

CREDIT MARKETS SPECIAL | EUR CORPORATE HYBRIDS| EUROZONE

# Corporate Hybrids: the Bond-“Sweet Spot” 2024?

Rising refinancing risks in the high-yield (HY) segment increase the attractiveness of bonds from issuers with strong credit ratings. Yields on subordinated non-financial investment grade (IG) corporate bonds can keep pace with those in the HY segment. Possible interest rate cuts offer further upside potential in 2024. There is now a wide range of green hybrids on offer.

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## Good environment for IG Corporate Hybrids

### Strong credits will remain in demand in 2024

Hybrid bonds from issuers with strong credit ratings are likely to appeal even more to investors in 2024 than in 2023. Rising refinancing requirements and significantly higher refinancing costs will put pressure on high-yield issuers with weak credit ratings. Default rates are likely to rise. Senior investment grade bonds are also benefiting from the prospect of key interest rate cuts. However, in conjunction with the gradual brightening of the economic outlook, there should be an even stronger tailwind for subordinated IG hybrid bonds. IG hybrid bonds offer yields comparable to those of senior "BB" bonds.

### Solid fundamental outlook for IG hybrid issuers

Utilities and oil & gas companies account for the lion's share of the outstanding volume of EUR IG hybrid bonds at 34% and 31% respectively. Following the sharp decline in European utilities' debt repayment periods in 2023, consensus expects only a slight increase in 2024. The oil & gas sector was able to significantly improve its credit metrics in 2022 thanks to very high oil & gas prices. In 2023, the credit metrics weakened only slightly. By the end of 2024, the consensus is currently even forecasting a slight decrease in the sector's debt repayment period. Despite high investment requirements for utilities (grid and renewable portfolios) and oil & gas companies (adjustment of business models), the outlooks for the sector credit profiles remain stable.

Green hybrids now account for 17% of the EUR IG hybrid volume. They mainly come from utilities. VW issued green hybrids for the first time in 2023.

### Net new hybrid issue volume should remain low

The net new issue volume should remain low, as the costs of hybrid issues remain high from an all-in perspective. Therefore, refinancing transactions should continue to dominate in 2024. EUR 19bn of hybrids have their first call date in 2024, including one from Austria's OMV (call date: 03/19/2024). Some issuers are likely to decide to issue hybrid bonds (for the first time) despite the relatively high costs. One motive in economically challenging times is to strengthen the capital structure. IFRS recognize hybrids 100% as equity. Rating agencies usually classify 50% as equity. Owners' or shareholders' shares are not diluted.

The higher yields on hybrids compared to senior bonds, key interest rate cuts and the gradual brightening of the economic outlook should attract investors in 2024. A low net new issue volume could contribute to spread tightening. IG corporate hybrids already outperformed senior IG and HY corporate bonds in 4Q 2023.

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Note: Information on past performance is not a reliable indicator of future performance.

## Monetary easing should ensure strong performance in 2024

IG hybrid bond yields remain high by historical standards

Despite the rally in 4Q 2023, yields on IG hybrid bonds remain high by historical standards. They are close to the levels they reached after the outbreak of the coronavirus pandemic in March 2020 (see chart below left).

IG hybrids outperform senior IG bonds after monetary easing

If the key interest rate cuts expected by the market occur in 2024, this should provide further support for hybrid bond prices. The monetary easing in 2016 (introduction of the corporate bond purchase program by the ECB) and 2020 (launch of the pandemic emergency bond purchase program by the ECB) pushed their risk premiums well below their 10Y average calculated from today's perspective (see chart below right). Over the two-year periods 2016-2017 and 2020-2021 - i.e. in phases following monetary easing - IG corporate hybrids generated higher total returns than senior IG corporate bonds.

Company-specific factors play a greater role for subordinated bonds than for senior bonds

Despite the major influence of monetary policy, especially in the investment grade segment, investors should not completely disregard company-specific factors. Last year, for example, the green hybrid bonds of the Danish utility Orsted (issuer ratings: BBB+/Baa1/BBB+), which focuses on renewable energy, recorded the weakest performance of all EUR IG corporate hybrids. The Group had to cancel (offshore) wind power projects in the USA at the beginning of November 2023 due to higher interest rates, supply chain problems and less favorable tax conditions than originally hoped for. This resulted in high write-downs and cancellation costs. The rating agencies reacted with negative outlook changes.

The credit risk of green bonds is not automatically lower than that of conventional bonds

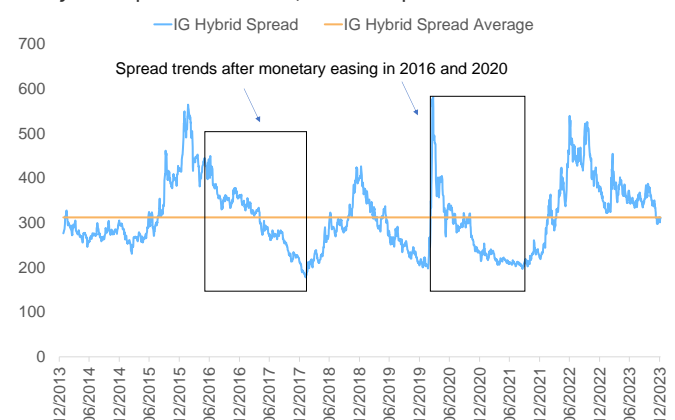
This example is a reminder that the sustainability characteristics of bonds say little about their credit risk and performance potential, at least in the short term. Bonds whose issue proceeds are invested in environmentally friendly or other sustainable projects do not automatically have a lower credit risk than conventional corporate bonds.

