IDEAS
FIXED INCOME /// JUNE 2014

The new subordinated debt : Cocos and Hybrids

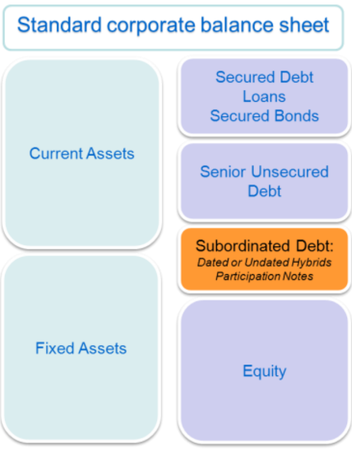
HIGHLIGHTS

- **A bond offering a more attractive yield for a lower subordination**
- **Cocos in strong development for regulatory reasons (Basel III)**
- **Hybrid debts answer the investors' appetite for yield and the issuers' need to strengthen their balance sheet**
- **A strongly performing asset class in 2013 and 2014 YTD**

1. All you need to know about subordinated debt

Subordination in the balance sheet

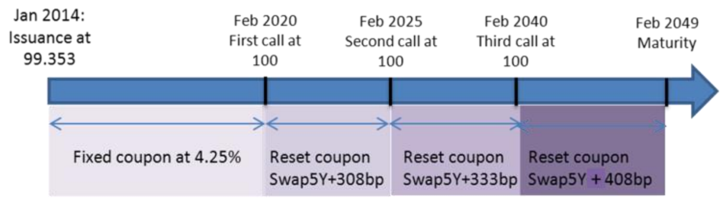
Hybrid debt is subordinated to senior debt: in case of default, it will rank after the senior bondholders but before equity holders and will receive a lower recovery rate.



Which coupon, which price along the bond life ?

Hybrid debt is usually issued with a fixed coupon. If the issuer does not call the bond at first call date, then the coupon is reset taking into account the swap rate level at that time. There is also a step-up coupon at the second and third call dates usually: the coupon is increased and still takes into account the swap rate level at that time. The investor benefits from market price increases over time, the coupon payment and, if the bond is not called, the coupon reset and step up. The call option is owned by the issuer only.

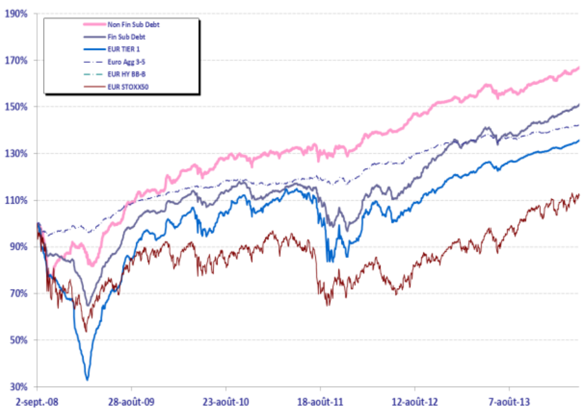
Here is an example: Orange bond 4.25% issued in January 2014 for €1bn.



The attractive yield and performance of subordinated debt

To compensate for subordination risk, hybrid debt investors receive a higher coupon, hence a higher yield compared to senior debt. On average, the yield offered on hybrid debt for corporate issuers is about 204bps higher and 290bps higher on cocos.

Historical performance of subordinated index compared to other assets[1]



[1] Indexes used are iBoxx Non fin sub, iBoxx Fin Sub Debt, iBoxx Tier 1, Barclays Euro Aggregate 3-5Y, Boa MLy High Yield Euro BB-B, Euro Stoxx 50. Source: NAM

In addition to this risk premium, with buoyant primary markets at present, investors benefit from a primary premium as new issues are regularly over-subscribed, hence contributing to further upside in secondary trading.

Historically, hybrid debt and financial subordinated debt have generated high performance. From September 2008 to December 2013, hybrid corporate debt returned about 65%, financial subordinated debt performed by about 50% and Tier 1 debt was up 32%. In the period under review, hybrid and financial subs outperformed the Euro Stoxx 50 equity index whilst underperforming Euro High Yield slightly. Subordinated debt also enjoyed lower volatility than high yield (about 7% in annualized terms).

2. Corporate hybrid debt analysis

The incentives to issue corporate hybrid debt for issuers

Corporate hybrids provide a substitute to new equity, at a lower cost, with the benefit of tax deductibility of coupons for the issuer.
From the issuer's point of view, the main drivers of hybrid debt issuance are:

- Increasing liquidity flexibility along with unchanged credit metrics;
- Capex / new projects (EDF);
- paying dividends (Iberdrola);
- M&A, pension funding;
- Share buybacks;
- Replacement of "old format" hybrid bonds.

