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Investing for a
world of change

Credit spotlight: Corporate hybrids

Multi-Asset Credit — understanding the universe

January 2024

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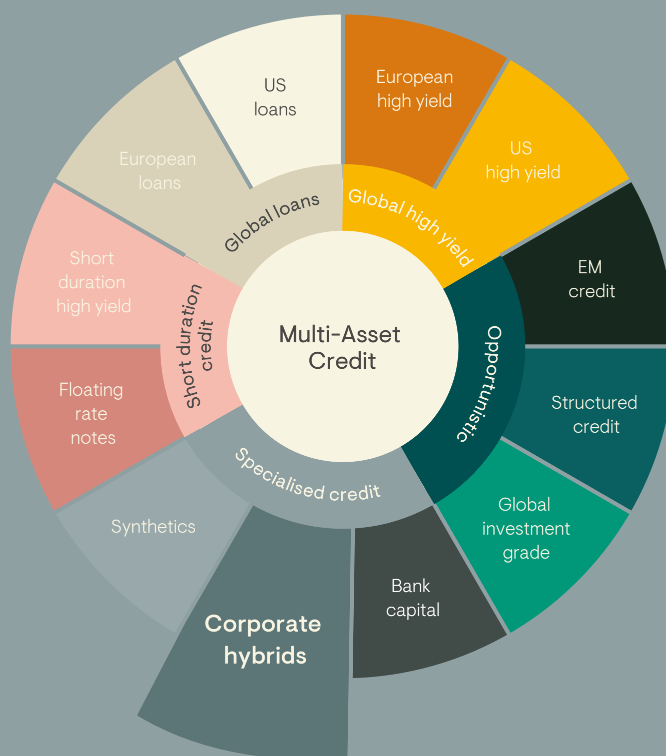
Our Multi-Asset Credit strategy aims to generate attractive long-term total returns by investing dynamically across global credit markets.

To target a smoother investment journey and competitive risk-adjusted performance, the team actively allocates across a broad credit opportunity set.

Ninety One's Multi-Asset Credit strategy



A key feature of our approach is our ability to use the broad opportunity set and seek to dynamically allocate the portfolio to the more attractive elements of the credit market at the right time.

For further information on investment teams and investment process, please see Important information section.
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The fast view

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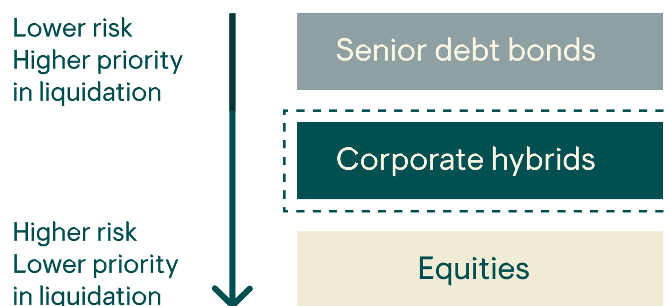
- Corporate hybrids are subordinated bonds that are generally issued by investment-grade companies.
- They are either perpetual (i.e., have no maturity date) or have very long maturities, typically over 60 years.
- They are known as hybrids as they combine features of bonds (coupon payment, callability) and equities (coupon deferral, long maturity).
- For issuers, corporate hybrids enhance the credit quality of the senior part of the capital structure, allowing issuers to retain higher credit ratings.
- For investors, corporate hybrids typically offer a pickup in spread over senior bonds from the same issuers, given their subordinated nature.

What are corporate hybrids?

Corporate hybrid securities are instruments that are typically issued by companies with investment-grade credit ratings. They are either perpetual (i.e., have no maturity date) or have very long maturities, typically over 60 years. Corporate hybrids earn their name due to having characteristics of bonds and equities: like bonds, they pay a predetermined coupon that is not tied to the issuing company's performance; and similar to equities, they are perpetual or have a very long maturity.

In terms of seniority, corporate hybrids rank between a company's senior unsecured debt ('senior debt') and common equity. They are typically rated two notches below the company's senior debt rating, reflecting their subordinated nature. As an example, Enel, an Italian energy company has senior debt ratings of Baa1/BBB/BBB+ across all three rating agencies but is rated Baa3/BB+/BBB- for its hybrid debt.



