# The end of corporate hybrids?

An IASB proposal to reclassify the popular perpetual cumulative corporate hybrid structure as liability has cast a shadow over the primary and secondary markets since its release in June. Here, Véronique Diet Offner, in charge of liability management for EMEA and corporate hybrid structuring, DCM solutions and advisory, Crédit Agricole CIB (CACIB), shares insights from concerned parties on the implications for outstanding and future issues and ways to mitigate the impact of the change.

2018 may be remembered as a two-sided year for the corporate hybrid market.

The year started with the welcome release by S&P of a revised methodology on the early replacement of hybrids. Before this revision, issuers were not allowed by the agency to replace their outstanding hybrids before their fifth anniversary. With this new methodology, S&P allows issuers to actively manage their hybrid stock without time constraints as long as the replacement instrument has at least the same equity content, and the quantum issued is at least of the size of the nominal amount repurchased. Several hybrid issuers have since taken advantage of this revision and have launched large replacement exercises across their hybrid curves to try and optimise the financial conditions of replacement — examples include Telefónica, EDF and ENEL, with CACIB acting as dealer manager for the latter.

However, the second key event for 2018 has been casting a shadow over the market since July: the Discussion Paper on Financial Instruments with Characteristics of Equity released by the IASB at the end of June presents a new preferred approach on the classification of the perpetual cumulative corporate hybrid structure. This approach would jeopardise the equity classification of this structure at a time when it represents over two-thirds of the corporate hybrid market.

In this context, CACIB in mid-October organised a roundtable on corporate hybrids focusing on the impact of the IASB discussion paper on the corporate hybrid market and its various stakeholders.

IASB board member Mary Tokar offered a comprehensive explanation of the preferred approach and confirmed what a large part of the market had understood, i.e. that perpetual cumulative hybrids (as typically structured) would be classified as liability if the preferred approach were to be implemented. Indeed, the IASB is contemplating developing an "amount feature" on top of the "timing feature" already in IAS32, to provide guidelines for the classification of instruments as either equity or liability. According to this new approach, a financial instrument would not meet the amount feature and would thus be classified as financial liability if the issuer promised a return to the instrument's holder that had any independence from the issuer's own performance or share price. According to the IASB, this would be the case for cumulative hybrid securities because the coupons, if deferred, accumulate for payment at liquidation.

> **'It represents over two-thirds of the market'**

The potential shift in classification from equity to liability under IFRS would be an obvious issue for non-rated hybrid issuers, as highlighted by Arnaud Kolb, group treasury and financing manager at Eurofins Scientific: "Perpetual hybrids have historically represented an economically efficient tool for non-rated issuers to finance external growth without breaching covenants and without diluting shareholders."

However, it would also be an issue for rated issuers who were not only interested in the 50% equity content from rating agencies but also in the IFRS equity classification.

Regarding timing, the IASB did not wish to commit to a calendar, but mentioned that considering the nature of the consultation process, implementation before 2024 seems highly unlikely.

"The IASB is currently in the first step of this process, with stakeholders being invited to provide comments on the Discussion Paper until January 2019," said Tokar.

The discussion paper has, however, already started affecting the primary and secondary markets, and in particular asset managers' investment policies.

Highlighting the impact on the secondary market, Victoria Whitehead, senior credit portfolio manager at BNP Paribas Asset Management, who is in charge of a fund investing in investment grade hybrids, said: "We have always been mindful of the early redemption risk in corporate hybrids, in particular due to the rating and accounting calls in their documentation. Hence, when investing in the secondary market we tend to favour low secondary price hybrids and have been even more

Mary Tokar, IASB
'Perpetual cumulative hybrids may be reclassified as liabilities'

selective since the release of the discussion paper. As far as the primary market is concerned, we are screening all new issues and analyse whether they have a first call date likely to be post the implementation of the IASB preferred approach."

A large majority of perpetual hybrids are rated and Gregg Lemos-Stein, global head of analytics and research for corporates at S&P, indicated that S&P's corporate hybrid methodology should not be impacted by any change in accounting treatment.

Nevertheless, some rated issuers who opted for perpetual corporate hybrids, not only for the rating agencies' 50% equity credit but also for their IFRS equity treatment, may decide to exercise their accounting call (option allowing the issuer to call the instrument at 101% in case of reclassification of the instrument from equity to debt) when and if applicable.

### Is that the end of perpetual corporate hybrids as a tool for issuers looking for IFRS equity?

One structure may still be considered as essentially equity: the perpetual non-cumulative structure. Such bonds are likely to be differentiated from cumulative instruments as the issuer would in this case be under no obligation to pay a coupon and the instrument would contain no unavoidable obligation to pay any amount independent of the issuer's available economic resources. For these instruments, the notional of the bond would still be considered as liability under the preferred approach, as upon liquidation investors would have a claim on it. However, the present value of the nominal amount would normally be insignificant under the going concern approach and hence the difference between the issuance proceeds and this present value may be recorded under equity.

From the rating angle, S&P is likely to analyse a perpetual non-cumulative hybrid in overall the same way as a cumulative hybrid and thus treat it as having 50% equity content, so long as it meets all other aspects of the agency's criteria.

From the issuer's point of view, Kolb at Eurofins Scientific highlighted that "any 'new' IFRS-compliant structure (whether the non-cumulative structure or any other that might meet the issuer's constraints and objectives) may be efficient provided its cost would make it an attractive way of raising IFRS equity for the issuer".

Damien Loynes, European head of corporate syndicate at CACIB, mentioned that order books for a corporate non-cumulative hybrid may differ from the order book of a cumulative hybrid. Indeed, on top of any investment guidelines restrictions, the fact that non-cumulative structures are unlikely to pass the IFRS9 SPPI test may be a major negative for insurance investors, which can typically represent around 20% of the books of investment grade hybrids. The need for deal-related roadshows may be more relevant than ever to gather visibility on the premium over the cumulative structure required by investors who will accept this new feature.

### How can the various stakeholders be expected to manage the transition period?

IASB board member Tokar indicated that "if the preferred approach were to be implemented, it is unlikely that the Board would consider grandfathering for the outstanding perpetual hybrids not meeting the new criteria".

On this basis, Kolb and Loynes highlighted the benefits of liability management strategies for issuers, whether in the context of replacement exercises or consent solicitations to modify the terms of existing hybrids (depending on their documentation and governing law).

Victoria Whitehead, BNPP AM
'We have been even more selective since the release of the discussion paper'

Whitehead at BNP Paribas AM said: "We generally consider liability management exercises on hybrid bonds positively as they bring liquidity and a premium over secondary prices. We thus tend to participate if we consider that the premium offered by the issuer to repurchase its outstanding hybrids is attractive enough, especially if we wish to invest in the replacement instrument."

Permanence is a key pillar of S&P's corporate hybrid methodology and S&P will ask issuers to give it visibility on their intention regarding accounting calls if they have hybrids with first call dates beyond the date when a change in accounting classification is expected. However, Lemos-Stein pointed out that "if there is no available or affordable alternative replacement structure for an issuer with outstanding hybrids, S&P would not consider replacement to be mandatory following an accounting call since the economic rationale for the instrument has changed".

Overall, the roundtable confirmed that the IASB's new preferred approach would impact significantly non-rated issuers but also rated issuers who require the IFRS equity treatment.

Nevertheless, if it is confirmed that non-cumulative structures (and potentially others) can be overall equity accounted and are cost-efficient, then most issuers should find a way to manage the transition without impacting investors too negatively, potentially via the use of liability management exercises. ●