Rating agencies assign equity credit for hybrid instrument, typically 50%. As regards accounting standards, hybrids may be treated as equity or debt in a company's balance sheet.

What to look for when investing in corporate hybrid debt?

When investing in hybrid bonds, you have to be compensated for:

- Very long tenors (mostly perpetual);
- Subordination;
- Suspension of interest payments. Under certain conditions, interest payments can be suspended. However, accrued interest must be paid retroactively once dividend payments resume or when the hybrid bond is repaid. Arrears do not always bear interest (See Enel).

The main threat until now has been changing methodologies of rating agencies. For example, the 3010 DONG hybrid bond has been re-qualified from 100% equity credit to 0%, just because the bond was dated (100 years). Standard & Poor's and Moody's continue to use different methodologies.

The structure of hybrid bonds, issued since 2013, is more standardized than in the past.

Use of funds: It is fundamental to understand why the company is issuing a hybrid debt instrument. Is this a new asset class? Will they use the funds to finance new projects with postponed cash flows during the construction phase? Or pay special dividends? Is there an incentive to maintain a rating level?

Covenants: Covenants are the single most important part of security analysis as they vary from one issuer to the next.

- Coupons can be deferred at the issuer's option, subject to dividend stopper / pusher constraints and special events.
- There are usually two step-ups, falling at different dates from call dates: 25bp and 75bp step-ups.
- Today, Replacement Capital Covenants[2] are intentional only (Alliander). In the past, they proved to be harmful to investors.

If the issuer's senior or corporate family rating falls into high yield category according to Moody's, the issuer automatically loses the equity credit on the hybrid debt.

The bond may be called at any time, at the issuer's option, upon the occurrence of a change of control, an accounting event, a rating methodology event, substantial repurchase event or a tax deductibility event.

3. Financial hybrid debt: a growing asset class

Last year, many European banks started to issue financial hybrid debt. The trend may continue as regulation will push banks to issue more and more subordinated debt.

Firstly, banks will need to build additional cushion for their Basel III capital ratio.

- Financial hybrid debt can qualify as capital.

Secondly, with the new bank recovery and resolution regime, banks will also build a cushion of bail-in-able debt to protect senior bond holders (and ratings).

- Financial hybrid debt can be part of this cushion.

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[2] [2] Replacement Capital Covenant ou RCC : Such covenant obliges (though the clause is only intentional on the part of issuers in recently issued hybrid debt) the issuer to replace existing hybrid debt with an equivalent instrument in terms of equity credit (which in practice equates to new hybrid debt).

Definition of financial hybrid debt and financial "Coco"

A financial hybrid security is a funding instrument that ranks junior to unsubordinated debt and depositors of a bank, and, in theory, senior to equity holders (although this could not always be the case with Cocos).

Coco stands for "contingent convertible security". This term is broadly (and mistakenly) used to describe financial hybrid debt that will absorb losses while the bank is still in activity. Practically, these instruments could absorb losses before equity holders[3]! Cocos include AT1 and T2 Cocos instruments.

Conversely, banks can also issue financial hybrid debt that will only absorb losses when the bank is in liquidation.

Analyst input: the research process for financial hybrid debt

Generally speaking, the stronger the issuer, the less likely the liquidation of the bank and hence, the less likely, subordinated bondholders will come to a point where they will absorb losses.

Thus, we look first at the issuer and assess its fundamental strength.

Then, for any given bank which financial profile we analyse, we shall look where the instrument ranks in the capital structure.

We also analyse its specific terms and conditions described in the bond prospectus.

- We look at the features relevant for coupon deferral. Indeed, for some instruments (namely AT1) non-payment of coupons is NOT an event of default. This means that a bank could continue to pay its dividends while it no longer pays its coupon.
- We also analyze conditions for principal loss absorption (upon which trigger and under which form). We would prefer a conversion into equity or a temporary write-down to a permanent write-down where there is no upside.
- Finally, we analyze features relevant for extension risk, whether there is a call option and when. Who decides to call and is there an incentive to do so?

4. How to manage hybrid debt within a fixed income portfolio?

The base rules for investing

As credit fund managers, we have adopted a specific investment philosophy. For investing in subordinated debt instruments, the fund manager has to follow three base rules:

- **Know your credits**: an in-depth analysis has to be run on the issuer. Only healthy issuers are selected for subordinated bond investment;
- **Know your structure**: investors need to assess the incentives to call and the risk of early call, to determine the risk of coupon deferral for financial subordinated debt and the risk of loss absorption;
- **Know how to price specific risks**: pricing tools are developed in order to evaluate the impact of coupon deferral / extension / subordination risks.

