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Corporate Hybrid Issuers Adopt a 30-Year Maturity Standard

Recent corporate hybrid issuance, in both Europe and the U.S., suggests a trend for moving from long-dated or perpetual contractual maturity structures to shorter-dated 30-year maturities.

The way hybrids are structured and treated by rating agencies, and the consequent economic incentives, make extensions of hybrids beyond their first call dates very rare. Even so, the market sometimes trades as if the probability of extension were higher than it is, exhibiting duration and volatility more in line with contractual maturities than with first call dates.

In our view, such a substantial reduction in contractual maturities should therefore reduce corporate hybrid risk premia and volatility over time, particularly during periods when investor concern about extension risk is heightened. We believe this is likely to change the perceived risk profile of the asset class for the better.

In a recent paper, we discussed the differences between European and U.S. corporate hybrid securities, and how the U.S. market has started to align its structures with Europe's and, as a result, grow more rapidly.[1]

As a reminder, European-style hybrids have typically been issued as perpetual securities or with 60-year contractual maturities, but with coupons that "step up" if the bond is not called at its first call date. These step-ups typically amount to 100 basis points after 25 or 30 years. Under Standard & Poor's methodology, this means that the bonds' equity content is lost after five or 10 years. Issuers have therefore tended to set the first call date in year five or 10, so that failing to call would coincide with loss of equity content, creating a reassuring incentive not to leave the bond outstanding.

By contrast, U.S.-style hybrids have traditionally been issued with 60-year contractual maturities but no coupon step-ups. That lack of coupon step-ups means that the loss of equity content on a 60-year security does not occur until year 40, which, in our view, has tended to make U.S. corporate hybrids unattractive for investors.[2] We call the no-step-up hybrids U.S.-style hybrids, in contrast to European-style hybrids, which have step-ups.

All that has started to change over recent months, as U.S. issuers have moved decisively to issue hybrids with 30-year contractual maturities. U.S. companies have issued some $12bn of hybrids so far in 2024, and every single one has come with a 30-year maturity. Even without coupon step-ups, that reduces the time to loss of equity content from 40 years to 10 years—just as coupon step-ups for European-style hybrids trigger loss of equity content at their first call date, which, as described above, is usually no later than year 10.

We think this new competition for hybrid investors' capital is starting to have some fascinating consequences in the European market, with potentially profound consequences for the way the hybrid risk profile is perceived and priced.

30-Year Maturities Become the New Normal

The prospect of the loss of equity content has been a very strong incentive to call European hybrids—between 2013 to 2023, 99% of hybrids from investment-grade issuers were called at the first call date. Nonetheless, in our view, investors tend to price hybrids as if the probability of extension were higher than it is, exhibiting volatility and spreads more in line with contractual maturities than with first call dates.

Were a European issuer to extend its hybrid, the investor would typically be left with a 60-year or perpetual maturity. However, with one of the new U.S.-style hybrids, issued with a 30-year maturity and no step-up, it would now be left with a much less onerous 30-year maturity. Seen this way, U.S.-style hybrids are suddenly more attractive than their European equivalents.

We may already be seeing the response by European issuers. For the first time, three of this year's European transactions, amounting to $2bn out of the total issuance of $18bn, have come to market with 30-year contractual maturities. We think this is no coincidence, and expect 30 years to become the new normal not only for U.S-style hybrids, but also for European-style hybrids issued with long-dated structures.

Issuers of European-style hybrids with perpetual structures may for now choose to retain those perpetual structures to keep the equity accounting treatment under IFRS. Yet we see the potential for them also to move toward this shorter-dated structure in the long run, especially if it provides a pricing advantage to do so. Interestingly, Enel set a precedent in 2021 when it moved its outstanding long-dated hybrids into perpetual structures via a consent solicitation. We could easily see the reverse—that is, consent solicitations to move perpetual structures into shorter-dated, 30-year structures.

[1] Linus Claesson and Robin Usson, "Corporate Hybrids Take the World Stage" (May 2024) at https://www.nb.com/en/link?type=article&name=whitepaper-corporate-hybrids-take-the-world-stage

[2] Corporate hybrid bonds have equity-like characteristics. Like equity, they are either long-dated or perpetual; like dividends, their coupon payments can be deferred without triggering a default. In recognition of their equity-like features, the main rating agencies assess European hybrids as having 50% equity content. However, this equity content may not last forever. At Moody's, for example, 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.