Corporate hybrids provide a number of advantages for both investors and issuers, which make them an interesting alternative to traditional bonds.

Benefits for issuers

As a result of the structural features outlined above, ratings agencies only include 50% of the nominal amount of issuance in their debt calculations, effectively treating a hybrid as 50% equity. Compared with issuance of a typical bond, a hybrid issue therefore results in a lower total level of debt on a company's balance sheet as far as rating agency calculations are concerned, therefore protecting the issuing company's credit metrics and reducing funding costs.

Another structural feature of corporate hybrids is the ability to defer coupon payments in times of market stress. This is a key advantage for the issuer – allowing them to meet their debt obligations. In reality, coupon deferral is a very rare occurrence as it prevents the company from paying dividends, which would naturally be perceived negatively by the market. In the event that coupons are deferred, they are done so on a cumulative and likely compounded basis so that any missed payments are fully met at a later date, potentially at a higher cost to the issuer. Corporate hybrids also give the issuer the option to not call (repay) the bond on its first call date, which is typically five or 10 years after issuance. In practice, corporate hybrids are usually redeemed on their first call date as coupons are reset to a floating rate after this point, and hybrids can also lose their 50% equity treatment if the option to call is not exercised.

A further benefit for issuers is that their position in the capital structure means corporate hybrids enhance the credit quality of a company's senior debt. A good example is in the utilities sector, where increased capital expenditure has been required to fund the energy transition, necessitating greater issuance of debt. The inclusion of hybrids in the capital structure has therefore allowed issuers in this sector to retain high-BBB senior debt ratings despite increasing levels of leverage.

A compelling investment opportunity

From an investor's perspective, due to their lower credit rating corporate hybrids typically offer a pickup in spread over senior debt bonds of the same issuer. For example, an investor could be paid an additional 200bps of spread annually to hold the corporate hybrids over the senior instrument.

Weighing the risks

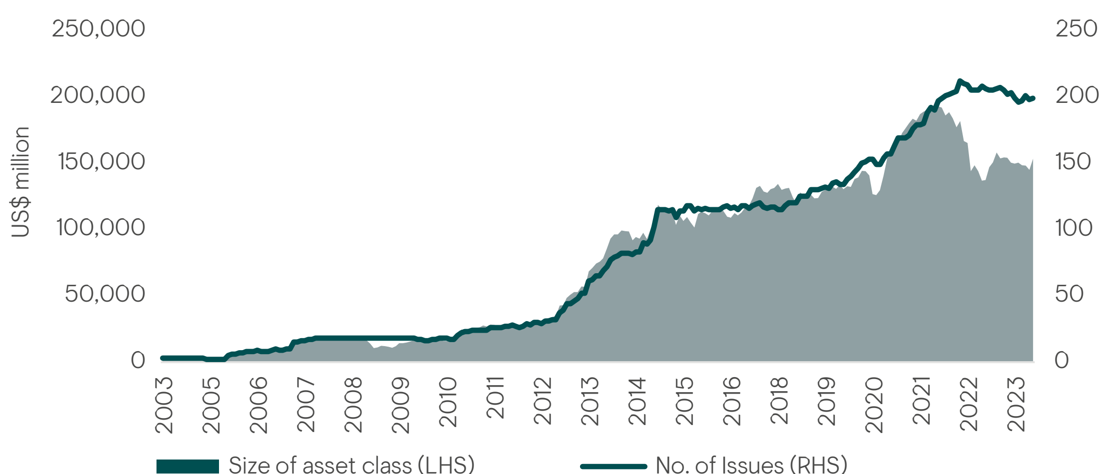
As with any investment, it is important to consider the risks as well as the opportunities, and many of the benefits that corporate hybrids offer to the issuer also represent a risk for an investor. It is these risks that allow investors to get the spread pick-up discussed above, and which need to be priced accordingly. The first example of this is extension risk; by offering the issuer the option not to call a bond on its first call date, investors in hybrids may have to bear the impact of an extended term and any potential market volatility in that period. The option of coupon deferral is also clearly a negative feature for investors looking to receive regular income.

