Corporate hybrids offer potential opportunities in low interest rate environment

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Executive summary

The corporate hybrid asset class has grown significantly in recent years based on its dual appeal to both investors and issuers. We believe the additional spread that corporate hybrids offer over the yield offered by senior debt makes carefully selected hybrids an attractive investment. While extension risk (the risk that a hybrid security is not called on its first call date) has increased since last year due to credit spread widening, we believe several mitigating factors may help limit this risk. In our opinion, therefore, it is possible to find compelling investment opportunities by carefully analysing credit fundamentals, the hybrid's structure and relative valuation.

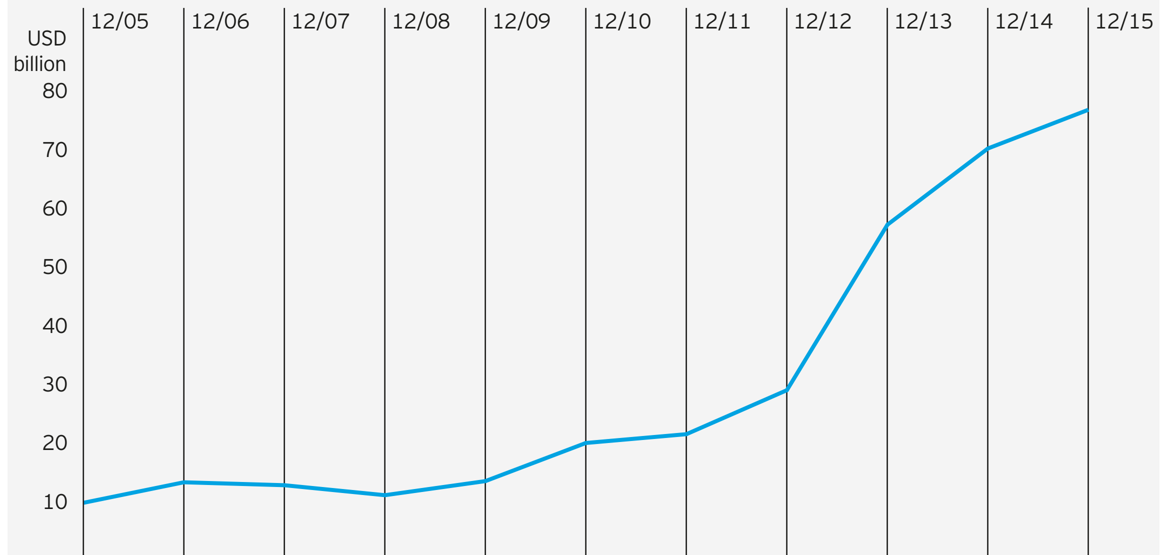
Key takeaways

- We believe the corporate hybrid asset class offers attractive investment opportunities.
- While extension risk has increased since last year due to credit spread widening, we believe several factors help mitigate this risk.
- In our opinion, the economic considerations behind calling and replacing a hybrid, the risk to an issuer's reputation from not calling a hybrid at first call date, and the credit rating agency treatment of corporate hybrids may help reduce extension risk, thus presenting a compelling opportunity in the asset class.

Introduction

Corporate hybrid securities have grown into an important asset class. The segment has expanded rapidly in recent years, as seen in Figure 1, due to its dual appeal to investors and issuers. Because credit rating agencies regard corporate hybrids as part debt and part equity, they have been appealing to corporate issuers seeking support for their credit ratings. Investors have found hybrids attractive due to their relatively higher yields compared to senior debt - although higher yields come with a higher degree of risk. Invesco Fixed Income believes the spread premium offered by corporate hybrids on top of senior debt makes carefully selected hybrids a potentially attractive investment.

Figure 1: Sharp rise in market value of global non-financial corporate hybrids



Source: BofA Merrill Lynch Global Hybrid Non-Financial Corporate Index, data from Dec. 31, 2005 to Dec. 31, 2015.