A Framework to Assess the Value Opportunity: Bank Capital

The logical consequence of this shift in hybrid structures would be lower market volatility—especially during times of sensitivity around extension risk—and a general compression in hybrid risk premia. But how much of a difference might it make?

Because regulatory requirements have led banks to make long and extensive use of hybrid and contingent capital, we think bank capital is a useful framework within which to consider this question. The structures, pricing and volatility of different bank capital securities may give us an indication of how non-financial corporate hybrids should behave.

Bank capital is tiered according to how easy it is for the bank to write it down (or, as a corollary, what rights the capital provider benefits from). In terms of creditor hierarchy, deposits and senior debt are at the top, and Tier 2 and Tier 1 capital sit below them. The table below sets out the typical main features of non-financial corporate hybrids, Tier-2 bank capital (in this case, "Lower Tier-2" subordinated debt) and Additional Tier-1 bank capital (contingent convertible securities, or "CoCos," which sit above the bank's Tier-1 common equity).

	Corporate Hybrid	Tier-2 Bank Capital (Subordinated Debt)	Additional Tier-1 Bank Capital ("CoCos")
Issued by	Non-financial corporates	Financial corporates	Financial corporates
Structure	Subordinated/Deeply subordinated	Subordinated	Deeply subordinated, senior only to common equity
Maturity	Typically 60 years, or perpetual, and increasingly 30 years	Various fixed maturities, minimum five years, bullet or with a call structure	Perpetual
Issuer call options	Five to 10 years to first call date, multiple call options thereafter	Optional, minimum five years to first call date and must be five years between call date and maturity (with 10NC5, 11NC6 and 12NC7 being the most common)	Typically five or 10 years to first call date, subject to regulatory approval
Coupon structure	Fixed to first call date followed by coupon resets	Fixed to first call date followed by coupon resets	Fixed to first call date followed by coupon resets
Coupon step-up?	Typically yes, after first call date	No	No
Coupon deferability?	Yes, cumulative, at option of issuer management only. Dividend pushers/ stoppers in place	No	Yes, non-cumulative, potentially at the insistence of the regulator. No dividend pushers/stoppers
Event of default on non-payment of coupon?	No	Yes	No
Potential regulatory intervention?	No	Yes, principal write-down in the event of government support for the issuing bank	Yes, principal write-down or conversion to common equity upon breach of capital ratio or if the bank is failing or likely to fail
Eligible for major fixed income indices?	Yes	Yes	No
Loss of S&P equity content if not called at first call date?	Yes	No loss of recognition by S&P, but amortization (loss) of regulatory capital recognition in the last five years	No
Extension risk	Low for European-style hybrids with step-ups	Low	Driven by economics

Source: Neuberger Berman.

Corporate Hybrids Are Not "Non-Financial CoCos"

We find that investors often mischaracterize corporate hybrids as "the non-financial version of bank CoCos." That's understandable: the perpetual life and first call date at year five or 10 look similar. But we have always thought that the comparison flatters CoCos and overstates the risk of hybrids.

Even when they are extended or their coupons are deferred, hybrids are unambiguously debt securities: coupons are stepped up if the bonds are not called, interest accumulates if coupons go unpaid, and coupons cannot be deferred without equity dividends also being stopped. By contrast, CoCo coupons are not stepped up, are not cumulative and do not have dividend stoppers. Moreover, in extreme scenarios, to restore the issuer's capital ratios the banking regulator is likely to insist their value be written down, or that they be formally converted to common equity (then also potentially written down). Finally, hybrids are bond index-eligible while CoCos are not; only banks' Tier-2 bonds are part of fixed income indexes.

Hybrids Are More Analogous to Lower Tier-2 Bank Capital…

We think Tier-2 capital is the more realistic comparison: in our view, the nearest analog to a corporate hybrid in a bank's balance sheet is Lower Tier-2 subordinated debt issued with a call structure.

