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Corporate Hybrid Capital
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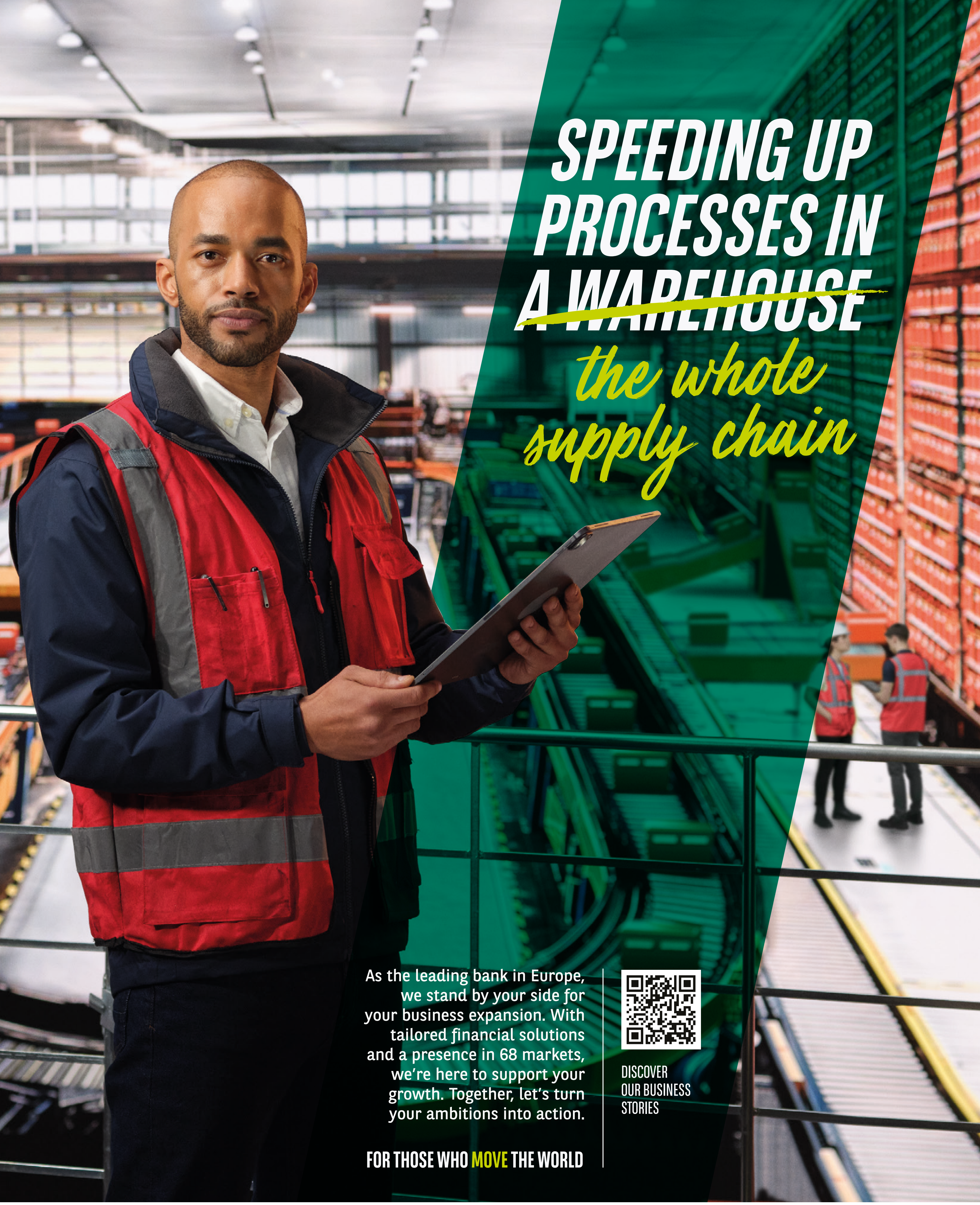

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Hybrid capital proves its flexibility and resilience

The hybrid capital market has shown itself to be resilient in the face of the tests posed by a global pandemic, rising interest rates and changes in the rating agencies' treatment of these instruments. It is now a key component of European investment grade corporate capital structures. There is also increased interest from US corporates and, more generally, from sectors not traditionally associated with the hybrid market. *GlobalCapital* brought together in February 2025 a panel of leading issuers and bankers to discuss the outlook for the market, as well as the practicalities of managing a hybrid programme.

