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Corporate Hybrids Take the World Stage

Despite declining in size since 2021, and skeptics calling for its demise amid rising interest rates, the European-standardized corporate hybrids market has experienced a resurgence since the second half of 2023. Notably, new issuers have entered the market for the first time, including Spain's Redeia, Australia's APA Infrastructure and Vår Energy from Norway.

Moreover, we continue to see growth in the U.S. hybrid market, and we think we may be on the verge of a period of concerted globalization for the asset class. We have already seen some evidence of convergence on European standards in U.S. hybrid issuance, heightening their attractiveness to global investors, and we think recent changes to rating methodology by Moody's significantly enhances their appeal to U.S. Corporate Treasurers.

We regard these as pivotal developments for the global corporate hybrids market. Similar evolution in other less-mature asset classes has often provided opportunity for global players. At Neuberger Berman, we believe our comprehensive global research capabilities equip us to capitalize on this opportunity.

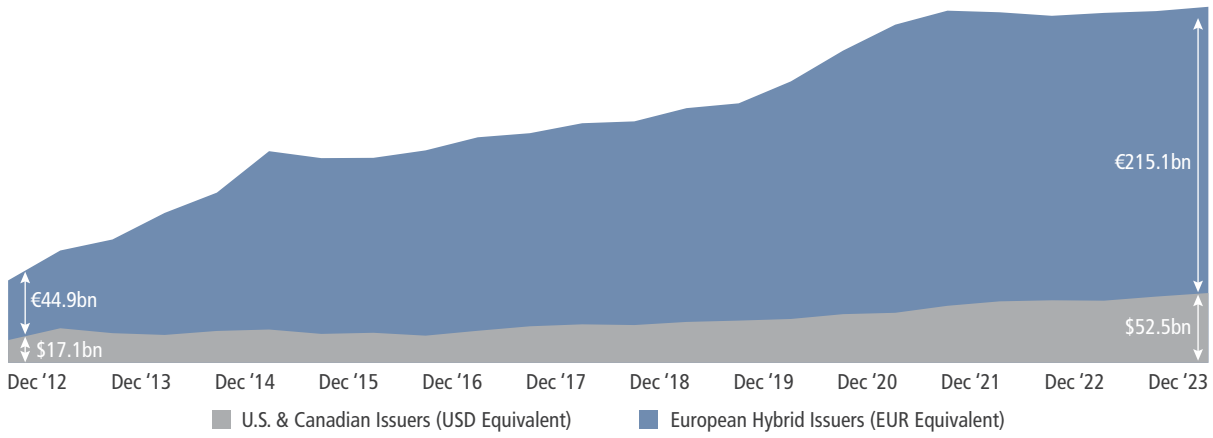
Executive Summary

- We believe European issuers have dominated the global market in corporate hybrid securities because European structures have standardized on an optimal "sweet spot" between the needs of investors and issuers while the U.S. hybrid market has remained fragmented.
- In our view, one reason for this fragmentation has been the way Moody's rating methodology treated U.S. hybrids: a change to this methodology makes hybrids significantly more attractive to U.S. Corporate Treasurers, and we expect this to trigger growth in the U.S. market.
- We already see early signs of convergence with European standards in the U.S. market, and anticipate more—possibly in the form of a two-tier split between long-dated instruments with coupon step-ups (the most common European structure) and the increasingly popular 30-year structures with no step-ups (effectively the same as European hybrids with 10-year first call dates).
- This convergence marks a shift toward more investor-friendly structures, and reinforces the importance of hybrid structure and loss of equity content in the risk-profile of hybrids; this does not appear to be well understood in the immature U.S. market, and in the immediate term that creates relative-value as well as diversification opportunity for experienced hybrid investors.
- Over the longer term, as global standardization advances and the complexity of the U.S. market declines, we believe Neuberger Berman's strong global research capabilities and ability to invest in corporate hybrids globally make us uniquely positioned to take advantage of the resulting opportunities.

Back in 2012, issuers from Europe accounted for more than 70% of the global market in corporate hybrid securities. Since then, they have been the source of 80% of the market's growth.

It is very unusual for Europe to be the most fertile ground in which to grow a financial asset class to maturity. Why has it been the case with hybrids, and why do we think other markets are about to take off at last?

