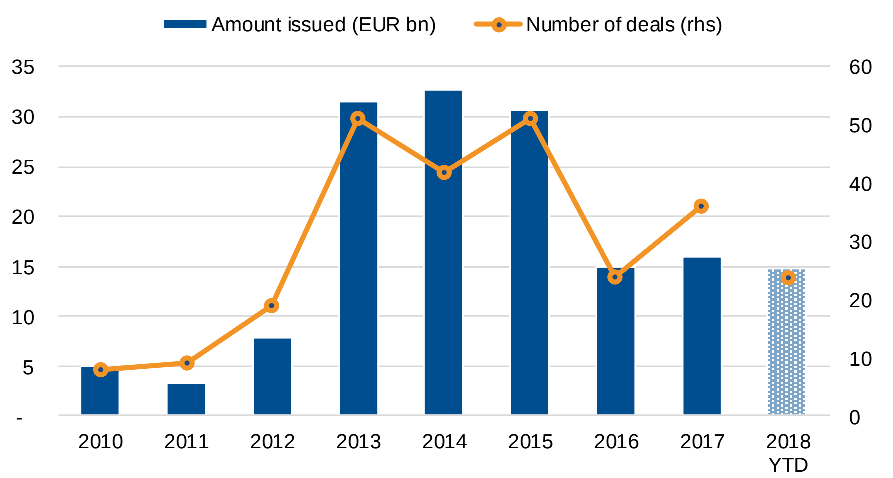
Europe's hybrid bond market rebound gathers pace: Issuance set to exceed EUR 20bn in 2018

Hybrid bond issuance in Europe remains on track this year to reach its highest level since 2015 after a busy second quarter marked by a growing diversity of issuers, including real estate and consumer discretionary companies. With first-half issuance of EUR 14.8bn falling just short of full-year issuance in 2016 and 2017, Scope Rating expects the placement of hybrid-bond issuance this year will likely surpass EUR 20bn. Low interest rates and still buoyant equity markets remain powerful incentives for capital-intensive companies to issue the contractually subordinated bonds, which blend the characteristics of debt and equity instruments, to help finance acquisitions and refinance maturing issues. Several debutants from the real estate sector came to market with hybrid issues which have long been a preferred source of funding for power utilities and telecoms firms. Scope identified the following trends in the hybrid market segment in the first half:

- H1 hybrid bond issuance reached EUR 14.8bn, just short of yearly issuance in 2016 and 2017 (see Figure 1).
- A handful of jumbo deals explain the rebound in the value of bonds placed.
- Hybrid instruments are growing in importance again, approaching 5% of all debt capital market issues.
- Real estate companies were prominent issuers, especially in the second quarter, accounting for 30% of H1 2018 hybrid issuance by volume.
- Companies keen to preserve borderline BBB investment-grade credit ratings remain the leading actors in the hybrid segment, particularly those which conduct extensive M&A.
- More than EUR 5bn in hybrid debt issuance is in the pipeline judging by issues whose first call date is in H2 2018 and other big-ticket transactions.

Figure 1: Hybrid debt issuance of European corporates



Source: Bloomberg, Scope

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Europe's hybrid bond market rebound gathers pace

Hybrid issuance volumes rise in H1 2018

Low interest rates are still the main catalyst for hybrid issuance in 2018. Hybrid debt placements volumes already reached a peak in half of the year with issuance reaching the EUR 14.8bn compared to EUR 14.9bn for overall 2016 (Figure 1).