***GlobalCapital*: How has the experience of the interest rate raising cycle changed corporates' thinking about hybrids?**

Leonardo Vagaggini, Enel: Let me start by saying that of course hybrid for us is an important asset class; we have a portfolio of around €8.2bn of hybrids. So it's an instrument that suits our investment plan and our capex plan.

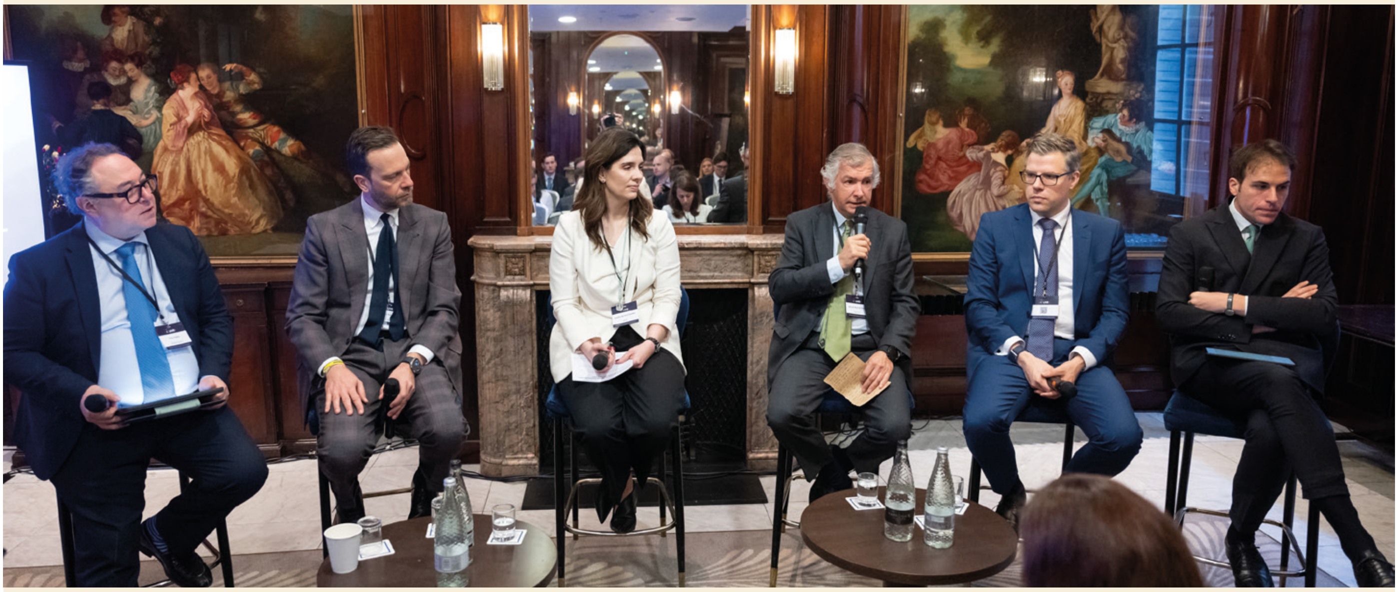
Of course, the surge in interest rates from 2021 has affected the asset class, but of course we have also seen the upside in the same way. When we consider the possibility to issue a hybrid, we consider that it's 50% equity and 50% debt, and interest rates affect the cost of both equity and debt. So in the end for us the key variable is the subordinated-senior spread.

And if we look at the movement of the sub-senior spread over the past two years, we are right now at the tightest level. So for example we issued in the very first window in January, a dual tranche hybrid transaction where we achieved a 110bp senior-sub spread — this was the tightest level in Enel's history.

Philipp Tempel, Deutsche Lufthansa: For us the hybrid is a special instrument. We refinanced an old one in January, which we didn't call in 2021 because of Covid. So far, we have been less impacted by the rising interest rates — our new coupon is exactly the same yield as the old one.

