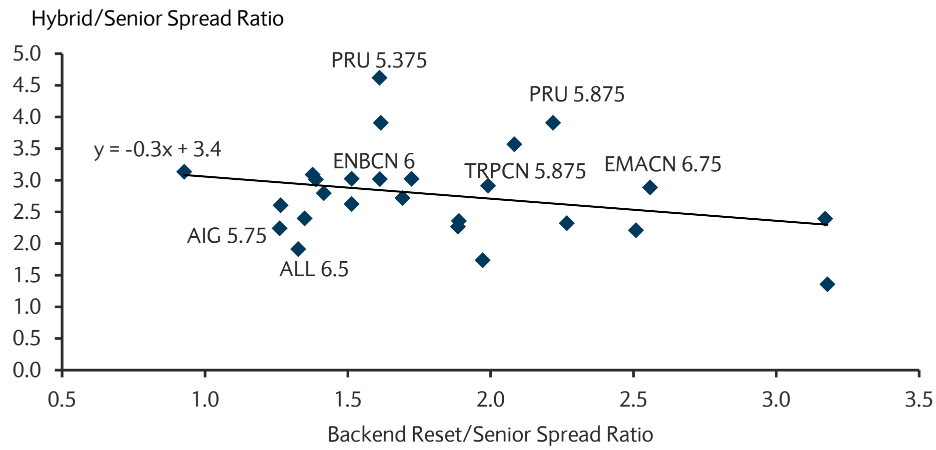
than life insurance peers, and risks associated with higher severity claims from catastrophic weather events such as hurricanes are well managed, in our view. As a result, we are comfortable moving down the capital structure.

Securities That Lose S&P Equity Credit after the First Call Date

Some corporate and insurance hybrids lose S&P equity credit on the first call date and, all else equal, are more likely to be redeemed than securities that continue to receive rating agency credit. From the issuer's standpoint, the securities become like debt (from a rating agency credit perspective) and may be redeemed as long as the reset spread is wider than senior spreads. Figure 6 shows the relationship between the hybrid/senior spread ratio and the ratio of hybrid reset to senior (a measure of extension risk) for this cohort. These securities generally trade tighter than securities with higher extension risk – the average hybrid/senior spread ratio is about 2.9x, compared with nearly 4x for the hybrids in Figure 4.

FIGURE 6

Corporate/Insurance Hybrids Likely to Lose Capital Treatment on First Call Date



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

The following opportunities appear compelling:

- **Buy PRU 5.375s and 5.875s**: Prudential (PRU) hybrids offer significant pickup over senior debt and have limited extension risk given that the securities lose S&P equity credit after the first call date. PRU has reduced its total leverage over the past five years by lowering its operating debt balances, and its ratings have improved, migrating to the A index through upgrades from Moody's and Fitch. The life insurance business is inherently vulnerable to lower interest rates, but PRU's diversity is a strong mitigating factor. Although margin compression is likely in this rate environment, we expect the company to generate top-tier operating results.

- **Buy EMACN 6.75s**: We are Overweight Emera (EMACN) holdco given the company's deleveraging strategy and cheap valuations relative to the BBB utility sector. The company has successfully defended its investment grade ratings at Moody's. We recommend buying EMACN 6.75% hybrids as a high-beta long on the credit.

- **Buy ENBCN 6s and TRPCN 5.875s**: ENBCN 6s and TRPCN 5.875s trade about 3x senior spread. Given coupon steps, they lose S&P rating agency credit after the first call date limiting extension risk. We have Market Weight and Underweight ratings on TC Energy (TRPCN) and Enbridge (ENBCN), respectively. For TRPCN, the company's recent asset sales are helping to fund capex and facilitate some deleveraging to below 5x, consistent with management's goal, while the rating agencies' downgrades of TC Energy out of the single-A category earlier in 2019 removed a longstanding overhang. The Underweight rating on ENBCN is driven primarily by valuation, albeit with some fundamental concerns associated with the company's Line 3 Replacement project, which has faced regulatory delays. That said, ENBCN's simplified structure, leverage target of 4.5-5.0x, and desire to avoid raising equity capital suggest that it will have more limited needs for junior subordinated capital.

- **Sell EPD 5.25s, Buy TRPCN 5.875s**: To add exposure to what we consider to be a better (ie, lower extension risk) structure, we recommend swapping from Enterprise (EPD) 5.25% 2077s into TC Energy (TRPCN) 5.875% 2076s. The TRPCN junior subs lose equity capital treatment at S&P on their first call date, so although the trade involves giving up some spread to call and pickup over senior, the TC Energy notes have a 1.9x ratio of reset to senior spread, versus 1.3x for the EPD 5.25s, implying lower extension risk. TRPCN has senior ratings that are comparable or slightly higher (Fitch) than EPD, stable ratings outlooks, and is also a large-cap midstream credit. Given their subordinated positions in the capital structure, we consider the higher dollar price of TC Energy's junior sub notes relative to those of EPD to be of little importance for valuation.

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Materially Mentioned Issuers/Bonds

ALLSTATE CORP/THE, A/CD/CE/D/E/J/K/L/M/N
ALL 5 3/4 08/15/53 (USD 107.25, 08-Oct-2019)

CITIGROUP INC, A/CD/CE/D/E/GE/I/J/K/L/M/N
C 5 PERP (USD 102.15, 08-Oct-2019)

EMERA INC, CD/J
EMACN 6 3/4 06/15/76 (USD 109.25, 08-Oct-2019)

ENBRIDGE INC, CD/CE/J/K/M
ENBCN 6 01/15/77 (USD 103.63, 08-Oct-2019)

ENTERPRISE PRODUCTS OPERATING LLC, A/CD/D/E/J/K/L/M
EPD 5 1/4 08/16/77 (USD 99.83, 08-Oct-2019)

GENERAL MOTORS FINANCIAL CO INC, A/CD/D/E/J/K/L/M/N
GM 5 3/4 PERP (USD 94.75, 08-Oct-2019)
GM 6 1/2 PERP (USD 97.75, 08-Oct-2019)

GOLDMAN SACHS GROUP INC/THE, A/CD/CE/D/I/J/K/L/M/N
GS 5.3 PERP (USD 105.50, 08-Oct-2019)

MPLX LP, A/CD/CE/D/J/K/L/M
MPLX 6 7/8 PERP (USD 99.50, 08-Oct-2019)

PNC FINANCIAL SERVICES GROUP INC/THE, A/CD/CE/D/J/K/L/M/N
PNC 4.85 PERP (USD 101.88, 08-Oct-2019)

PRUDENTIAL FINANCIAL INC, A/CD/CE/D/J/K/L/M
PRU 5 3/8 05/15/45 (USD 106.52, 08-Oct-2019)
PRU 5 7/8 09/15/42 (USD 106.90, 08-Oct-2019)

STATE STREET CORP, A/CD/CE/D/J/K/L/M/N
STT 5 5/8 PERP (USD 103.50, 08-Oct-2019)

TRANSCANADA TRUST, A/CD/D/J/L
TRPCN 5 7/8 08/15/76 (USD 105.38, 08-Oct-2019)

US BANCORP, A/CD/CE/D/I/J/K/L/M/N
USB 5.3 PERP (USD 106.88, 08-Oct-2019)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

Market Weight (MW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return

of the sector to be in line with the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be less than the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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To view sector definitions and monthly sector returns for Asia, EEMEA and Latin America Research, go to https://live.barcap.com/go/research/EMSectorReturns on Barclays Live.

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Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.
Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
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Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.
Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.
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Market Weight (MW):
The analyst expects the six-month excess return of the country's index eligible bonds to be in line with the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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