European hybrid bonds set for comeback
Refinancing needs, credit-rating concerns to drive corporate deals in 2023

Europe's hybrid corporate bond market should return to growth in 2023, driven by refinancing, after a dramatic slump last year when rising interest rates and worsening economic prospects deterred companies from tapping the market.

Issuance should rebound to at least EUR15 billion from last year's EUR 12bn, the lowest level since 2017 and a steep drop from the EUR 40bn issued in 2021.

Many issuers are facing first call dates in 2023, equivalent to around EUR 26bn in outstanding hybrid bonds. There around EUR 200bn in outstanding hybrid bonds in Europe, including EUR 28bn with first call dates in 2024.

Early to market this year with hybrids are Italian utility Enel SpA, with EUR1.75 billion in two tranches, as well as Energias de Portugal SA and Spain's Iberdrola SA, each with a EUR 1bn hybrid. Eurofins Scientific SA, the French testing firm which chose to refinance a hybrid with a senior bond last year, has tellingly returned to market with a EUR 600m issue, paying a 6.75% coupon.

Equity weighting in hybrid issuance to drive deals in 2023

To be sure, hybrid coupon rates are likely to remain high this year which will continue to deter interest-rate sensitive issuers such as real-estate companies. Some issuers will be tempted to skip their initial calls because the step-up coupon is below the cost of replacement borrowing, though that may disappoint investors who might demand a higher premium in future to reflect extension risk.

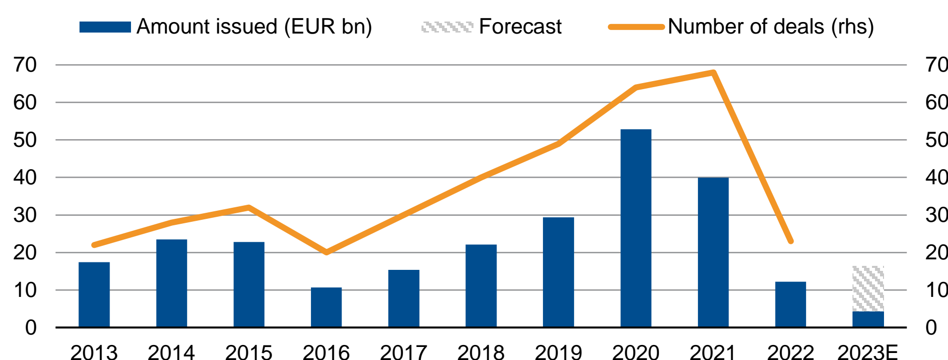
Even a subdued recovery in hybrid deals this year from non-financial companies would underline the segment's emergence as a still small but increasingly important part of Europe's capital markets, particularly for capital-intensive business such as utilities and telecommunications companies.

The partial equity component of hybrid bonds ensures they remain an attractive way to raise funds without impairing credit metrics and triggering credit rating downgrades.

Europe's capital-intensive investment-grade companies, the typical issuers of hybrids given their sufficiently strong, predictable cashflows, will be able to absorb rising interest costs this year, though inflation and slowing earnings growth will present more of a challenge as the tailwind of the post-pandemic recover fades.

Hybrid bonds will also remain an option for companies seeking to finance large acquisitions.