2015 call dates unfolded as expected

2015 was a milestone year for the corporate hybrid asset class. It marked the arrival of the first call date for a number of issuers. Investors typically prefer companies to honor first call dates to avoid extending the maturity of their bonds. The possibility that bonds will not be called at the first call date is known as "extension risk." Assessing this risk is an important part of our corporate hybrid structure analysis. An issuer's decision to call a hybrid at first opportunity depends in part on whether it can refinance the existing hybrid at a lower coupon than the reset coupon. If a company can refinance at a lower coupon, it makes sense for the issuer to call the existing hybrid and replace it. There are, of course, other important considerations for issuers when it comes to the call decision, such as reputational risk - the risk to an issuer's reputation if it does not act in line with investor expectations that it will call at the first opportunity. Last year, almost all hybrid issuers with a first call date in 2015 ("2015 call hybrids") were able to refinance their instruments at a lower coupon and, apart from one, all instruments were called at the first opportunity.[1]

However, we believe extension risk has risen since last year. Spreads in the corporate hybrid market have widened since a year ago, increasing the likelihood that hybrid issuers will likely face potentially higher financing costs. This increase is largely due to broad risk-off market sentiment and investor caution around potential changes in rating agency methodology that could trigger an early call. With credit spreads wider than a year ago, we believe higher yields may create a disincentive for companies to call their hybrid securities since calling them would mean refinancing at a higher cost. The failure of issuers to call a hybrid on the first call date means investors would bear the impact of an extended term and potentially a lower yield than the prevailing market yield. Nevertheless, despite increased extension risk, we believe the corporate hybrid asset class offers attractive investment opportunities for us as careful investors, especially in the current low interest rate environment.

1 Source: BAML Global Hybrid Non-Financial Corporate Index and the BAML Global Hybrid Non-Financial High Yield Index, as of Dec. 31, 2015.

Corporate hybrid features

Hybrid securities are bond-like in that they pay a predetermined coupon not tied to operational performance. They are equity-like in that their coupons can be deferred indefinitely at the option of the issuer and their maturities are either perpetual or very long-dated. Due to these equity-like features, the rating agencies typically treat these instruments as 50% debt and 50% equity.

The average composite rating for corporate hybrids is currently BBB,[2] which partly reflects their junior status versus the senior debt of what are typically high-quality corporates.

In terms of seniority, hybrids rank in between a company's senior unsecured debt and its common equity. Therefore hybrids carry greater risk than senior debt due to their subordination risk. Other key risks include coupon deferral and extension risk (the risk that they are not called on the first call date). Investors are, however, compensated with additional yield for taking on these additional risks.

The importance of extension risk

The analysis of extension risk is a key part of our assessment of each hybrid instrument's structure. We prefer hybrid securities with a reset coupon that is higher than, or fairly close to, the rate at which we estimate a replacement could be issued. We believe this incentivizes issuers to call at first opportunity. This could, for example, be the case if a company issued a hybrid at a time when it was under fundamental stress and has since improved its credit quality. Therefore, despite broad market spread widening, a company may be able to refinance at a cheaper coupon than the reset level.

Other factors that could help mitigate extension risk:

Reputational risk

Also considered in our analysis of extension risk is reputational risk. If a company wishes to maintain open access to the hybrid market, it may be inclined to meet investor expectations by calling a hybrid, even if it is not able to refinance that hybrid at a lower rate than the reset coupon. We think that, for many companies, access to the corporate hybrid market is important because hybrids are viewed as useful financing tools. Companies often use hybrids, for example, to support their credit metrics since the major rating agencies typically treat these instruments as 50% equity and 50% debt. Companies may also use hybrids as funding for acquisitions, or in order to increase financial flexibility. Furthermore, unlike dividends, interest paid on hybrids is tax deductible for the issuer depending on the jurisdiction of the issuer.

