Insights

CORPORATE HYBRID BONDS – AT A GLANCE

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SUMMARY

The corporate hybrid bond market has recently drawn the attention of corporate bond issuers, investors and rating agencies. In a falling interest rate environment and generally constructive primary and secondary European debt capital markets activity, seasoned issuers across sectors – including utilities, real estate, and energy – have accessed debt capital markets in the hybrid format, often with tight pricing spreads. Corporate utility companies represent the primary issuers of corporate hybrid bonds on account of current significant capital expenditure needs, and, looking forward, the need to raise capital to increase energy capacity in order to accommodate AI and data center development. Therefore, hybrid bonds are expected to be a core financing option for the utility sector.

In this article, Vishal Mawkin (partner, London), Andrew Rodman (counsel, New York) and Asad Khan (trainee solicitor, London) of BCLP provide an overview of the key corporate hybrid bond terms, noting important considerations for issuers and investors.

WHAT ARE CORPORATE HYBRID BONDS?

Corporate hybrid bonds share many of the same terms and features as traditional senior bonds while also behaving from a commercial perspective in a similar manner to equity securities. Corporate hybrid bonds are usually issued by investment grade issuers, and are subordinate to the claims of all, or certain categories, of the issuer's other creditors on insolvency.

Key characteristics of corporate hybrid bonds can include:

- Bonds that are subordinate to claims of senior creditors on an insolvency;
- Long-dated bonds that are callable (typically five to 10 years from issuance - generally with an investor expectation that the bonds will be called on the first call date);

- Coupon reset features for which the interest rate is fixed, but resets at different reset dates based on an applicable benchmark;
- The right of an issuer to elect, at its option, to defer payment of all or part of interest accrued (which shall not constitute a default under the bonds); and/or
- Additional redemption features if the bonds no longer receive a favourable accounting treatment on the classification of the bond as a 'liability' and/or if a credit rating agency modifies its equity credit rating criteria resulting in (i) a shortening in the length of time for which equity credit pertaining to the bonds would have been in effect, or (ii) a lower equity credit being assigned by the credit rating agency than the relevant equity credit assigned on the issue date of such bonds.

Importantly, a hybrid bond does not need to include each of the above features. The position of the bonds in the capital structure is generally the most relevant.

THE ISSUER'S PERSPECTIVE

For an issuer, a hybrid bond can offer a number of advantages over senior (unsubordinated) bonds. Principally, if a corporate issuer has a layer of subordinated debt in its capital stack, the subordinated debt can act as a buffer in the event of distress and/or insolvency, with the bondholders typically earning a higher yield to compensate them for this larger risk. Corporate hybrid bonds may also enhance the senior part of the capital structure, allowing an issuer to retain higher credit ratings. This is particuarlarly relevant for issuers in sectors with large capital expenditure needs, such as utilities.

At the same time, an issuer can increase its leverage while appealing to a wider investor community, particularly where an issuer maintains an investment grade rating from credit rating agencies.

A further advantage for issuers is the manner in which corporate hybrid bonds are treated by credit rating agencies, affording an opportunity for an issuer to raise debt finance without necessarily negatively impacting their credit rating, and without diluting shareholders . Credit rating agencies often view hybrids as 50% equity and 50% senior debt meaning that only 50% of the nominal amount of the issuance is included in debt calculations. This benefit can help issuers manage their debt-to-capital ratio as calculated by credit rating agencies. However, recent scrutiny from credit rating agencies, and updates to criteria, may have an impact on existing hybrid debt and the benefits and costs for issuers raising debt in the hybrid format. See "*The Perspective of Credit Rating Agencies*" below.

The issuance of hybrid bonds may also fall outside, or within an exception to, an issuer's other debt incurrence covenants on account of the 'equity credit' allocated to hybrid bonds.

Issuers also enjoy flexibility regarding how to offer hybrid bonds. Some corporates incorporate hybrid bond provisions into their Euro Medium Term Note Programme (EMTN Programme) prospectus and programme architecture (sitting alongside customary senior bond terms), allowing the issuer to maintain the flexibility to issue bonds in a subordinated format (sometimes with different reset dates and redemption features) in a cost-effective and relatively quick manner and by using the same programme disclosure. Other issuers elect to issue hybrid bonds on a standalone basis, with disclosure sections from the EMTN Programme base prospectus incorporated by reference into the standalone prospectus. U.S. corporate issuers may include subordinated bonds in the base prospectus of their shelf registration statement, which will facilitate a takedown of such debt securities.

Principally in the European debt capital markets, an issuer can also structure its hybrid bonds to be issued in green format, with such green bonds aligned with definitions and governance practices set out in ICMA's Green Bond Principles and as set out in the issuer's Green Bond Framework. The issuer will commit to invest the proceeds raised towards green (eligible) projects, affording an opportunity for an issuer to allocate capital efficiently as part of any net zero strategy, promote wider sustainability features of the business, target new and liquid investors focused on sustainability and, potentially, achieve a 'greenium' (green pricing premium versus non-green bonds).

THE INVESTORS' PERSPECTIVE

The attraction for investors is that corporate hybrid bond coupons are higher than senior bonds of the same issuer on account of the subordination features. However, the credit risk is higher due to the position of the bonds in the capital structure. There is also extension risk if an issuer elects not to call a bond on its first call date, which may, thereafter, cause pricing volatility in the secondary market. Any exercise of coupon deferral features will also likely cause pricing volatility in the secondary market.

At the same time, corporate hybrid bonds are typically still investment-grade rated, issued by issuers with stable and predictable cash flows well known to the investor community, with experienced treasury officers.

THE PERSPECTIVE OF CREDIT RATING AGENCIES

The equity credit recognition is one of the key benefits for issuers. However, credit rating agencies continue to evaluate their hybrid criteria, which is having an impact on outstanding bonds and the structures deployed in new issuances.

For example:

- In 2024, Moody's simplified its methodology and updated its criteria for awarding equity credit to subordinated bonds of investment-grade issuers, shifting to a three-tier system of assigning equity credit, aligning with the existing systems of S&P and Fitch. One feature of the modified criteria is that hybrid bonds no longer have to be the most junior in the capital structure; and instead, the bonds need only be junior to specified debt that is more senior. This change could make subordinated bonds more attractive than preferred shares.
- Furthermore, earlier this year, S&P changed a part of its hybrid rating criteria to effectively eliminate a clause known as a sliding step-up date that revises the maturity date of a hybrid bond to an earlier date if an issuer is downgraded. Since hybrid bonds are supposed to give an issuer some flexibility in times of distress, if the amount of equity credit assigned changes on account of a downgrade, this could have adverse consequence on an issuer.

A keen eye must be kept on the market to assess how issuers and investors react to changes in the rating agencies' criteria. More generally, inflation trends, geopolitical risk and whether central banks pause or slow their rate cutting cycles will feed through to the opportunity and risk calculations for participants in the corporate hybrid bond market.

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