But generally I would say that — thinking also about other industries that have been more impacted, like real estate — there's a value in

Discussion participants



Moderator: **Toby Fildes**, managing director, *GlobalCapital*

Giulio Baratta, co-head of IG finance and head, debt capital markets, EMEA, BNP Paribas

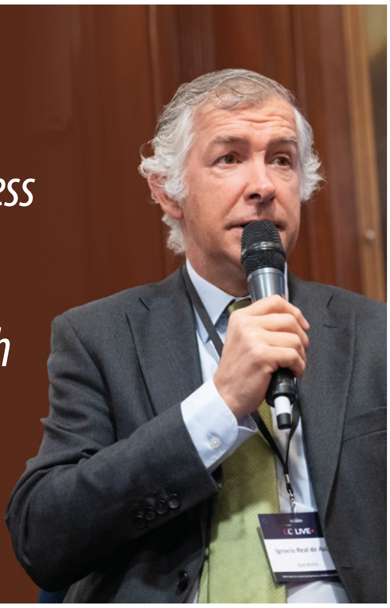
Sandra de las Cavadas, managing director, head of European corporates IG and HY DCM, BBVA

Ignacio Real de Asúa, head of capital markets and financial risk management, Iberdrola

Philipp Tempel, head of capital markets, ratings and creditor relations, Deutsche Lufthansa

Leonardo Vagaggini, head of capital markets, Enel

> *"From the issuer's perspective, we need the instrument to be more or less standard, with minimal changes in terms of regulation or methodology. This consistency is necessary for both issuers and investors"*
>
> ***Ignacio Real de Asúa, Iberdrola***



diversification. If you just issued in the low interest rate environment, then you are obviously much more impacted when rates rise. It's very important to diversify the maturities that are upcoming.

But as Leonardo said, from a corporate perspective, you are looking more at the senior-sub spread and at the premium you have to pay to get the equity content and that's quite a favourable environment at the moment.

Ignacio Real de Asúa, Iberdrola: We also have €8.2bn of hybrids outstanding. I believe there are two additional elements to consider. One is that the diversification of the resets is very important. We saw in 2022 and 2023, mainly due to the volatility in interest rates, that markets were nearly closed in the second half of those years. Therefore, it is crucial to take advantage of the windows to refinance the hybrids. We consider these instruments as permanent financing, so we will continue issuing hybrids as we consider them as a perpetual instrument.

The other element to consider, which has already been taken into account, is that they provide us with 50% equity. Thus, we can consider it very cheap equity. The first hybrid we issued had a coupon of 5.75%. The current environment for us, for a non-call five year hybrid, would be around 4%. So, while interest rates are high these days, the final levels for hybrids are competitive.

Sandra de las Cavadas, BBVA: If we look at the previous period, hybrid issuance volumes were a no-brainer as rates were super-low, representing a stark contrast versus the period when we saw interest rates going up, as issuers clearly had to take a tactical and strategic approach towards the asset class. In my view, it is most likely that this will continue to be the case throughout 2025.

The other thing worth highlighting is how we've seen some issuers maximise the flexibility provided by rating agencies' methodologies. Issuers made sure to refinance exactly the amount of hybrids that they needed to call through that period of hiking rates; either using S&P's 10% rule, not refinancing because of their underlying credit quality improvement etc.

Now that we are going into this new period of lower rates, we could see that approach change again, but for now, I think that strategic approach will very much continue to be common practice.

Giulio Baratta, BNP Paribas: Hybrids do what they say on the tin. They are a capital instrument. Capital needs to be managed, regardless of the exogenous elements, including interest rates. Issuing hybrids carries elements of execution risk as they are an investment product that carries a certain higher beta in terms of risk and volatility of its pricing. When markets move fast, rates or spreads move quickly and swings in the relative cost are not optimal from a borrower's perspective. This implies that the issuance and refinancing of these instruments has to be managed a little bit pre-emptively as you were saying, with liability management, with tactics to issue when the market is there for you and when you don't need it, as opposed to when you have to.

Overall, what I would focus on the most is the differential between the cost of a hybrid and the cost of senior debt, i.e. the senior-sub spread. That's what does the trick in cost optimisation for your hybrid capital base.

GlobalCapital: What have we learnt from the stressed situations that arose from some property companies with hybrid debt?

De las Cavadas, BBVA: For me there have been three main lessons learnt.

Firstly, even though hybrids are a very useful tool, they should be thought of within the context of a sustainable long-term capital structure. They are not a substitute for equity.

The second lesson is that extension and deferrability risks — whereas before they were more theoretical — have become a reality in today's context. They are much more in investors' minds versus the past. Consequently, I believe that issuers should factor in these risks when making decisions on how to best manage their hybrid stack.

Finally, the third lesson is that proactive liability management and refinancing is key. We've seen some companies that have decided to extend. Some other companies have decided to do liability management exchanges. So my take-away is that those that have a transparent communication to the market, proactively refinance their hybrids and also find solutions that align both investors' and issuers' interests manage to best retain market access and price efficiency.

