Fixed Income Investing – Part XVIII
Canadian Hybrid Securities

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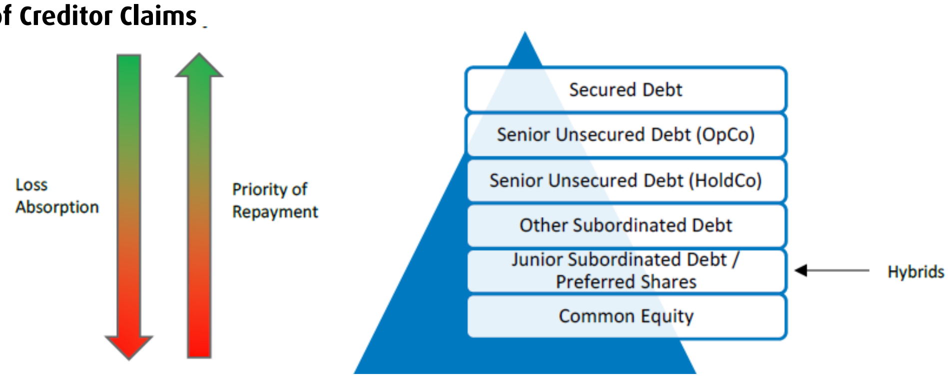
In times when traditional fixed income investments offer historically low yields, investors look for alternative options to meet their income requirements. Preferred shares that are lower-rated and sit further down the capital structure have routinely fulfilled this demand, but in recent years, issuers have chosen to issue hybrid bonds instead. This article explores the Canadian hybrid bond market and what you need to know before investing.

What are hybrid securities?

Like the name suggests, hybrid securities blend attributes found in both bonds and preferred equities, but from a legal perspective they are deemed to be debt securities. Hybrid bonds are deeply subordinated bonds in a company's capital structure and generally rank alongside preferred shares and only ahead of common equity **(see Figure1)**. Because of this subordination, the main credit rating agencies have typically rated hybrid issues two notches below that of their senior unsecured debt. For example, TC Energy's senior unsecured bonds are rated BBB+ with S&P while their hybrid issues are rated BBB-.

Figure 1 – Hierarchy of Creditor Claims



Source: BMO Capital Markets

Some of the typical equity-like features found in hybrids are:

- No cross-default language, so an issuer can commit a technical default on a hybrid without triggering a default in more senior obligations.
- The issuer can defer a coupon payment, like they can forgo paying a dividend.
- Replacement language stipulating that should the hybrid be called by the issuer, it will be replaced by equal or better-quality capital (i.e., another hybrid, preferred share or common equity).

The typical structure of corporate Canadian hybrid securities issued so far have legal maturity dates 60 years from the date of issuance, but have set dates along the way when the issuer can call the bond back. There are two main structures used for these securities:

- The fixed-to-fixed style has an initial 10-year period paying a fixed rate coupon before its first call date. If it is not called at this time, a 20-year period with a fixed rate coupon follows – this coupon is set at a pre-determined margin greater than the Government of Canada 5-year bond yield and resets every five years. Finally, there is a 30-year period with a fixed rate coupon that, again, resets at a set margin (this time it is 75 basis points higher than that of the previous 20-year period), that is greater than the Federal 5-year bond yield.
- The fixed-to-float structure is similar in that it starts off with a fixed-rate coupon for 10 years, followed by a 20-year period where the coupon rate is set at a pre-determined margin greater than the 3-month Banker's Acceptance ("BA") rate, which will change or float every quarter. If it hasn't been called by this point, the coupon for the final 30 years also floats every three months at a set margin greater than the BA rate.

The structures may seem convoluted, but they're necessary to maintain the equity-like treatment by the credit rating agencies rather than being counted as debt in the leverage calculations, which would lead to them negatively impacting the issuer's credit ratings.

Figure 2 – Illustrative Structures of Hybrid Securities

Source: Company Reports, BMO Capital Markets

Who issues hybrid securities?

The first Canadian corporate hybrid bond was issued in 2017, and the market has grown gradually since then to its current size of $8.25 billion. Hybrid bonds have been a useful funding tool for companies undergoing periods of high capital spending with a view to protecting their credit rating. As such, the majority of issues so far have come from the Pipeline sector, with TC Energy, Inter Pipeline and Enbridge all repeat issuers. From an issuer's standpoint, hybrids are more desirable to preferred shares given that they offer overall lower financing costs and the fees involved with issuance tend to be lower.