Rating agency treatment

Another element of our assessment of extension risk is our view of equity treatment by the credit rating agencies. The rating agencies typically treat hybrid instruments as 50% equity and 50% debt. For most outstanding hybrids, Standard & Poor's (S&P) treats the hybrid instruments as 50% equity until the hybrid's first call date (i.e. treats the instruments as 100% debt after the first call date). We believe this loss of equity benefit creates a strong incentive to call at the first call date and therefore helps reduce extension risk. We are vigilant of any deviation by S&P from this treatment going forward.

2 Source: BAML Global Hybrid Non-Financial Corporate Index, as of March 31, 2016.

S&P methodology rationale

Under S&P's methodology, the removal of the equity benefit after the first call date is due to the lack of a so-called "replacement capital clause" within most outstanding instruments. This clause says that the hybrid issuer is obliged to replace the hybrid with a similar or subordinated instrument if it is called and it mitigates the reduction in permanence resulting from a step-up in the coupon after the first call date. This clause therefore makes the instrument more permanent or "equity-like." The lack of this clause in outstanding hybrid securities means that, after the first call date, hybrids become less equity-like, leading S&P to treat them thereafter as 100% debt.

With careful security selection, hybrids have the potential to offer relative value opportunities

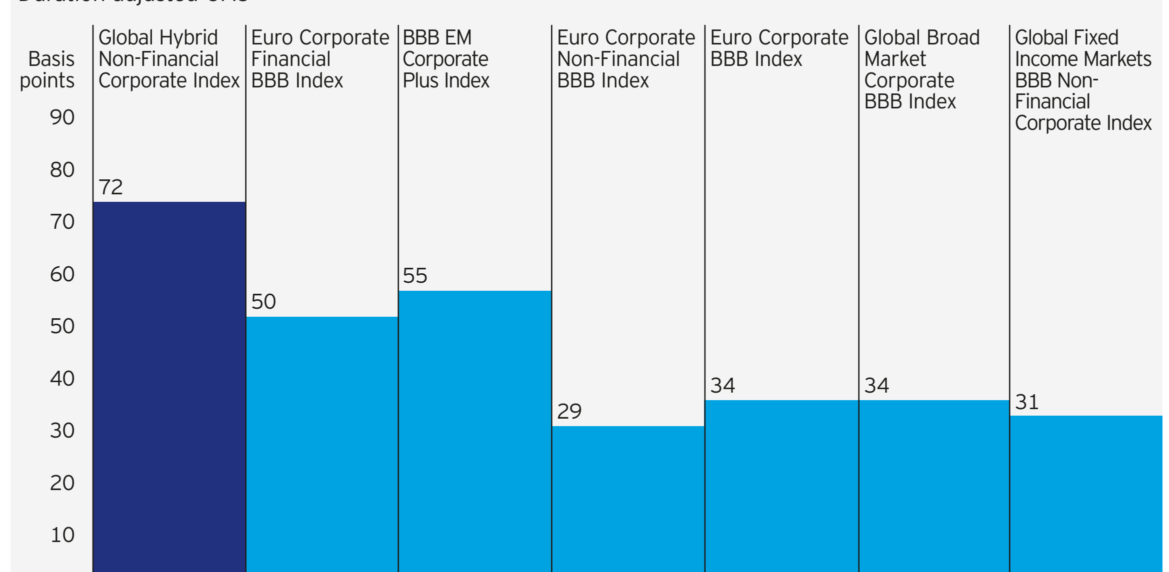
Despite a potential rise in extension risk, we continue to see investment opportunities in the corporate hybrid asset class. As discussed above, we believe a relatively high reset coupon, reputational considerations and rating agency treatment (loss of equity benefit) may help mitigate extension risk. Furthermore, we believe corporate hybrids offer the potential for attractive relative value compared to comparable fixed income alternatives, taking into account increased extension risk.

