Hybrid bonds – attractive opportunities for superior returns

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The European Central Bank (ECB)'s March meeting once more confirmed that traditional fixed-income investments no longer generate much-needed excess returns in a climate characterised by cheap central bank liquidity. In addition to this realisation, central bankers also sprang a surprise by expanding not only the volume of their bond purchase programme but also the range of instruments being purchased by adding corporate bonds to the list. For investors, this step means that another fixed income segment is expect to join government bonds, covered bonds and securitisations in receiving massive support from an 'investor of last resort'.

The markets responded positively, sending corporate bond prices higher and significantly narrowing credit spreads. Companies with strong credit ratings took advantage of this environment to launch new issues, which were well received even without high premiums. Some issuers, such as French pharmaceutical company Sanofi, even succeeded in placing bonds with zero interest rates. Average yields for senior investment-grade rated instruments also declined as a result, falling to just 1.08 per cent at index level (BofA Merrill Lynch Euro Corporate Index). Investors must therefore assume a greater level of risk and move down the pecking order of the capital structure. Subordinated hybrid bonds offer one solution for institutional investors.

A rapidly growing market

These subordinated hybrid bonds are being issued by industrial and utility companies and resemble a mixture of bonds and equities, thus giving them both debt and equity characteristics. Although the probability of default is comparable with that of senior instruments in the event of insolvency, the default rate is significantly lower. Hybrid bond maturities are generally much longer than those of traditional bonds and in some cases are even perpetual, at least on paper.

These characteristics have helped to establish a sizeable market for hybrid instruments. Overall, the volume of euro-denominated instruments with an investment grade rating has increased more than sixfold since 2010, while the market value of traditional corporate bonds has only grown by around 50 per cent over the same period. Almost 50 companies have already issued these bonds, with issuers from France, Germany and the Netherlands featuring particularly strongly, and they are also becoming increasingly popular among issuers from Mexico and Australia.

Benefits for investors and issuers

But what is it that makes hybrid instruments so interesting for issuers and investors? The primary motivation for companies is the opportunity to recognise these bonds as equity and thus improve their creditworthiness. Companies can also take on de facto equity without diluting their shares. Finally, issuers also have the option to temporarily suspend coupon payments or call in the bond after a predetermined period.

While this high degree of flexibility is advantageous for issuers, it poses an additional risk to investors, as the subordinated treatment of hybrid bonds becomes a problem if the issuer encounters financial difficulties. Nevertheless, we currently consider the credit profiles of the relevant companies to be relatively stable, while their generally high equity buffers also reduce the risk of default.

It is always beneficial for issuers to redeem (call) the bond early if they can procure more favourable refinancing terms on the capital markets at that time than with their hybrid bond. As the opportunity to recognise the bond as equity often ends on the first redemption date, the issuer is likely to make this call provided they possess sufficient liquidity. Investors must bear these circumstances in mind as they may need to reinvest their capital when the bond is redeemed. This situation may be remedied by a fund solution that bundles together a variety of differently-designed hybrid bonds, thus enabling investors to limit their extension risk through diversification.

Markedly higher yields compared to traditional corporate bonds

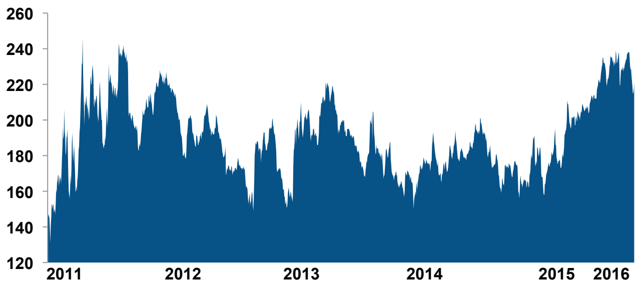
However, an attractive premium compensates purchasers of hybrid bonds for these assorted risks. The average return on the BofA Merrill Lynch Euro Non-Financial Subordinated Index is 3.43 per cent, more than 200 basis points higher than comparable corporate bonds. This advantage is even greater (see chart) when compared to senior instruments from industrial companies offering an average return of 0.87 per cent (BofA Merrill Lynch Euro Senior Non-Financial Index). For example, investors must accept significantly poorer ratings to generate similar returns from emerging markets bonds.

As expected, liquidity in this segment is lower than for senior instruments. Although sellers have been hit particularly hard over the past year, the picture has changed since the ECB's decision, with high demand occasionally making it difficult to acquire securities at all. The bid/offer spread is around 50 to 75 basis points. By comparison, senior bonds trade at around 30 to 40 basis points. To a certain extent, investors therefore receive a kind of illiquidity premium.

Hybrid bonds therefore offer significant potential for professional investors. However, the complexity of this investment class means that analysis, the selection of suitable securities and ongoing monitoring of the risks already mentioned remain essential for making a successful investment. At Union Investment, we are meeting these challenges with a strong team of experienced specialists and a targeted research and investment approach. The investment strategy derived from this approach is incorporated into three funds focused on subordinated bonds which enable us to generate much-needed excess returns for our national and international clients.

Over the past few months, premiums for hybrid bonds on the rise compared with senior bonds

Spread difference between European hybrid* and industry-senior bonds** (in bps)



As of: 27th April 2016
Source: Bloomberg; *BofA Merrill Lynch Euro Non-Financial Subordinated Index, **BofA Merrill Lynch Euro Senior Non-Financial Index

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