Hybrids represent only 3.5% of the total corporate bonds

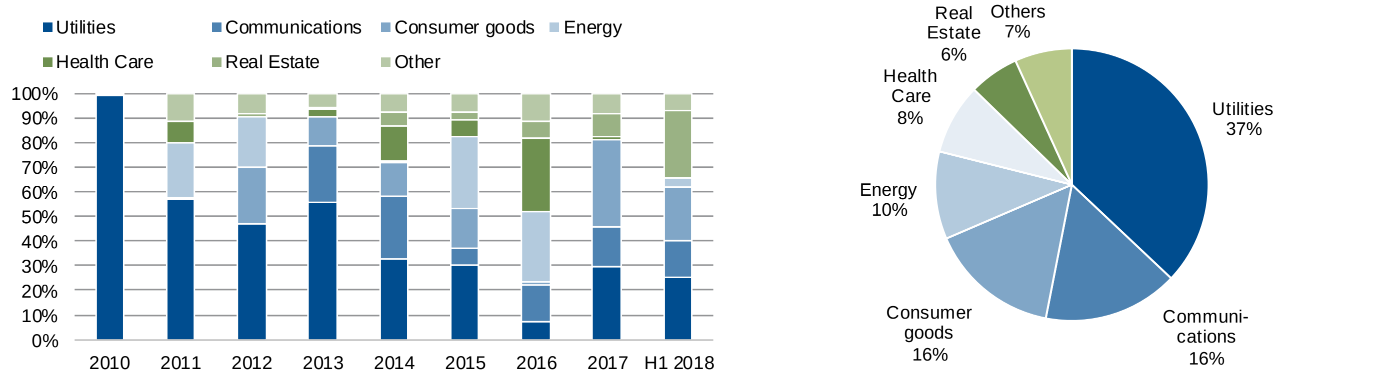
Hybrid instruments are growing in importance surpassing the 3.5% of the total corporate bond supply. Scope still believe that their proportion of the market share can reach 5%. (see also Scope's research 'Hybrid bond issuance bounces back in Europe, helped by M&A, low interest rates').

Capital intensive sectors are driving the volumes

Real estate companies have been the most active users of hybrid debt for this year as can be seen in Figure 2 principally for financing their expansive growth strategy: the proceeds of the latest hybrid deals from real estate corporates Peach Property, CPI Property Group, Klövern and Unibail-Rodamco have been used for expanding their asset portfolios. Utilities continue to be frequent issuers, such as Enel which placed a EUR 1.5bn hybrid in May to restructure its hybrid bond portfolio. Overall, utilities, telcos and consumer goods firms have been responsible for more than 60% of hybrid issuance in Europe in 2018.

Figure 2: Total segment split between 2010 and H1 2018

Measured by number of issues | **Aggregated sector split measured by issued volumes**



Source: Bloomberg, Scope

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More than 50% of volume comes from major actors

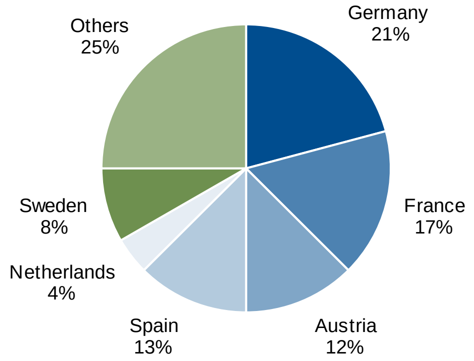
Although there were relatively few deals in H1 2018, placement values were relatively large, see Figure 3, with more than half of the hybrid transactions belonging to the industrial and telecoms sectors. Volkswagen, a frequent hybrid issuer, placed the largest corporate hybrid bond to date this year, consisting of a EUR 2.75bn dual tranche followed by Telefonica Europe. In total, five companies issued more than 50% of the H1 2018 overall amount.

Figure 3: Major hybrid issuers in H1 2018

Issuer	Amount in EUR bn	Sector
Volkswagen International Finance NV	2.75	Consumer Discretionary
Telefonica Europe BV	2.25	Telecommunication
Unibail-Rodamco SE	2.00	Real estate
Enel SpA	1.50	Utilities
Engie SA	1.00	Utilities
	9.50	