FIGURE 1. SIZING THE CORPORATE HYBRID ASSET CLASS: A "EUROPEAN" ASSET CLASS
Total amount outstanding, EUR or USD equivalent



Source: Bloomberg.

How Corporate Hybrids Came to Be a "European Market"

We believe the main reason Europe has been so receptive to hybrid issuance is because the structures in this market quickly standardized to an optimal "sweet spot" between the respective needs of investors and issuers. That, in turn, owes a lot to the way in which the tax-deductibility of coupons is treated, and how this relates to the treatment of hybrids by Moody's, the rating agency.

The European corporate hybrids market is relatively simple. These securities are bonds with some equity-like characteristics. Like equity, they are either long-dated or perpetual and, like dividends, their coupon payments can be deferred without triggering a default. They generally come with a first call date set five or 10 years after issuance and, to incentivize issuers to exercise that call option, most European hybrid coupon rates are automatically "stepped up," periodically, if they are left outstanding.

In recognition of their equity-like features, the main rating agencies—including Moody's—assess European hybrids as having 50% equity content.[1] However, this equity content may not last forever. For Moody's, it expires 10 years before the hybrid's maturity date. For Standard & Poor's (S&P), equity content lasts until 20 years before the hybrid's "effective maturity," which is the sooner of (i) the instrument's actual maturity date or (ii) the date when cumulative coupon step-ups have reached 100 basis points or higher. Because European investors prefer some certainty about the shorter duration of hybrid securities, issuers have tended to structure European hybrids to align with S&P's methodology: their coupons generally step up to 100 basis points after 25 or 30 years, which means that S&P's "effective maturity" and loss of equity content coincides with the hybrid's first call date in year five or 10, further increasing the issuer's incentive to call on that date.

While rating agencies recognize these equity- and dividend-like features, European tax authorities nonetheless treat hybrid coupons as tax-deductible bond coupons. It's that combination that enables hybrids to occupy the sweet spot between investors and issuers.

For investors, hybrids offer effectively short-duration exposure to overwhelmingly investment-grade issuers, compensating them for subordination risk and the value of the call option to the issuer with high yield-like spreads that are meaningfully wider than the same issuers' senior bond spreads. This is a valuable addition to the fixed-income investor's toolbox: buying a corporate hybrid over a high-yield bond is equivalent to buying subordination risk over additional credit risk or, said differently, choosing "higher loss in the event of default" (by going down the capital structure) over "higher probability of default" (by going down the rating spectrum).

For their part, European Corporate Treasurers like the 50% equity content that hybrids get from rating agencies because they therefore contribute less to an issuer's leverage metrics than the equivalent amount of traditional senior debt.[2] And because Europe's tax authorities, like others in the developed world outside the U.S., accept hybrid coupons as tax-deductible, they are also cheaper than equity. The overall effect of issuing them instead of senior debt or equity is to lower both gearing and the weighted average cost of capital (WACC).

[1] We use the terms "equity credit" and "equity content" interchangeably throughout this article.
[2] In addition, corporate hybrids are considered 100% equity under the International Financial Reporting Standards.

FIGURE 2. ISSUING HYBRIDS CAN LOWER THE WEIGHTED AVERAGE COST OF CAPITAL

A hypothetical corporate capital structure, with and without hybrid capital

Initial Capital Structure & Initial WACC

	Debt	Hybrids	Equity
% Mix in the Capital Structure	40%	0%	60%
Corporate Tax Rate (US)	28%	28%	0%
Cost of Capital	5.5%	7.5%	10.0%
Post-Tax Cost of Capital	4.0%	5.4%	10.0%
Weighted Average Cost of Capital	7.6%		

Capital Structure & Initial WACC - When Hybrids replaces Equity Issuance

	Debt	Hybrids	Equity
% Mix in the Capital Structure	40%	15%	45%
Corporate Tax Rate (US)	28%	28%	0%
Cost of Capital	5.5%	7.5%	10.0%
Post-Tax Cost of Capital	4.0%	5.4%	10.0%
Weighted Average Cost of Capital	6.9%		
Δ WACC with hybrids	-0.7%		

Source: Neuberger Berman. For illustrative purposes only.

So, why haven't hybrids taken off on the other side of the Atlantic?