Relative value comparisons

In Figure 2 below, we have selected a peer group of investable asset classes within the BBB space, as the average corporate hybrid is rated BBB. In order to optimize comparability, we have adjusted for differences in duration. Notably, the Global Hybrid Non-Financial Corporate Index has one of the shortest durations (4.5 years) among the fixed income alternatives shown. On a duration-adjusted basis, the Global Hybrid Non-Financial Corporate Index offered a spread of 72 basis points (defined as spread per year of duration), which compares favorably to other asset classes in the peer group. The Emerging Markets Corporate Plus BBB Index, for example, offered the second highest duration-adjusted spread at 55 basis points.[3]

Figure 2: Corporate hybrid relative value comparison

Duration-adjusted OAS

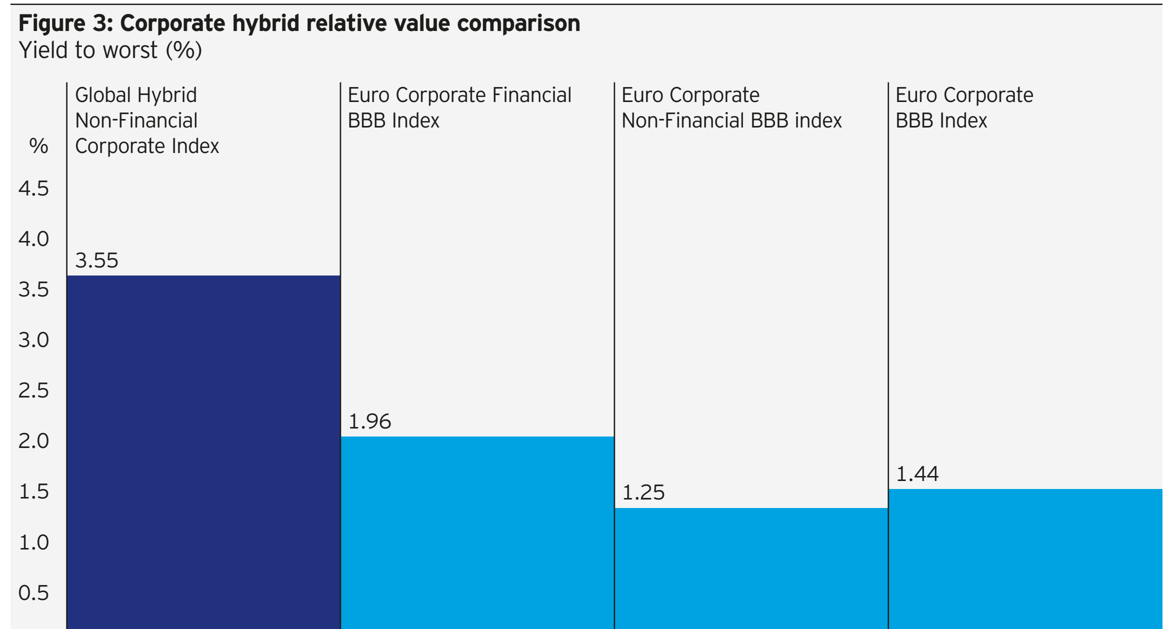


Source: BofA Merrill Lynch Indices as of March 31, 2016.

3 Source: BAML Global Hybrid Non-Financial Corporate Index as of March 31, 2016.

On a yield basis, the Global Hybrid Non-Financial Corporate Index offered the highest yield (3.55%) when compared to euro-denominated indices such as the EUR Corporate Financial BBB Index (1.96%), as seen in Figure 3 below. We have selected the euro-denominated indices as comparisons since the Global Hybrid Non-Financial Corporate Index is predominantly (about 80%) comprised of euro-denominated instruments.[4]

Figure 3: Corporate hybrid relative value comparison
Yield to worst (%)



Source: BofA Merrill Lynch Indices, March 31, 2016.

Conclusion

We believe the additional spread that corporate hybrids offer over the yield offered by senior debt makes carefully selected hybrids an attractive investment. While extension risk has increased since last year due to credit spread widening, we believe there are mitigating factors. In our opinion, therefore, it is possible to find compelling investment opportunities by carefully analyzing credit fundamentals and the hybrid's structure and by performing a relative value assessment.

4 Source: BAML, as of March 31, 2016.

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