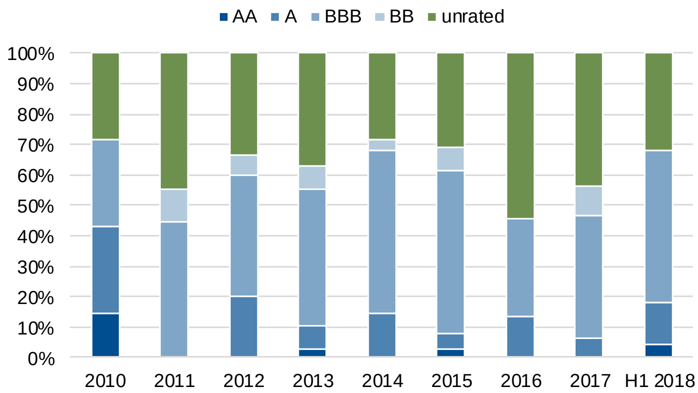
German and French corporates led first-half hybrid issuance, undeterred by political uncertainty in Germany, Italy and the UK which threatened weigh on market sentiment (see Figure 4).

Figure 4: Country of risk of hybrid issuers in H1 2018 (measured by number of instruments issued)



Source: Bloomberg, Scope

Figure 5: Issuer rating category (measured by number of instruments issued)



Source: Bloomberg, Scope

BBB rated companies have the strongest incentive to use hybrids

The largest proportion of issuers is still in the BBB category, in other words firms which have the incentive of trying to preserve their investment-grade rating by avoiding excessive borrowing through using hybrid securities (see Figure 5). Non-rated companies have also issued hybrid instruments to take advantage of attractive yields.

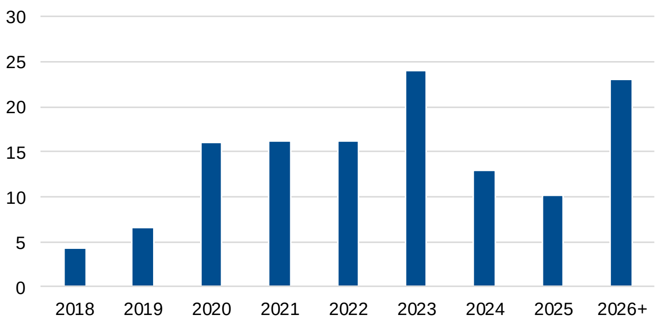
FY 2018 outlook

Refinancing and new deals in the pipeline will drive 2018 hybrid placements beyond EUR 20bn

The pipeline for hybrid bonds is busy for the second half of the year. The third quarter started with the German non-rated retailer Otto GmbH & Co. KG issuing a EUR 300m hybrid. Scope expects further hybrid placements over the next few months as companies seek refinancing for upcoming call dates of outstanding hybrids. As can be seen in Figure 6, utilities and telcos are expected to call and redeem outstanding amounts for 2018. For the telco sector, Telekom Austria and Koninklijke KPN are expected to follow Telefonica Europe by replacing the called hybrids with a new one at a lower coupon rate. Also, in the telecom sector, Vodafone plans to partly finance the EUR 18.4bn acquisition of Liberty Global’s European assets with hybrid bonds. Among utilities, Elia announced that they will issue a EUR 700m hybrid bond to partly finance the acquisition of another 20% of 50Hertz. The usage of hybrids will continue as long as the securities offer investors an attractive yield pick-up for investment grade-rated corporates or publicly unrated corporates which are deemed to exhibit investment-grade credit quality.

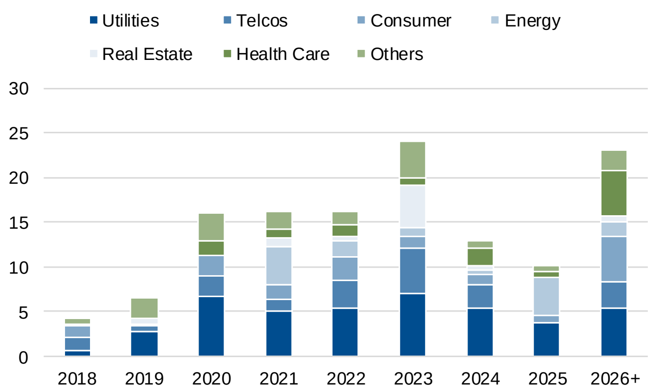
Figure 6: Currently outstanding hybrids issues according to their first call date (in EURbn)

Outstanding amount



Source: Bloomberg, Scope

Industry breakdown



Source: Bloomberg, Scope

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