Baratta, BNP Paribas: The last point you mentioned is important. We have had months and months of discussions with some of the hybrid issuers in the space, real estate especially, where there was a bit of a standstill in terms of what to do next, because clearly spreads or pricing for those hybrids were getting down to valuations that were concerning. There was relative illiquidity in the secondary markets, which was creating all sorts of question marks in terms of what to do.

In reality, also staying close to investors and listening to what they had to say was the fundamentally important thing to do. First of all: companies, please do talk to us, continue to talk to us, talk to us more. Keep us updated on what's going on in the business and hear our thoughts about how we think your business could sail through these situations.

***GlobalCapital*: Back to our issuers, is the product proving its worth as a risk absorber?**

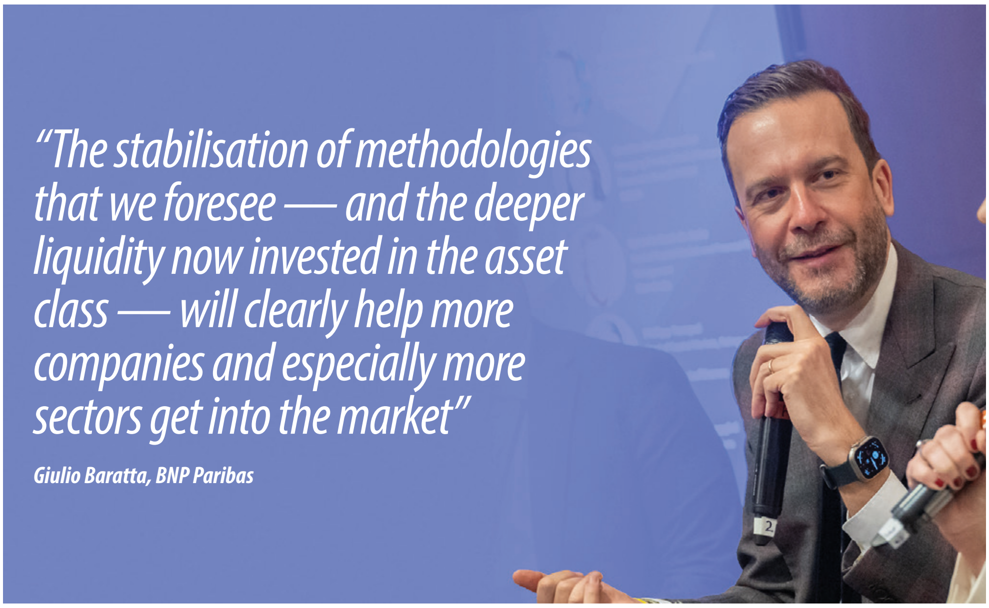
Tempel, Lufthansa: It's half and half, it's a hybrid. So I wouldn't say it has the same risk-absorbing characteristics as equity. It's not the same as equity. But it does give some value in terms of weighted cost of capital.

However, it's clear for all issuers that the base case is that you pay back after the reset date. But nevertheless, the instrument gives you the flexibility for a worst-case scenario. That gives you somewhat flexibility. There haven't been, to be honest, so many issuers who have not called it at the first reset date. Lufthansa has been one of the few during Covid.

We actually wanted to repay, but EU regulations at the time meant we couldn't pay it back.

So in a nutshell, it gives you flexibility, but it's also not the same as equity. It's not the same as in the bank capital structure where there is definitely more of a risk-absorbing factor. From a corporate perspective, the key feature is really to have this kind of cheap equity approach of saying OK, you have lower cost of capital in total for that and you have a win-win situation, both for the investor who gets a pick-up but also from a corporate WACC [weighted average cost of capital] perspective.

De las Cavadas, BBVA: I agree. It's been a risk absorber to a certain extent. Again, linking into the property companies, we've seen how they've used the flexibility of the instrument and that has served as a mitigant. And then I'd say as well that even if the issuer decides to extend, rating agencies tend to see that as credit positive because



"The stabilisation of methodologies that we foresee — and the deeper liquidity now invested in the asset class — will clearly help more companies and especially more sectors get into the market"

Giulio Baratta, BNP Paribas

you are preserving the company's liquidity and financial stability.

Vagaggini, Enel: On this point, of course there are features of the instrument that are risk absorbers. Hybrids are more utilised by investment grade corporates and these features have not been triggered because of the solidity of European investment grade corporates. But in the case of insolvency, restructuring or the need to preserve cash, there are features of the instrument that can be triggered.