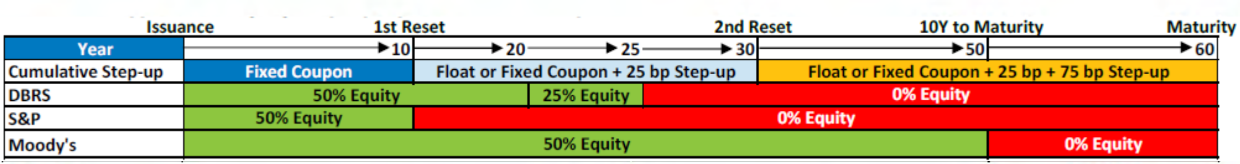
Banks and insurance companies have recently been issuing similarly structured instruments called Limited Recourse Capital Notes ("LRCNs"), however, they have not been approved by the Office of the Superintendent of Financial Institutions ("OSFI") for distribution through retail channels and are not covered in this article. Nonetheless, their presence will likely result in shrinkage of the preferred share market as issuers opt for these types of securities.

Bond rating treatment of hybrids

The credit rating agencies treatment of hybrid securities with respect to its allocation towards equity is a key factor when investors evaluate their value as it can materially impact the issuer's credit rating and the eventual term of the bond. The debt-to-equity ratio is an important credit metric used by the agencies, and having a higher equity weight is more favourable for companies wanting to be assigned a higher credit rating. Therefore, both issuers and investors have a preference for hybrid instruments to have a greater equity treatment, and for longer.

Of the main rating agencies, S&P's methodology is regarded as the strictest. All agencies provide 50% equity treatment to hybrid capital during its first 10 years, and it is at this point that S&P drops the equity treatment of investment grade hybrid bonds completely if they are not called in. This change has the effect of increasing leverage and negatively impacting the issuer's credit rating; providing a strong impetus for companies whose hybrid bonds are rated BBB- or better by S&P to call in the debt, as they are able to refinance them by issuing either another hybrid to maintain the equity treatment, or a senior-ranked bond at a lower cost. If a hybrid is rated as high yield (lower than BBB-), the issuer is allowed a single extension by S&P before the equity treatment is dropped.

Figure 3 – Typical Rating Agency Equity Treatment for Hybrids



Source: Rating Agencies, BMO Capital Markets

The other major rating agencies do not have such strict requirements, so hybrids that are not rated as investment grade by S&P, but are by DBRS or Moody's, could in theory extend the bonds at least once without damaging their credit ratings. As the hybrid market grows and more hybrid issues that are not rated by S&P come out, further weight will have to be given to extension risk. Over time, as we watch these dates come and go, market convention will develop and clarity will increase.

Risks of hybrids

Fixed income investors who include hybrid bonds in their portfolio need to be fully aware of the structure they are buying. In addition to the junior subordination and equity-like features listed above, some potential risks involved include:

Extension risk – In general, investors expect hybrid instruments to be called at its first coupon reset date as the issuer would risk losing both their equity treatment under the S&P methodology and their reputation in the market if they were to extend. However, the extension risk does exist and is heightened if the hybrid is: 1) not rated by S&P (i.e., equity treatment not lost after first call date); 2) rated as high yield by S&P, as the equity treatment would be extended by five years; or 3) if the credit profile significantly deteriorates and the issuer's credit spreads become higher than the reset spread.

Forced conversion – In the event of bankruptcy, hybrid bonds will automatically be converted into preferred shares and as such have limited claim on the break-up value of the corporation.

Coupon deferral risk – The negative reputational risk of an issuer opting to defer a coupon payment would be very high in most circumstances, making this a last resort. Only in extreme cases when the issuer is facing a significant liquidity crunch would we expect this option to be exercised.

Covenant risks – In accordance with the hybrid's covenants some triggering events give the issuer the option to call the bonds early, the main causes being:

- **Rating event** – If a credit rating agency were to reduce the equity credit assigned to a hybrid issue due to a methodology change. The risk of this occurring is low as long as issuers continue to use the existing structures.
- **Tax/Accounting event** – A tax event would be triggered if the interest payable on a hybrid was no longer deductible for tax purposes. A change in accounting standards that leads to an adjustment in the financial statement treatment of hybrids could trigger an accounting event.
- **Change of control** – A change of control would generally be triggered in the event of a takeover.

The future of hybrid securities

Given the favourable treatment by the credit rating agencies and the lower financing costs, it has become advantageous for companies to refinance high-cost preferred shares with hybrids. So far this has been limited to corporates in the pipeline industry, but we expect this to extend to other sectors over time.

Beyond serving as a replacement for preferred shares, we may conceivably see hybrid bonds become an increasingly integral funding tool for companies looking to preserve their credit rating during times of high spending, such as large capital programs or acquisitions. Over the next five years we could find large companies in the Utility, Telecommunication, and Real Estate sectors coming to the hybrid market as a way to access funding.

Conclusion

With the preferred share market shrinking and likely to continue to do so, hybrid bonds are expected to increase their market share and offer an attractive alternative for yield seekers. However, as this article has highlighted, it's important to understand the nuances of these complex instruments in order to determine if they are suitable investments based on your investment profile and objectives.

For more information, please speak with your BMO financial professional.

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