Also, due to its position in the capital structure, in the event that a company becomes insolvent and its assets are liquidated, holders of corporate hybrids will be paid out after those who own more senior debt, meaning the credit risk with these instruments is higher. However, it is important to note that corporate hybrids are typically still investment-grade rated.

What does the market look like?

The global corporate hybrids market has exhibited significant growth over the last 20 years, going from a market size of US$1.5 billion in 2003 to c.US$150 billion today. This has also been reflected in the number of bonds in the market which has increased from only three to roughly 200. The number of issuers that currently have corporate hybrids in the market has grown to 80; as a result, the asset class is now much deeper and more diversified.

Figure 1: Growth of the asset class



Source: ICE BofA Merrill Lynch as at 30 November 2023. Data represents a combination of the ICE BofA Global Hybrid Non-Financial Corporate Index (GNEC) and the ICE BofA Global Hybrid Non-Financial High Yield Index (HNEC).

Looking through a sectoral lens, the majority of the issuance has been from companies in the utility, energy and telecoms sectors. These account for roughly two thirds of the market. This is a reflection of the significant capital expenditure requirements for companies in these sectors – corporate hybrids have been issued to protect the credit rating of issuers' senior debt despite higher leverage. Outside of Volkswagen, which has been a large issuer of hybrids, the three largest issuers currently in the market are EDF, TotalEnergies and Telefonica Europe, again reflecting the appeal of issuing corporate hybrids in the above sectors.

Figure 2: Breakdown by sector

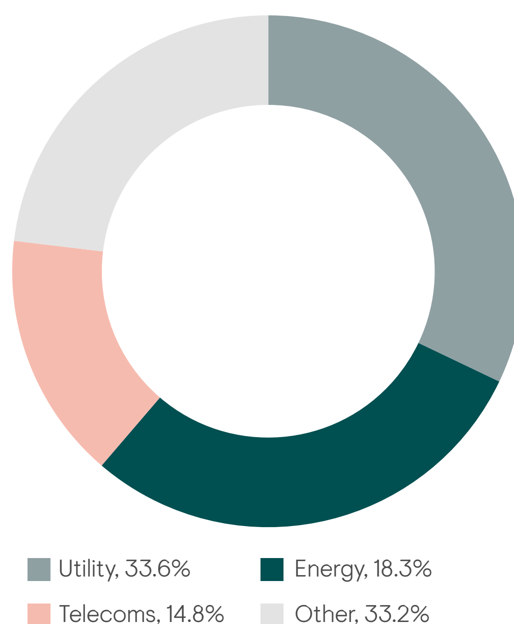
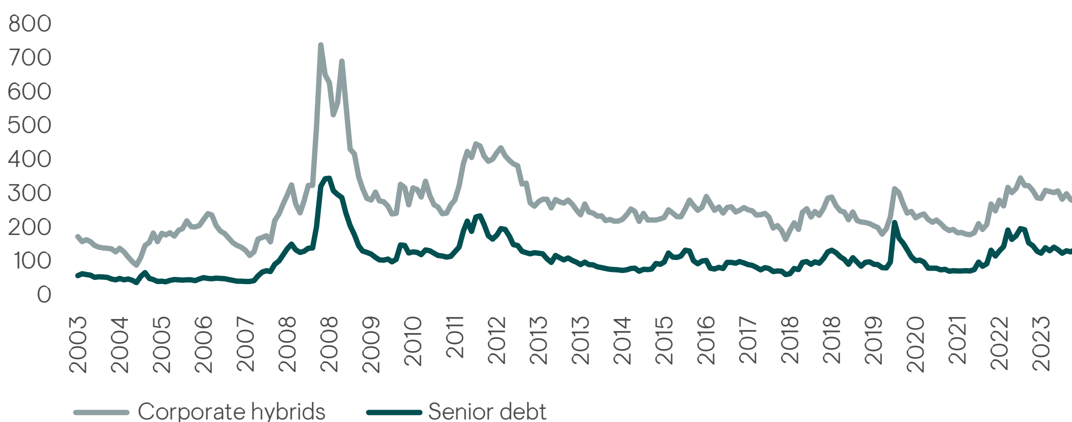


Figure 2: This is not a buy, sell or hold recommendation for any particular security. Source: ICE BofA Merrill Lynch as at 30 November 2023. Data represents combination of the ICE BofA Global Hybrid Non-Financial Corporate Index (GNEC) and the ICE BofA Global Hybrid Non-Financial High Yield Index (HNEC).