Unlike their counterparts in Europe, U.S. tax authorities only allow tax-deductibility when an issuer can trigger a default by missing its coupon payments. As a result, U.S. hybrid structures have evolved so that coupons can be deferred only for a specific amount of time, usually 10 years, after which a default and bankruptcy is triggered.

Because this possibility of default makes U.S. hybrids less equity-like than European hybrids, Moody's, which has historically classified the equity credit it assigns to certain instruments into five buckets of 0%, 25%, 50%, 75% and 100%, placed U.S. hybrids in the 25% bucket. This has incentivized U.S. issuers to choose preferred securities over hybrids, as Moody's put preferreds into its 50% bucket to reflect their junior, more equity-like position in a capital structure. For U.S. issuers, the lack of tax-deductibility on preferreds' dividends has generally been outweighed by the advantages of this 50% equity credit.

FIGURE 3. A DISTINCTION WITHOUT A DIFFERENCE? "U.S." PREFERREDS AND "EUROPEAN" HYBRIDS

	Preferred Securities	Hybrid Securities
Maturity	Perpetual	Long-dated or perpetual
Issuer Call Option	5 – 10 years from issuance	5 – 10 years from issuance
Format	$1,000 par (institutional) or $25 par (retail); exchange traded	Mostly $1,000 par; institutional
Payment Obligation	Discretionary payments that can be suspended indefinitely without triggering a default. Payments may be cumulative or non-cumulative. U.S. banks and insurance preferreds are non-cumulative.	Deferrable but cumulative. (For U.S. issuers, payments are generally deferrable for a specific number of years, after which they must be paid.)
Payment Type	Dividend	Interest
Coupon Type	Fixed to floating rate; fixed-for-life; fixed-to-fixed. Very rarely with a step-up.	In U.S.: Pre-2020: mostly fixed to floating rate (sometimes with step-ups) Post-2020: fixed-to-fixed (sometimes with step-ups)
		In Europe: fixed-to-fixed with step-ups
Capital Structure Priority	Above common equity, but below all other debt	Above preferred securities or equivalent, but below all other debt
Predominant Region of Issuance	U.S.	Europe

Source: Neuberger Berman.

This headwind against the U.S. hybrid market is now easing significantly.

On February 1, 2024, Moody's published a new, simplified methodology for assessing hybrid equity credit. From now on, it will classify securities into just three buckets—0%, 50% and 100%. This new framework effectively dissolves the distinction between hybrids and preferred securities issued by investment-grade corporates, assigning them both 50% equity credit—despite the fact that hybrids remain senior to preferreds.[3] With regard to U.S. hybrids, this brings Moody's assessment of the *amount* of equity credit into line with that of the other major rating agencies (although its methodology for determining how long it lasts remains different).

We think this substantially enhances the attractiveness of hybrids to U.S. Corporate Treasurers. They now come with the same equity content as preferred securities but the cost advantage of tax-deductible coupons.

We believe the additional 25% equity credit from Moody's has been "propping up" the preferreds market, which has never been unequivocally favored by issuers because it is relatively small and predominantly retail. As such, we anticipate rapid growth in refinancings of preferred structures into hybrids once U.S. Corporate Treasurers familiarize themselves with the asset class.

U.S. and European Hybrids: Early Signs of Much-Needed Convergence

While the change at Moody's lays the foundation for a growing U.S. hybrids market that is both investor- and issuer-friendly, to realize that potential we think the market needs to become much more standardized and less fragmented than it is today. In essence, it needs to become more "European."

As we have seen, European hybrids—with their coupon step-ups and loss of equity content timed to coincide with the first call date, which gives investors a good amount of visibility and certainty as to how to price a hybrid's duration—have evolved to fit well with the rating agencies' methodology for assigning equity content. We have begun to see tentative signs of convergence on European standards, but U.S. hybrids have been and are still being issued with many different structures, with little apparent optimization to rating agencies' methodologies.

[3] https://www.moodys.com/research/Moodys-updates-its-methodology-for-hybrid-equity-credit--PBC_1351072.

To explain what we mean, consider the two examples of typical European hybrid structures (which are also sometimes seen in the U.S.), alongside the three examples of alternative structures commonly issued in the U.S. market, in figure 4.