Figure 1: Lost appetite? European corporate hybrid bond issuance 2013-2023E



Source: Bloomberg, Scope

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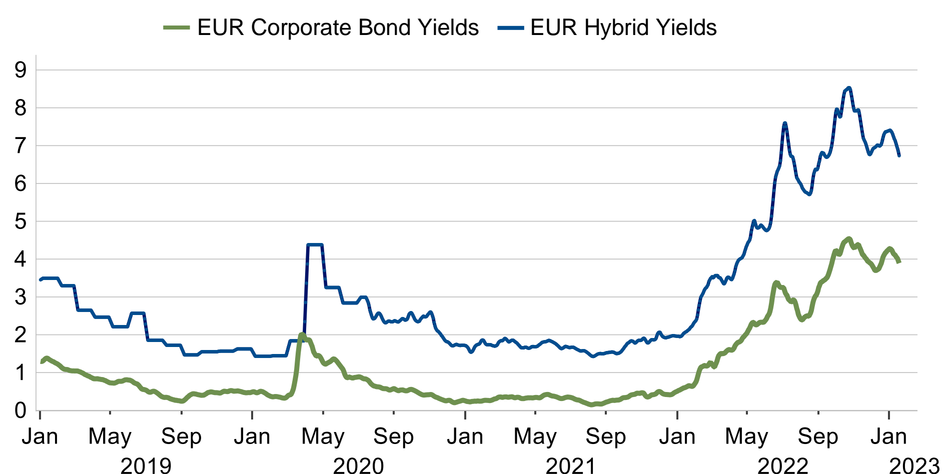
To call or not to call

Changed interest-rate environment has hit market hard

Typically, in hybrid bonds, if issuers do not observe the call date, the coupon is recalculated to include an extra premium for the extra time investors will hold the bond.

In recent years, hybrid bonds were issued with very low coupons, reflecting low underlying interest rates and the low hybrid risk premium at a time of ultra-loose monetary policy. As credit spreads have widened, resetting the coupon can be less onerous than the coupon on a new hybrid bond or alternative.

Figure 2: Mind the spread: corporate hybrid yields surged in 2022



Source: Macrobond, Scope

In Europe, a few issuers last year decided not to call their deals at the first call date, such as property investor Aroundtown SA or replaced them with lower cost senior funding, such as Eurofins. These companies generally are only occasional issuers of hybrid bonds and/or have strong enough credit ratings to absorb the loss of the equity weighting of the outstanding hybrid in their capital structure.

Indebted companies with less financial headroom may be more likely to opt for a hybrid bond even with a higher coupon to maintain leverage ratios at the cost of diminished interest cover. Indeed, unless a hybrid-debt issuer has significantly strengthened its balance sheet since the original placement of the securities, the company typically replaces the called and redeemed instrument with another hybrid bond.

More than EUR 50bn in first call dates in 2023, 2024

In Europe, the hybrid market faces a large volume of first call dates falling due in the next few years – more than EUR 50bn over 2023 and 2024 – reflecting the market's growth in volume since 2018, given typical call dates of five years. Looking at the upcoming first call dates of outstanding hybrids, utilities and telcos are among the most prominent issuers set to seek refinancing over the next few years (**Figure 3**) and so likely to continue to drive hybrid issuance.

Equity treatment of corporate hybrids comes into sharper focus

Equity treatment of hybrid debt comes to the fore

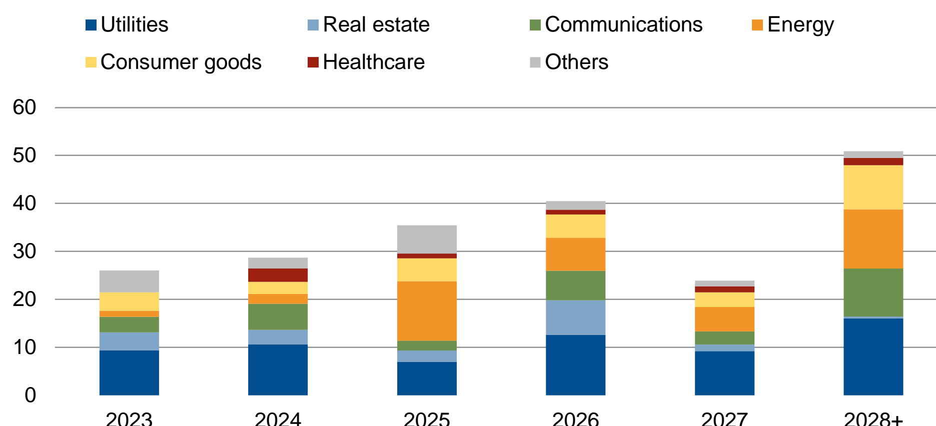
Hybrid debt instruments typically allow the issuer to early redeem the instrument before its specified maturity, avoiding a step-up of coupon payments. Buying back a portion of the hybrid does not alter our view of the equity classification as a hybrid instrument as it is legitimate for issuers to make use of their excess cash for liability management.