***GlobalCapital*: What will be the corporate finance drivers of hybrid issuance going forward? Is it going to be M&A?**

Baratta, BNP Paribas: It should be M&A. We are all waiting for the M&A to come. But it is much more than M&A. First of all, hybrids should be seen as a permanent piece of the capital structure. Also, they are available and should be seen as such by any investment grade company.

Beyond M&A, they are for example well suited to help in sectors that are facing high capex cycles. In fact, the instrument suits this kind of need perfectly as it provides cash for medium to long-term investment and strengthening of the capital structure.

Real, Iberdrola: I believe one important element is how rating agencies are going to regulate these kinds of instruments.

From the issuer's perspective, we need the instrument to be more or less standard, with minimal changes in terms of regulation or methodology. This consistency is necessary for both issuers and investors. Over the past few months, we have seen some small changes, but I think it is crucial that these remain minor.

***GlobalCapital*: Giulio, you mentioned that hybrids are limited to a couple of sectors. When we were looking at the data, yes there is still some degree of concentration in certain sectors and countries. I presume you're going to say this will not be the case going forward, it's going to be expanding, is that right?**

Baratta, BNP Paribas: Certain sectors will continue to be the bigger users. At the same time, the stabilisation of methodologies that we foresee — and the deeper liquidity now invested in the asset class — will clearly help more companies and especially more sectors get into the market. Stability surrounding the instrument, including methodologies, is a key element to seeing more of what we are starting to see from 2025.

De las Cavadas, BBVA: In terms of sector diversification, we are seeing that becoming more of a reality in the US. Following the recent update to the methodology, we have seen stronger participation from US corporates in the market. Notably, sectors such as healthcare, auto suppliers and TMT have already utilised this instrument, and we anticipate further sector diversification in the US.

In Europe, as Giulio mentioned, issuance remains concentrated in capital-intensive sectors. However, as yields continue to decline, we may see more first-time issuers entering the market. In fact, last year, we witnessed a few debut issuers and this trend continues with Iren recently accessing the market. Hopefully, this momentum will persist, encouraging more companies to consider hybrids.

Baratta, BNP Paribas: In terms of the development globally of the instrument, I notice a difference when we do marketing in the US as opposed to here. European companies are already accustomed to the instrument and its market is more developed than in the US.

In the US at the moment the instrument is more associated with some sort of event-driven need or straight rating defence, as opposed to becoming something that companies may need, regardless of a specific instance, or as a permanent piece of their capital structure.

There is an element of education, early adoption and simplification of methodologies that will help with that familiarisation. There is enormous potential for hybrids in the American market.

De las Cavadas, BBVA: I fully agree. The market is trending quite fast towards a standardisation in the US, with the new 30 year non-call 10 structure becoming more prevalent. We are very positive about the prospects for growth there.

***GlobalCapital*: We'll all be in New York in a year's time. Going back to our issuers, how should companies concerned about the cost of their hybrid layers approach refinancing? Philipp, maybe this is one for you because you have just done a refinancing.**

Tempel, Lufthansa: It's a tough one. We just did a refinancing and we don't have that much hybrid debt outstanding.

Following up on the earlier question, the quantity of issuers might increase, we might see growth in the market because you have the refinancing and naturally you will grow the market. But obviously it will clearly be driven by the key sectors where you naturally have a lot of capex.

For us in January it was purely a refinancing exercise, it wasn't that we had a strategic view on it and said: 'OK, we need X billion of additional hybrid and how do we structure it'. So maybe it's a better question for my issuer colleagues on the panel.

Real, Iberdrola: We have to be prudent because we have seen a lot of volatility in the past. In our case, and perhaps in others, some banks have said that we are a bit aggressive because we have been doing the refinancing quite close to the reset dates of the hybrids.

However, we generally consider the amount of the hybrid we are refinancing. Our next refinancing will be €1.6bn, which is completely different from the exercises we have done in the past.

The main element is to follow the markets, maintain the confidence of investors in the company and be prudent in how we refinance. It becomes problematic if you reach the reset date and find the markets are closed — this is a situation we obviously need to avoid.

Vagaggini, Enel: Yes, I totally agree with Ignacio about the prudence. Having also a big portfolio of hybrids, refinancing is something that we have basically every year and we have call dates every year. So we try to approach the market, both in a prudent way of course, but also in a strategic and proactive way — but also to comply with the rating agencies' methodologies to refinance at the call dates, to not lose the equity content of the portfolio.