FIGURE 4. EUROPEAN VERSUS U.S. HYBRID STRUCTURES

The European Model: Loss of Equity Content at First Call Date

PerpNC5 or 60NC5 Step-Up Structures: First 25bps Step-Up in Year 10, a further 75bps in Year 25

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn	Fix Cpn + 0bps Step-Up	Fix Cpn + 25bps Step-Up			Fix Cpn + 25bps +75bps Step-Up						
S&P Methodology	50% Equity Credit	0% Equity Content - Hybrid treated as pure debt										

PerpNC10 or 60NC10 Step-Up Structures: First 25bps Step-Up in Year 10, a further 75bps in Year 30

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn	Fix Cpn + 0bps Step-Up	Fix Cpn + 25bps Step-Up						Fix Cpn + 25bps +75bps Step-Up			
S&P Methodology	50% Equity Credit		0% Equity Content - Hybrid treated as pure debt									

Examples of U.S. Hybrid Structures

60NC5 No Step-Up Structures: A 5yr Bond or a 40yr Bond?

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn	Fix Cpn + 0bps Step-Up										
S&P Methodology	50% Equity Credit							0% Equity Content - Hybrid treated as pure debt				

40NC5 No Step-Up Structures: A 5yr bond or a 20yr Bond?

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn	Fix Cpn + 0bps Step-Up										
S&P Methodology	50% Equity Credit					0% Equity Content - Hybrid treated as pure debt						

30NC5 No Step-Up Structures: A 5yr bond or a 10yr Bond?

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn	Fix Cpn + 0bps Step-Up										
S&P Methodology	50% Equity Credit			0% Equity Content - Hybrids treated as pure debt								

Source: Neuberger Berman.

The first example is a typical European perpetual or 60-year hybrid with a first call date at five years (PerpNC5 or 60NC5). The first coupon step-up doesn't occur until year 10, but the cumulative coupon step-up hits 100 basis points in year 25. As a reminder, under S&P's hybrid methodology, a hybrid loses its equity content 20 years before its effective maturity, which is the sooner of (i) the instrument's actual maturity date or (ii) the date when cumulative coupon step-ups have reached 100 basis points or higher. As such, the S&P equity content of this instrument is lost if it is left outstanding beyond its first call date in year five. The second example is a perpetual or 60-year hybrid with a first call date at 10 years (PerpNC10 or 60NC10). Again, the coupon step-up schedule means the equity content is lost after that first call date, in year 10.

As we mentioned above, the incentive baked into this loss of equity content is critical. Once equity content goes, the hybrid effectively becomes an expensive piece of straight subordinated debt, as it no longer reduces leverage from the rating agencies' perspective, and the full hybrid coupon gets included in the Interest Coverage Ratio. To assess the like-for-like refinancing cost the issuer would therefore look at spreads in the senior bond market. Senior spreads are invariably narrower than hybrid spreads, so the economic incentive to call is decisive—the only real question is whether to refinance at a lower senior spread or to pay up to regain the equity content with a new hybrid. This helps to explain why, from 2013 to 2023, 99% of European-standardized corporate hybrids from investment-grade issuers were called at the first call date. Such a strong track record highlights just how valuable the equity content is for issuers. Indeed, issuers have tended to call at the first call date even when the call-economics have favored extensions: for example, a non-stressed issuer in a stressed sector—European Real Estate in 2022—paid 232bps of excess spread on a new instrument just to retain the equity content in the capital structure, indicating the value of the favorable rating agency treatment.

Now let's consider the U.S. structures in figure 4. These illustrate a common feature of U.S. hybrids: the lack of coupon step-ups. Without this, the point at which equity content is lost becomes entirely a function of the hybrid's actual maturity date—and a whole range of different tenors are seen in the U.S. market. One of our examples is a 60NC5 bond: this can be called in year five, but doesn't lose its equity content until 20 years before its actual maturity, or year 40. Should it be priced as a five-year bond or a 40-year bond? And should our 40NC5 bond have the duration of a five- or a 20-year bond?[4]

Longer-dated structures without coupon step-ups are much less likely to be called at the first call date than those with coupon step-ups because the equity content will stay in place for many more years. Moreover, when equity content stays in place, the issuer looks at spreads in the hybrids market rather than the senior market to assess the cost of refinancing like-for-like. That means the decision to refinance or to leave a hybrid outstanding—and therefore the pricing of that hybrid—becomes highly sensitive to changes in market environment rather than to the different qualities of the hybrid and senior instruments. If spreads have gone up since the hybrid was issued, and there is no coupon step-up, the incentive to leave it outstanding is decisive because there is no requirement to forego the equity content. Our 60NC5 hybrid should therefore be priced as a (very long-duration) 40-year bond, not a (short-duration) five-year bond.

