EDMOND DE ROTHSCHILD

HYBRID BONDS[1]: SCALING THE REFINANCING WALL

Hurdles have been cleared perfectly so far

► After two years of net negative issuance, the primary market for corporate hybrid bonds is poised for a strong rise in activity. Due to large volumes of early call dates over the next three years (see graph), issuers will have to borrow to refinance their debt. In 2024 alone, 21 billion euros[2] are expected to be called back, weighing a little over 10% of the asset class.

Will this imply a rise in extension risk[3]?

MARC LACRAZ
*Fixed Income portfolio manager**

THE FIRST 4 MONTHS OF 2024 WERE POSITIVE

Investors have been anticipating the end of the monetary tightening cycle, begun in 2022, since the end of last year. While the timing of interest rate cuts is still uncertain, further rises are now increasingly unlikely. As a result, demand for bond yields rebounded in 2024. We believe that capital markets offer strong upside potential and fixed income funds have gathered positive net inflows. Companies have taken advantage of these highly favourable conditions. At the end of April, over 7 billion euros were issued in new hybrid bonds[4]. Some issuers, such as Orange, even began to pre-finance bonds with calls in 2025 and 2026. One noteworthy development is that order books were systematically oversubscribed, which is indicative of massive investor demand. Furthermore, these new bonds bear coupons with no premium[5] compared to older bonds. In some cases, the new issue premium was negative, a sign of rising investor appetite.

*The fund manager referred to in this document may change during the life of the product.

1. Hybrid bonds are a subordinated financial instrument issued by non-financial companies that combine bond and equity features.
2. A callable bond is a bond that can be redeemed by the issuer prior to maturity, on a pre-determined date.
3. Extension risk is the risk that issuers decide not to call their hybrid bonds at their first call dates due to adverse market conditions.
4. Source: Bloomberg
5. Premium: an instrument is said to be trading at a premium when the market agrees to pay a higher price for this instrument over others.

Meanwhile, some issuers have chosen to call their bonds early without refinancing their debt. Holcim, for example, decided to withdraw from the hybrid market, which it no longer needs to support its credit rating, while Total and OMV took advantage of the flexibility enabled by the Standard and Poor's methodology. The latter allows issuers to retire up to 10% of their hybrid stock per year without losing the 50% equity content applicable to the outstanding stock. In total, 2.5 billion additional dollars were redeemed on the first scheduled call date.

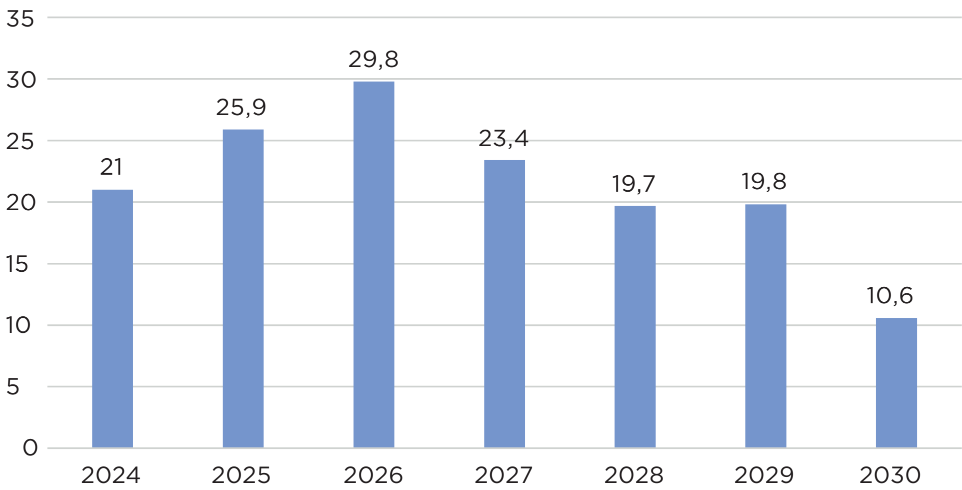
REAL ESTATE MAY SOON EMERGE FROM THE IMPASSE

The real estate sector is finally benefiting from some positive news flow. While the segment only accounts for 6% of the investment universe, it concentrates many the most pressing concerns for investors and is therefore under particular scrutiny. Akelius, a Swedish company specialising in the European and North American property markets launched a capital increase to fund the partial call of a hybrid bond with a first call date in 2026. Balder followed a similar path and successfully called almost 40% of a bond issuance that was also callable in 2026.

On a different note, April saw the first exchange offer since Unibail in 2023. Aroundtown and its subsidiary Grand City invited bondholders to exchange their existing perpetual[6] bonds into newly issued notes with higher coupons and a term of 5 years until the first reset date. This enables the issuer to retain the equity content on its hybrid bond stock and therefore strengthen its Investment Grade[7] rating. We believe this is win-win solution that removes the binary "call or non-call" decision for issuers who do not have the means, at that moment in time, to issue new instruments with attractive terms and conditions. 74% of the bonds were tendered in the debt swap, which is indicative of the high interest shown by hybrid bondholders of both companies[8] in this proposal. The irony is that in 2022, Aroundtown had shocked the market with its first-ever decision not to redeem a bond at the first call date. We can only welcome the adoption of a policy that is more favourable to bondholders. Debt swap is emerging as a new tool, and we expect other issuers to use this option in the future.

To sum up, non-calls should be limited to idiosyncratic situations. The extension-risk premium will continue to subside, a factor we believe will support the performance of hybrid corporate bonds over the next 12 months.

EUR DENOMINATED HYBRID CALL DATES (EUR bln)



Source: Bloomberg LP, BofA Global Research, 24.03.2024

6. Perpetual bonds are bonds with no maturity date and offering a call option. This means that the issuer retains the right to call back the bond at any point of time after a defined period, and to redeem the capital to the bondholder at a pre-determined price.

7. Investment grade bonds are issued by issuers with credit ratings ranging from AAA to BBB- according to rating agencies, based on the Standard & Poor's scale.

8. Source: Aroundtown

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