Rating agencies recognize this similarity. Just as Tier-2 bank capital is rated one or two notches lower than the issuing bank's standalone rating, hybrids are two notches down from their issuers' long-term ratings. By contrast, AT1 CoCo bonds are rated three, four or, in some cases with S&P, even more notches lower.

Some aspects of bank subordinated debt pose more risk to the investor than a typical corporate hybrid. Coupons do not step up if the security is not called, and there is also no direct loss of rating-agency equity content following an extension to act as a disincentive against a non-call event. Moreover, a bank has to ask regulatory approval before calling a Tier-2 bond, and while approval is usually granted, this lowers the flexibility for calls relative to a corporate hybrid. Finally, in the extreme case of a bank resolution, the regulator can "bail-in" Tier-2 bonds.

These characteristics are partly balanced by the non-deferability of bank Tier-2 debt coupons, their generally shorter contractual maturities, and the reduction of regulatory capital recognition at a rate of 20% per year in the last five years of the bond's life. At four years before maturity, the amount of a bond's face value recognized as Tier-2 capital falls to 80%, at three years to maturity it falls to 60%, and so on until the final year of the bond's life, when it contributes zero value to the issuer's Tier-2 capital. Like a hybrid's loss of rating-agency equity content, this loss of regulatory capital recognition acts as an incentive to call and replace the instrument.

… And as Hybrid Maturities Shorten, They Transition Closer Toward Tier-2 Capital

However, if one of the more attractive elements of subordinated bank debt is the shorter maturities, the recent trend for shorter contractual maturities in hybrids could change the current perception of relative value.

Tier-2 subordinated bonds are typically shorter-dated than corporate hybrids at issuance, but they are still relatively long-dated. To qualify as Tier-2 capital, a callable subordinated bond's contractual maturity can be no sooner than five years after its first call date, and its first call date can be no sooner than five years. That means the bond cannot be any shorter-dated than 10 years. The most common structures are 10-, 11- and 12-year contractual maturities with a first call date in year five, six and seven, respectively.

Should corporate hybrid contractual maturities trend away from perpetual or 60 years and toward 30 years, as we anticipate, we think it could meaningfully change investors' perception of the risk associated with extension, relative to 10- to 12-year callable subordinated debt. With bank debt's lack of coupon step-ups and equity content in the balance, as well as the sheer amount of leverage banks carry relative to the typical investment-grade non-financial corporate, we believe these shortening contractual maturities will make the hybrid risk profile much more analogous to Tier-2 bank debt.

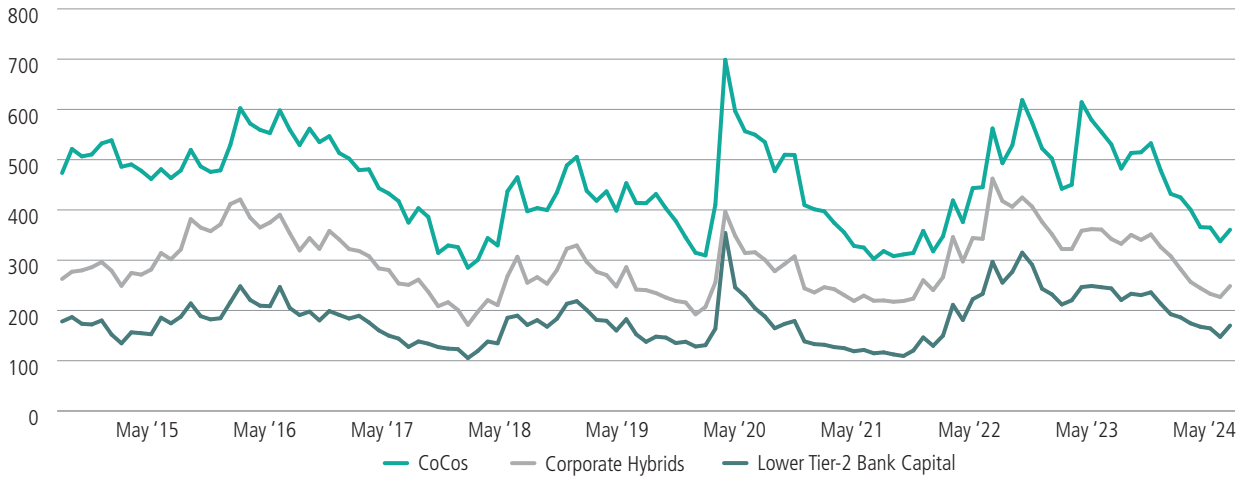
Attractive Relative and Absolute Valuations, Even If Spreads Do Not Tighten

Figure 1 offers a suggestion of what this could mean for corporate hybrid pricing.