**IG hybrid yields remain high in historical comparison**  
Ø IG hybrid yield and Ø coupon, in %



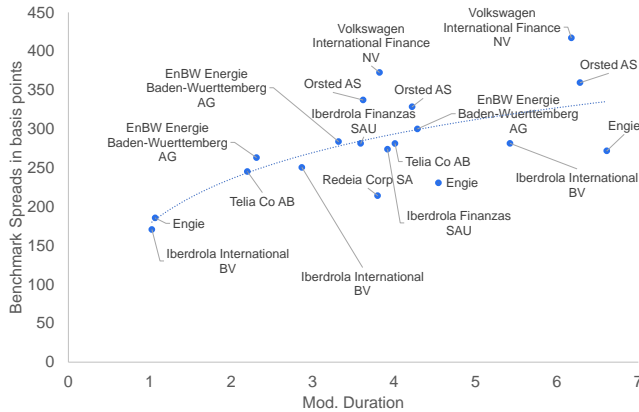
Source: Market data provider, Erste Group Research

**IG hybrid spreads already slightly below 10-year average**  
IG hybrid spread to Bund, in basis points



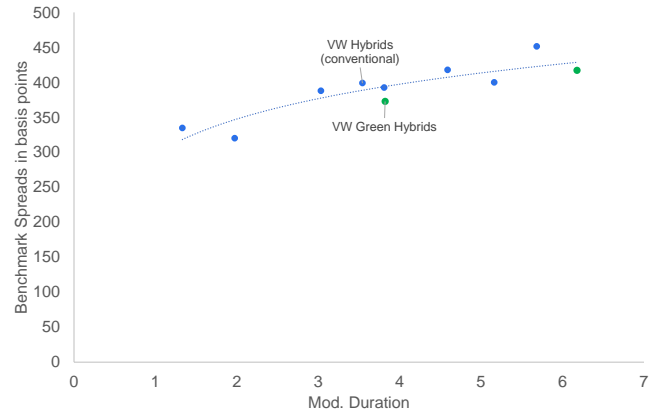
Source: Market data provider, Erste Group Research

### VW with highest spreads in the IG Green hybrid universe IG Green Hybrids: Spread to Bunds in bps vs. M. Duration



Source: Market data provider, Erste Group Research

### VW Green hybrids have a low "greenium" VW: Green & conventional hybrids: Spread to Bund (BP)



Source: Market data provider, Erste Group Research

Automotive group VW issued green hybrids for the first time in 2023

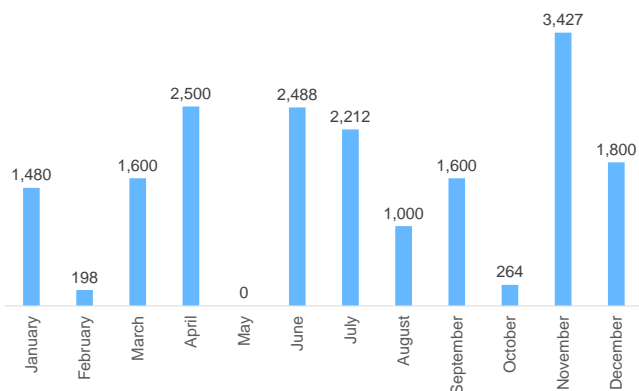
With regard to the question of whether green bonds have lower risk premiums than comparable conventional bonds, 2023 brought new data points. This is because VW issued green hybrids for the first time on September 6, 2023. VW also has many conventional hybrids outstanding. This facilitates statements on the existence of a "greenium" (= difference between the spreads of conventional VW hybrids and the VW green hybrids with the similar duration). According to the Group's Green Finance Framework (2022), VW's green hybrid emission proceeds flow exclusively into EU taxonomy-aligned investment projects. The relevant taxonomy-aligned economic activity at VW is the "production of low-carbon technologies for transportation", specifically investments in e-mobility.

VW Green Hybrids with low "Greenium"

Like the conventional VW hybrids in the entire IG hybrid universe, the two VW Green Hybrids in the IG Green hybrid universe also have the highest spreads (see left chart above). The chart on the right suggests a Greenium of around 20 basis points. Overall, we have so far seen only weak evidence of a significant "greenium" in the hybrid market (see also the [Green hybrid report](#) of July 21, 2023).

### Monthly breakdown of hybrid call dates in 2024

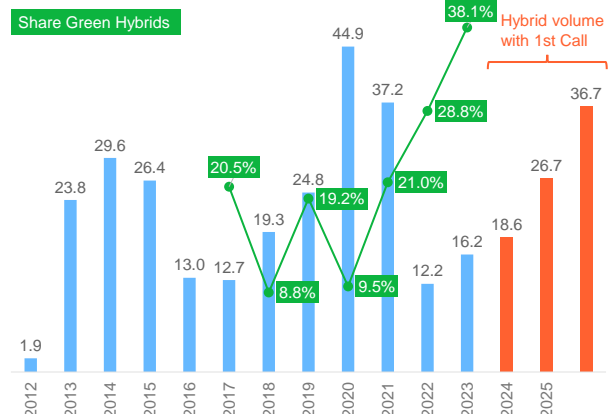
Volume with 1st call date, in EUR mn



Source: Market data provider, Erste Group Research

### Hybrid "refi" demand is still relatively low in 2024

Hybrid issue volume and maturities, in EUR bn



Source: Market data provider, Erste Group Research

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