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Neither fish nor fowl

A London correspondent writes:

Issuance of corporate hybrid bonds, a predominantly European security which sits on the totem pole of credit between senior debt and common equity, has grown by more than fourfold in the past three years, to the grand total of €110 billion. For ratings and regulatory purposes, a hybrid is neither exactly debt nor exactly equity. It answers the needs of leveraged issuers and yield-starved investors alike. It offers incremental returns relative to senior bonds in the same capital structure. Plainly, there must be something wrong with it.

The vast majority of issuers are familiar bellwether names, e.g., Telecom Italia, BHP Billiton, EDF. To own the hybrid instead of the senior bond of such a solid corporate citizen carries little incremental credit risk, despite the subordination. Then there are the less sterling issuers—e.g., the French mass retailer Groupe Casino, or some of the big German utilities. In these cases, investor beware (see below for details).

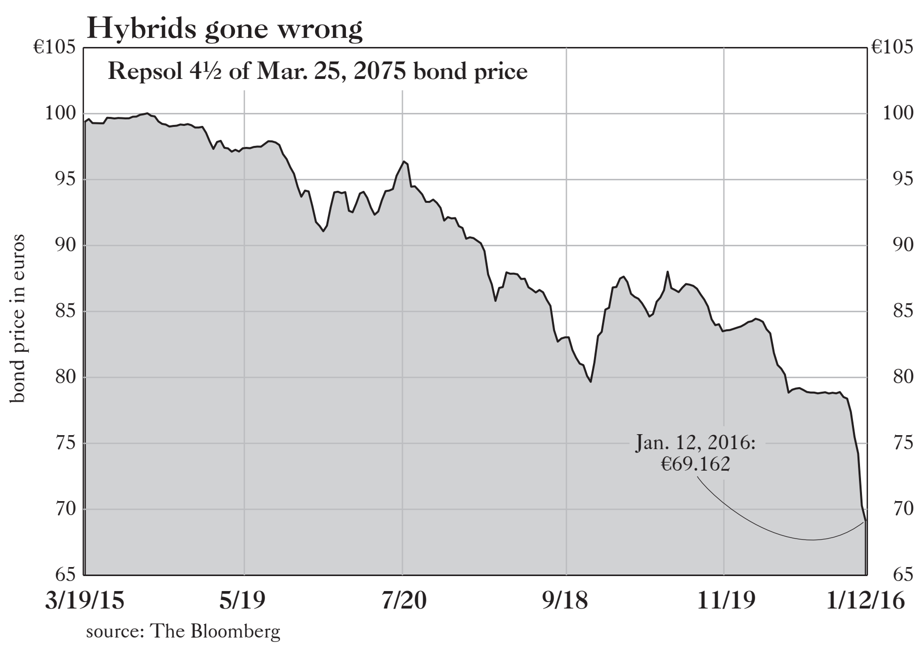
Corporate hybrids resemble preferred stock in some ways but not in others. Really, they are a distinct type, featuring an initial call date beyond which the coupon changes (typically, from fixed- to floating-rate, with a step-up in spread) and the ability for the issuer to defer coupons under certain conditions without causing a default. To issuers, hybrids offer tax, accounting and credit-rating advantages besides. Their coupons are tax-deductible to the issuer and can be classified as equity, rather than debt, on the balance sheet under International Financial Reporting Standards' accounting conventions.

Hybrids serve another useful corporate purpose. Given their equity-like characteristics, €2 billion's worth of hybrid bonds will typically increase gross debt by only €1 billion, by a rating agency's reckoning. Thus, by issuing hybrids, a company can raise capital without impairing its credit or diluting its shareholders.

The readers of *Grant's* may doubt that such alchemy is possible in the zero-sum game of corporate finance. The bankers politely ask them to suspend disbelief. Here, as in other cases of financial innovation, we are dealing with an arbitrage: of credit-rating methodologies, of tax rules and, yes, of investor sophistication.

Though the first recognized hybrids were issued in 2003, the market was less than €25 billion in nominal value as recently as 2013. Credit the income famine for the subsequent quadrupling.

To protect the senior creditors was apparently the top priority of the designers of the first cohort of hybrids. To charm the investor appears to be the principal interest of the designers of the post-2013 generation. The new-model hybrid loses almost all its rating-agency equity credit beyond the first call date, your friendly salesman will not forget to inform you. There will be a well-nigh irresistible incentive to call it. Never mind that the stated maturity date is, say, 60 years hence, if it isn't eternity. Rest assured that this bond will be called at the first opportunity. Unless, of course (as the salesman may not get around to adding), interest



rates turn higher or the issuer's credit rating sinks lower.

As for the latter risk, consider Repsol S.A. The Madrid-based oil and gas producer issued €2 billion's worth of hybrid bonds in two tranches, with coupons of 3.875% and 4.5%, in March 2015. An unscripted energy-price collapse duly followed. Today, those 4.5% hybrids trade more than 30 points below par, equivalent to more than six years of coupon income.

There is headline risk—and there is the fine print. One should be sure to read the latter, especially as it relates to rating criteria. The agencies have not scrupled to change hybrid-rating criteria, in some cases stripping the securities of their equity content. In such circumstances, issuers can sometimes redeem their bonds at par, or 101% thereof, which is hard cheese for the holder when the quoted price is, say, 109, as it was in the case of an ArcelorMittal security in early 2014.

While extension risk will not be a problem in 2016—less than €4 billion notional value of hybrids have a first call this year—the next several years will see an annual average of almost €10 billion reaching their first call date. Some issuers may find that the world has changed for the worse and that they are unable to maintain rating-agency equity credit by replacing their hybrid with a comparable new instrument.

Certainly, the German utility companies RWE and EnBW, where hybrids are a large—and requisite—portion of their capital structure, will face a choice. Perhaps, Mr. and Ms. Investor, now is the time to ask, "Do I really want to be a subordinated creditor to overlevered, government-owned, regulated entities?" It is not hard to envisage the ways in which hybrid bondholders can be impaired in such a situation.

Casino's €750-million 4.87% perpetual hybrid trades around 88 cents on the euro. On the one hand, the 9.5% yield to the January 2019 call date seems reasonable, especially when three-year Casino senior bonds deliver just 2%. On the other hand, if the Casino hybrid is not called at the first call date, the coupon resets to a spread of 381.9 basis points over five-year swaps, currently 0.25%. Which is to say that, post-call, the new hybrid would be quoted at 4.57% to perpetuity, less than half the yield available on the securities now outstanding. Insufficient, perhaps, given the Casino 2.798% bonds of 2026 presently yield 4.2%.

Not calling the bonds would result in their losing their equity content at the rating agencies. Then, again, management may be in no position to call them. Given the recent speculation by Muddy Waters over the veracity of Casino's financial reporting, given the company's weakening operations and given its high leverage, one may reasonably expect some downside pressure on the senior credit rating, now pitched at triple-B-minus. If management declined to call its outstanding hybrids, their price would surely tumble. A cash price of 58 would represent a 7% yield on a perpetual paying 4.07% annual coupons (if the five-year swap rate were unchanged in three years' time), and is 30 points below the current level.

Which bond salesman ever tells all?

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