What we would draw attention to, however, is the increasing popularity of the final structure shown in figure 4, the 30NC5. Like the other two U.S. structures, this hybrid has no coupon step-ups, but because its 30-year maturity is relatively short, it loses its equity content in year 10—just as our relatively common European PerpNC10 or 60NC10 do due to their step-ups.

Alongside the change to Moody's rating methodology, we think this gravitation of U.S. issuers to the 30NC5 structure signals the start of a convergence of the U.S. and European hybrid markets—with more European corporates expected to issue in U.S. dollars and more U.S. corporates exploring both the European and U.S. markets through 30NC5 structures. We see this is as the start of the "mainstreaming" of hybrid capital among U.S. non-financial corporates.

[4] To further complicate matters, in the U.S. market we see perpetual hybrids with no coupon step-ups and hybrids which step from fixed to floating rate coupons, reflecting the legacy influence of preferred securities in this market.

A Two-Tiered U.S. Market Converging on European Standards

We believe the U.S. corporate hybrid market will initially grow as corporates refinance preferred securities into subordinated instruments, spurred on by the change in methodology at Moody's. This will enable corporations to tap the institutional market more easily and benefit from the tax advantages of hybrids.

Once that initial refinancing wave is over, we believe there can be sustained, medium-term growth in the market, for the same reasons that have made corporate hybrids an essential funding instrument for European large caps. We also anticipate continued standardization, and possibly the formation of a two-tiered U.S. hybrid market split between long-dated instruments with coupon step-ups (the most common European structure) and 30NC5 structures with no step-ups (which are effectively the same as European PerpNC10 hybrids with step-ups).

Moody's methodology change comes at a ripe time, as M&A activity is picking up and U.S. corporate capex is increasing rapidly.[5] This is especially notable in the Utility sector, driven by the need to maintain, harden, decarbonize and expand the grid to accommodate the energy transition, but near- and re-shoring of the industrial asset base is triggering significant capital investments in other sectors, too. Adding some equity-like instruments to capital structures can help to mitigate the impact of these expenditures on rating agencies' assessment of credit metrics.

Ultimately, we think we could start to see a geographical rebalancing not only in new hybrid issuance, but also in investor demand, as global standardization comes a step closer and complexity diminishes.

CROSS-CURRENCY VALUE IN EUROPEAN-STYLE U.S. HYBRIDS

We have noticed a tendency for U.S. investors to price U.S. hybrids as if the market environment always trumps the hybrid structure. This is indeed the case for extremely long-dated securities with no coupon step-ups, but the same pricing assumptions are often evident for shorter-dated securities where the two factors are more finely balanced. For example, the 30NC5 bond in figure 4 that loses its equity content in year 10 ought, in theory, to trade as if it were a 10-year bond, but more often trades more like a 30-year bond.