A pragmatic assessment of the call structure

The call option is owned by the issuer. To analyze the probability for a bond to be called at next call date, we need to understand the issuer's rationality. We adopt a pragmatic approach in order to assess incentives to call:

- At what price could the issuer issue a new bond to refinance the call of the standing one?
- What is the financial situation of the issuer?

These questions will help us to estimate a call probability.

Then we look at the bondholders' point of view:

- If the bond is called at first date, what could be the return?
- If it is not called, what could be the most probable call date in the future? What would be the return at that date?
- We also need to have a look at the probability for no call, i.e. that the bond runs until maturity, and the return at maturity.

In other words, investors should consider all possible scenarios, estimating call probabilities and returns in each case.

A quantitative valuation of subordinated bonds

Quantitative analysts are developing pricing tools to assess the value of the different embedded options in subordinated debts.

Those options will defer from one bond to another and could be:

- Call option;
- Deferral coupon option;
- Write-down option;
- Step-down option.

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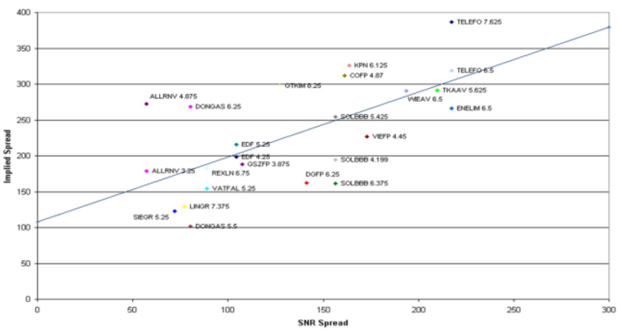
[3] Even if we reckon that once a trigger is breached the bank would be in such dire straits that its equity could be close to 0, we highlight that the position of cocos in the capital structure could be more subordinated than it seems.

Models then allow investors to compare subordinated bonds. They also allow an assessment of the spread between senior and subordinated debt. As an example, Natixis Asset Management built its own pricing model to compare the implied spread on subordinated bond to the issuer's senior spread:

Extract from in-house tool to price callable debt



The tools help portfolio managers to screen cheap and expensive bonds given subordinated spreads and relative value to senior spreads.

The tools also determine the call probability for each call date and an average holding period given those probabilities. Quantitative analysis assesses the investors' issues before investing on hybrid debts.

On the benefits of adding subordinated debt to a credit portfolio

Growth in subordinated debt markets since 2013 has attracted new investors lured by attractive yield levels. Sub instruments add value to a portfolio, as diversifying assets.

Firstly, subordinated debt recorded high performance in 2013 and on a YTD basis. The iBoxx hybrid debt index returned about 5.8% in 2013 and 8.84% in 2014 YTD (as of May 31st). Likewise, the iBoxx financial subordinated debt index rose 6.75% in 2013 and 14.1% in 2014 YTD (as of May 31st). The Coco index, launched by BoA Merrill Lynch early this year, is up 7.16%. Despite elevated performance, effective yields remain attractive: about 3.52% for corporate hybrid debt and 5.6% for Cocos (as of May 31st 2014)

Secondly, the subordinated debt offers protection against rising interest rates. Correlation with swap rates is low at -6%. The characteristics of the subordinated bonds, including a switch to floating rate reference after first call date, significantly reduce the sensitivity to interest rates. Moreover, the call may become more likely in case of a surge in interest rates (assuming unchanged credit spreads). The observed correlation with other assets remains relatively low (about 40% maximum with Euro High Yield). These characteristics make those bonds a good diversifying asset within a fixed income portfolio and enable to improve the potential return for a given risk level.

Conclusion

Hybrid debt is an attractive asset class for fixed-income investors:

- it offers a higher yield for a bond issued by an investment grade issuer;
- this product has low sensitivity to interest rate risk;
- it is a diversifying product even within credit portfolios;
- past performance has been elevated despite the 2008-2009 crisis.

This explains growing demand for these products. This market already totals about €728bn with 366 issuers and 1132 issues (BOA, BAM as of 30/4/2014). We expect primary market activity of about €40bn on corporate hybrid debt, €34bn on AT1 and €24bn on T2 debt (Natixis Research).

That said, the asset class is characterized by higher volatility. They include subordination risk. Therefore, investment in these securities requires specific expertise including a credit assessment and in-depth analysis of the issue itself in order to assess specific options. Bond valuation also requires appropriate quantitative pricing.

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