Rising hybrid coupons can deter new issuance

Issuers generally try to retain the equity characteristics of their hybrids by replacing a hybrid in the call date by another hybrid of equal size, though, at a time of higher interest rates and widening spreads, borrowers may want to avoid issuing new hybrids to avoid paying hefty coupons.

Scope continues to grant equity credit to issuers that skip the first call date in some circumstances, subject to a detailed assessment of the terms and conditions in line with our methodology.

Figure 3: Outstanding hybrid issues according to the next call date (in EUR bn)



Source: Bloomberg, Scope

Energy, telecoms, utility firms remain top hybrid issuers

Energy, telecommunications and utility companies account for more than half of the non-financial corporate issuance of hybrids, partly because their ownership lends itself to hybrid debt.

Options to raise equity are limited because the companies are unlisted or the state is a significant strategic shareholder so selling shares would dilute government ownership.

Figure 4: Largest hybrid bond issuance in 2022 and 2023 to date

Issuer sorted by the largest	Sector	>= EUR 1bn	Issue date	Coupon
Volkswagen International Finance	Automotives	EUR 2.25bn	March 2022	Dual tranche: 3.7% and 4.4%
Enel	Utilities	EUR 1.75bn	January 2023	Dual tranche: 6.6% and 6.4%
TotalEnergies	Energy	EUR 1.75bn	January 2022	Dual tranche: 3.3% and 2%
Bayer	Healthcare	EUR 1.3bn	March 2022	Dual tranche: 4.5% and 5.4%
Iberdrola	Utilities	EUR 1bn	January 2023	Single tranche: 5.1%
EDP	Utilities	EUR 1bn	January 2023	Single tranche:5.9%
Terna	Utilities	EUR 1bn	February 2022	Single tranche:2.4%
SSE	Utilities	EUR 1bn	April 2022	Single tranche:4%
EDF	Utilities	EUR 1bn	December 2022	Single tranche:7.5%

Source: Bloomberg, Scope

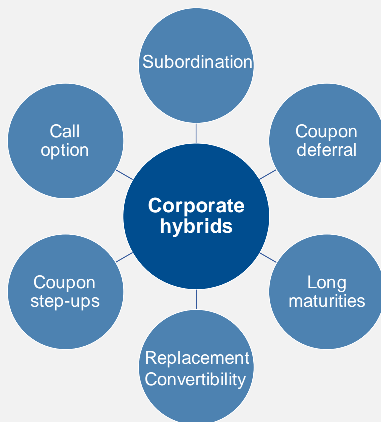
Europe's utilities sector is a good example. Companies are often entirely or partly state-owned such as Sweden's Vattenfall and Eléctricité de France. Governments also retain stakes in former telco monopolies such as Spain's Telefónica SA and KPN NV in the Netherlands.

Excursus: What is hybrid debt?

Case by case analysis of equity character

Bonds classified as "hybrid" blend the characteristics of debt and equity securities. Indeed, some of their characteristics make the bearer partially take on the risk of the business and bring the instruments closer to equity than to standard corporate debt. Although widely standardised in their documentation, the features of hybrid debt may significantly deviate from one issue to another. From Scope's perspective, the most important features which would qualify a hybrid bond for equity-credit are i) subordination, ii) mandatory or optional deferability of principal and coupons and iii) maturity and convertibility into equity at the discretion of the issuer. Hence, case-by-case analysis of every hybrid bond is required to determine the degree of equity content.