Over the past decade, the credit spread of the corporate hybrid market has been 112 basis points higher than that of the Lower Tier-2 bank capital market, on average. For CoCos, the average spread has been 270 basis points. While hybrids have not priced exactly midway between the two types of bank capital, given the existing track record of a 99% call rate for investment grade issuers over the past decade, we think they should come still closer to Tier-2 bonds if the trend for 30-year issuance persists.

We see similar results when we consider volatility and beta coefficients. Hybrid volatility at 7.5% sits just short of midway between Tier-2 volatility at 5.3% and CoCo volatility at 10.6%. Relative to European senior bonds, hybrid beta sits just short of midway between that of Tier-2 and CoCos.

FIGURE 1. CORPORATE HYBRIDS PRICE MIDWAY BETWEEN TIER-2 AND "COCOS"
Option-adjusted spread



Beta coefficients, trailing monthly returns, 2017 – 2024

	vs. Corporate Hybrids	vs. Euro Senior Corporate Bonds	vs. Global Senior Corporate Bonds (EUR Hedged)
Corporate Hybrids	-	1.263	0.916
CoCos	1.260	1.629	1.226
Lower Tier-2 Bank Capital	0.686	1.056	0.777

Annualized volatility, 2014 – 2024

Corporate Hybrids	7.45%
CoCos	10.58%
Lower Tier-2 Bank Capital	5.27%
Euro Senior Corporate Bonds	4.78%
Global Senior Corporate Bonds (EUR Hedged)	5.80%

Source: Bloomberg, Neuberger Berman. Data as of June 30, 2024. Indices used: Bloomberg Euro Universal Corporate ex-Financials Hybrid Capital 8% Capped (Corporate Hybrids); Bloomberg European Banks CoCo Tier 1 (CoCos); Bloomberg Euro Aggregate Credit Corporate/Banking Lower Tier 2 (Lower Tier-2 Bank Capital); Bloomberg Europe Aggregate Corporate (Euro Senior Corporate Bonds); Bloomberg Global Aggregate Corporate, EUR Hedged (Global Senior Corporate Bonds, EUR Hedged).

While it may take time for the trend to 30-year maturities to be confirmed, we are confident that this will become the new norm for the asset class and that at least some of the spread between hybrids and subordinated bank debt will therefore close.

In the meantime—even if hybrids persist in pricing wider than would be implied by their risk profile—we believe that investors can benefit from their income at attractive relative and absolute valuations.

Index Definitions

The **Bloomberg Euro Universal Corporate ex-Financials Hybrid Capital 8% Capped Index** tracks euro-denominated corporate bonds issued by companies active in the industrial or utility sector and with a minimum rating of Ba1/BB+. The weighting of any single security is limited to 8%.

The **Bloomberg European Banks CoCo Tier 1 Index** tracks the performance of contingent convertible securities, issued by European financial institutions, that qualify as Alternative Tier-1 bank capital.

The **Bloomberg Euro Aggregate Credit Corporate/Banking Lower Tier 2 Index** tracks the performance of subordinated bonds that qualify as Tier-2 bank capital and are included in the Bloomberg Euro Aggregate Credit Index, which tracks the investment grade, euro-denominated, fixed-rate corporate bond market.

The **Bloomberg Europe Aggregate Corporate Index** tracks the performance of euro-denominated corporate bonds from the Bloomberg Global Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate-term investment grade bonds traded worldwide.

The **Bloomberg Global Aggregate Corporate Index EUR Hedged** measures the performance, hedged to euros, of corporate bonds from the Bloomberg Global Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate-term investment grade bonds traded worldwide.

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