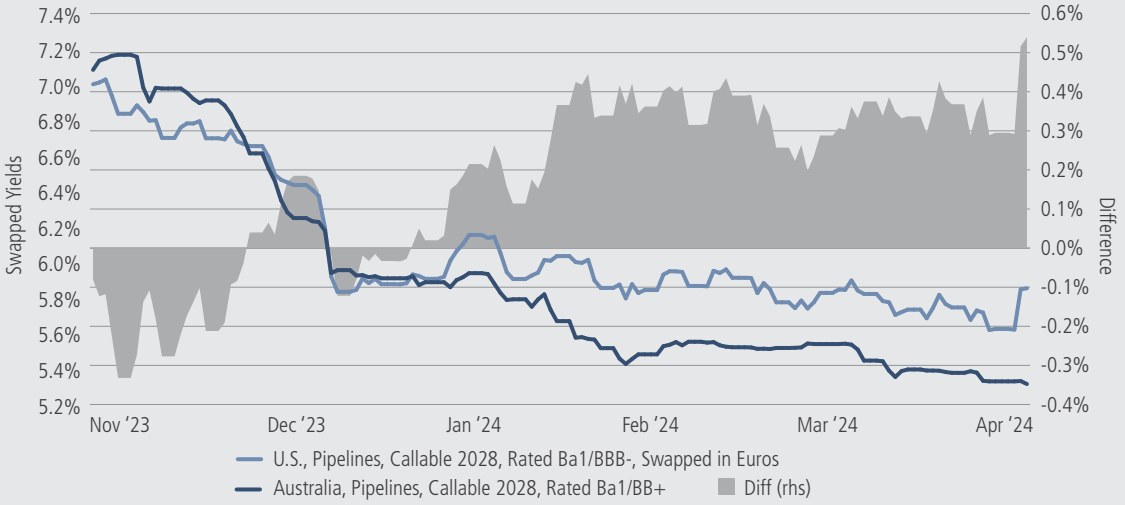
The four case studies shown here indicate that same tendency, in normal market conditions, for European-style hybrids from North American issuers to be priced at a premium over those from European issuers. That premium currently sits at around 40 basis points for BB rated TMT hybrids and around 50 – 80 basis points in the Commodities sector, after currency-hedging costs, for example. These differentials most likely reflect the asset class's lack of history in North America relative to the European market, and particularly a tendency in the U.S. market to price even European-style hybrids with more extension risk.

With its strong U.S. research capabilities and an ability to invest in U.S. dollar corporate hybrids, we believe Neuberger Berman is uniquely positioned to take advantage of this regional mispricing.

[5] For example, see Kelly Weber, "Bulking Up: Energy Sector Consolidation Accelerates" (October 2023), at https://www.nb.com/en/us/blog/fixed-income/bulking-up-energy-sector-consolidation-accelerates.

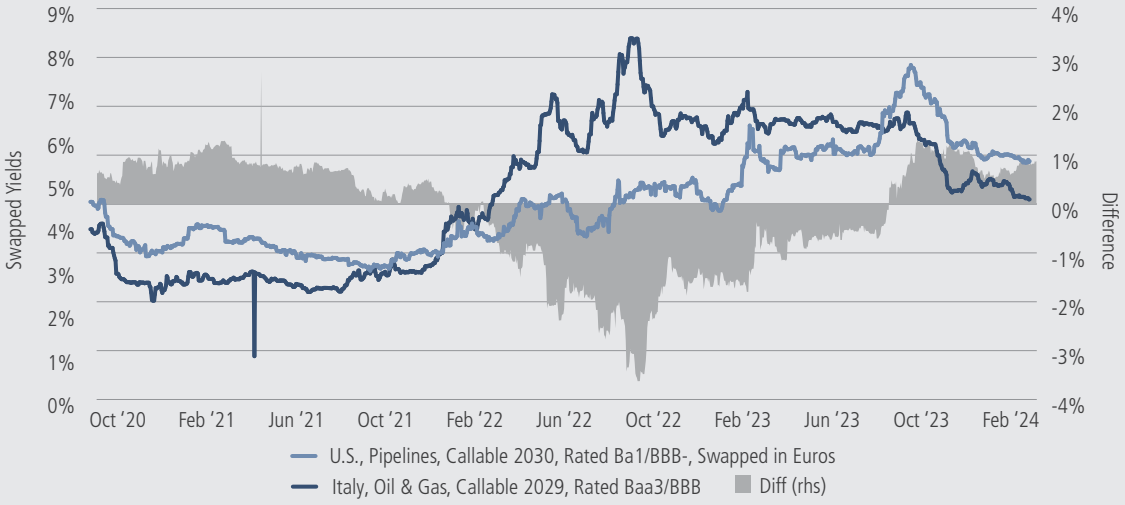
A seasoned U.S. issuer versus a new entrant Australian issuer: same structure, with loss of equity content at first call date; both in the Midstream Energy sector; similar credit rating