Figure 5: Common key features of corporate hybrid bonds



Benefits for issuers

- Potential suspension of coupon and principal payment
- Potential accounting as equity under IFRS
- Potential equity recognition from CRAs
- Tax-shield

Benefits for investors

- Investment in 'high-interest' debt from comparatively solid (mostly IG-rated) issuers

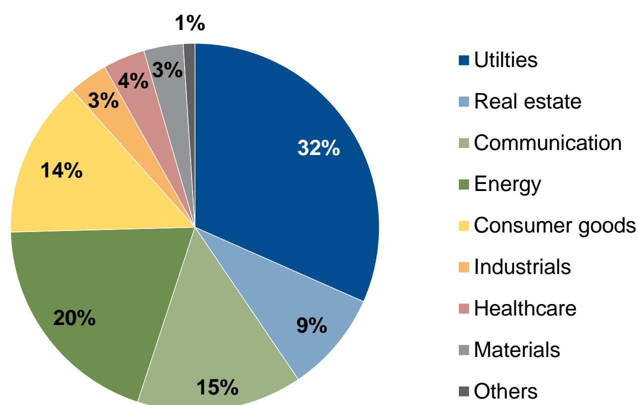
Source: Scope illustration; CRA = Credit Rating Agency

Real estate issuance has dried up as sector faces rates squeeze

One sector where hybrid issuance has dried up is European real estate, under pressure to sell assets to reduce debt as interest rates rise and property prices fall.

Germany's Vonovia AG repaid a EUR 1bn hybrid bond in 2021 and has not issued since. Aroundtown skipped its first call due in January 2023 on its EUR369m issue with a 3.75% coupon, saying it was cheaper to extend the issue than call it and replace it with a new hybrid bond.

Figure 6: Outstanding hybrid bonds by sector



Source: Bloomberg, Scope

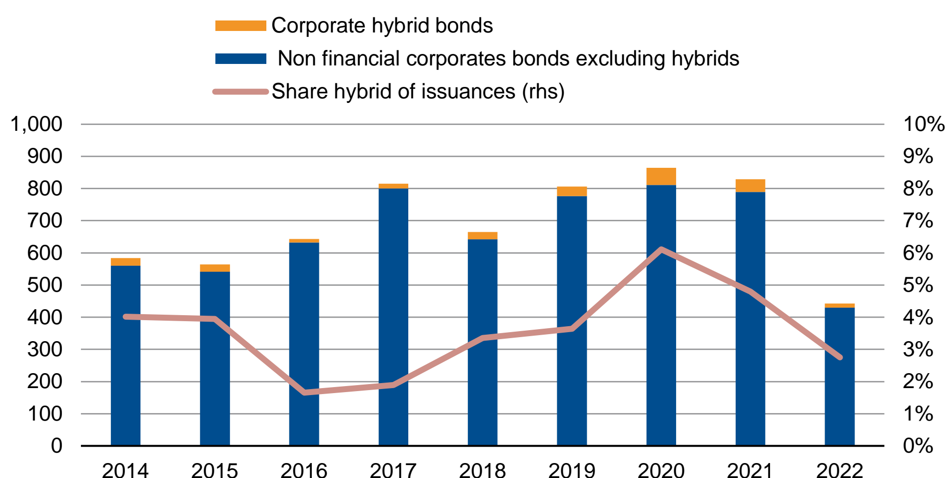
Subordinated debt instruments out of favour amid recession risk

Of course, hybrids are popular when market sentiment is benign. At times of turbulence, however, investors tend to refrain from taking the risk of buying subordinated debt instruments where payment of coupons and even the principal can be deferred at the discretion of the issuer.

Hybrid bond yields are quick to reflect this extra risk when market sentiment sours, making it more sensible for interest-rate sensitive companies to issue corporate bonds if they need extra capital-market financing.

Hybrid bonds are correlated to the overall market for non-financial corporate bonds. Issuance volume in Europe for the non-financial corporates fell to around EUR 440bn last year from 829bn in 2021 amid more volatile market conditions as the outlook for interest rates changed sharply with the surge in inflation and tightening of monetary policy.

Figure 7: Hybrids issues in comparison to debt issues of European non-financial corporates (in EUR bn)



Source: Bloomberg, Scope

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