Yields and returns

Over the last 20 years, the corporate hybrid market has offered an average of just over 150bps spread over senior debt, representing a significant pickup for an instrument that is typically only two notches lower on the rating spectrum.

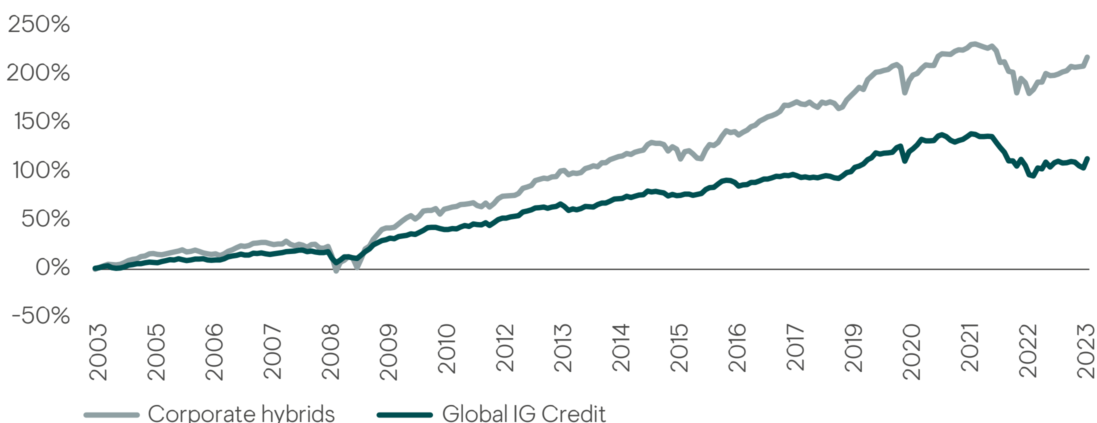
Figure 3: Spread of hybrids vs. senior debt



Source: ICE BofA Merrill Lynch as at 30 November 2023. Data represents the ICE BofA Global Hybrid Non-Financial Corporate Index (GNEC) and the ICE BofA Euro Senior Non-Financial Index (ENS0).

As a reflection of their superior return potential, corporate hybrids have significantly outperformed global investment-grade credit over the last 20 years, generating a cumulative return of 218% (5.96% pa) compared to the 114% (3.87% pa) for the global investment-grade credit market. This clearly demonstrates the potential benefits that these instruments can offer to enhance the total returns of a multi-sector credit strategy. It is important to note that the market has exhibited higher levels of volatility, and as such we feel is best accessed as part of a diversified portfolio rather than a standalone allocation.

Figure 4: Cumulative performance



Past performance does not predict future returns; losses may be made.
Source: ICE BofA Merrill Lynch as at 30 November 2023. Data represents the ICE BofA Global Hybrid Non-Financial Corporate Index (GNEC) and the ICE BofA Global Corporate Index (G0BC). For further information on indices, please see Important information section.

Summary

We believe that corporate hybrids offer a compelling investment opportunity as an alternative to traditional bonds. Due to a higher level of credit risk, corporate hybrids also typically provide a significant pickup in spread over the senior debt of the same issuer – more than compensating for the extra credit risk. The market has grown significantly over the last 20 years to become deeper and more diversified. We believe that corporate hybrids can be a very useful tool as part of a diversified portfolio, such as multi-sector credit strategies.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made.

Specific risks: Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated. **Loans:** The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Many loans are not actively traded, which may impair the ability of the Portfolio to realise full value in the event of the need to liquidate such assets.

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