Euro-equivalent yields and yield differential



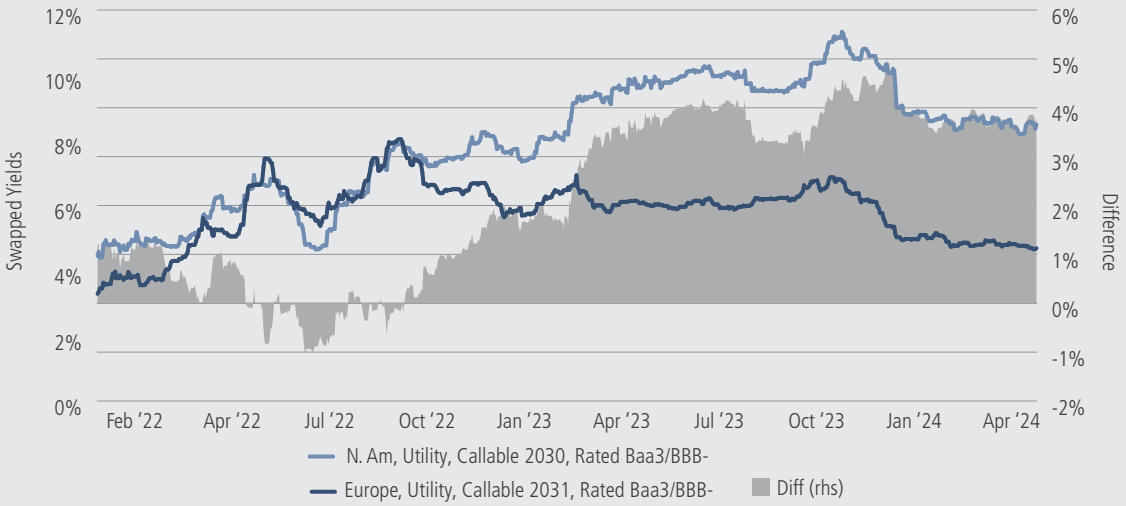
A seasoned U.S. Midstream Energy issuer versus an Italian Oil & Gas issuer: same structure, with loss of equity content at first call date; similar credit rating

Euro-equivalent yields and yield differential



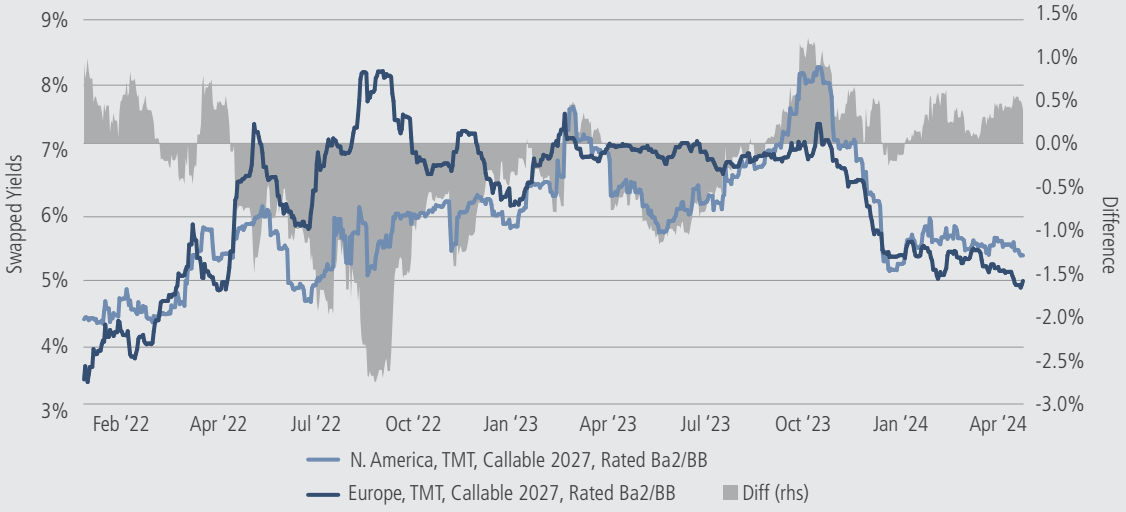
A seasoned North American issuer versus a European issuer: same structure with loss of equity content at first call date; both in the Utility sector; same credit rating

Euro-equivalent yields and yield differential



A North American issuer versus a European issuer: same structure, with loss of equity content at first call date; both in the TMT sector; same credit rating

Euro-equivalent yields and yield differential



Source for illustrations: Bloomberg, Neuberger Berman. Data as of April 3, 2024.

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