***GlobalCapital*: Do we like to see the use of genuine liability management to lower the cost of refinancing for issuers?**

Vagaggini, Enel: Yes, it's something that we have used in the past and we look at especially when we issue a new hybrid. Of course in our case we account hybrid as equity so we may not have all the benefit from a P&L perspective, in the income statement.

But of course for us it's an important element, first of all to eliminate double carry and also to free up investor capacity, to have a greater demand from investors and maybe to benefit from better pricing when we are doing the new issue.

Tempel, Lufthansa: We also thought about liability management, but we have only one hybrid outstanding and given that's a new one, we followed the new Moody's methodology of not being deeply subordinated. We obviously thought about that. But given that we have only one

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Sandra de las Cavadas, BBVA

outstanding, unlike other issuers who have a massive amount of hybrids outstanding, we decided against it. Because of practical reasons, it was also not to increase refinancing volume for this year, but also because the take-up would be likely very low. We have a lot of retail investors in the old one, it's €1k denomination.

***GlobalCapital*: When did you do the old one?**

Tempel, Lufthansa: In 2015 — it was still the old times before MiFID. The new one we did in January pays exactly the same yield, 5.25%. That was 10 years ago and nothing has happened in between!

Real, Iberdrola: One of the elements we are seeing these days is that we are refinancing hybrid issues from 2020 and 2021. The coupons on those transactions are very low, so we have less incentive to engage in liability management because it's essentially cheap debt. I remember in 2020, when we were doing a transaction, we were incentivised to try to take back those hybrids with coupons at 5% or similar. So it really depends on the market situation and the coupons you have to refinance.

***GlobalCapital*: Sandra, I think you touched on that didn't you? Who knows what will happen, but we will have to see what happens to rates?**

De las Cavadas, BBVA: I believe that much of 2025 is going to be a continuation of what we saw in 2024. Right now, we move from hybrids seen as cheap equity to cheap senior debt at the time of refinancing and that is the way that many corporates look at liability management. Now, we have to bear in mind that from a hybrids perspective we have peak maturity towers coming into play in 2026 and 2027, and that couples with the fact that we have also peak towers of senior debt coming up in 2026 and beyond. Together, this represents a significant combination of refinancing that needs to be addressed. So at some point I believe that they will use liability management, precisely for what Leonardo just mentioned, to free up some investors' lines and support their new issue.

"Refinancing is something that we have basically every year and we have call dates every year. So we try to approach the market, both in a prudent way of course, but also in a strategic and proactive way"

Leonardo Vagaggini, Enel

Baratta, BNP Paribas: For me, simplistically, in corporate hybrids, liability management is first a risk management tool to time the exercise of refinancing in the best way possible. And then it becomes a cost optimisation tool.

***GlobalCapital*: Any questions from the audience about what we've discussed so far?**

Robin Usson, senior research analyst, global investment grade credit, Neuberger Berman: Just a quick question for you Ignacio. When you talk about these — because we were talking about liability management exercises — how do you think about the three months par call when calling the bonds, because you were saying you were waiting until the first reset to call the bond? From memory you refinanced it before, but you waited to the last day to call the hybrid. So I was just curious as to how you make that decision.

Real, Iberdrola: We are accounting the hybrid as equity and one element to consider is the coupon of the hybrid we're refinancing. If the coupon is quite low, we aim to replace it much closer to the reset date. This is what we have done in the last three transactions. In the most recent transaction, we called the bond just two days before the reset date. However, the main factor is the financial aspect. We need to take advantage of this cheap money.

Usson, Neuberger Berman: So is it fair to assume that it's a matter of where you can place the money that you raised — so the money market rate versus your existing coupon?

Real, Iberdrola: Yes, it's a financial decision.

Vagaggini, Enel: I agree because in the end it's a financing exercise, so we are looking at the cost of the hybrid that we are going to call in the three month par call and usually at the cost of our invested cash. So we do this type of exercise usually, yes.

Ana Greco, head of European credit desk strategy, BBVA: A general question for the issuers. How do you approach and assess the US dollar market in terms of future hybrid issuance needs? As you are well aware, the USD is generally a broader and deeper market, which is now catching up in terms of appetite from US investors in regard to hybrid bond investments. In addition to this, we have European investors who are also now starting to look more into US dollar hybrids following Moody's change. What are your thoughts on this? Is it a market you are considering?

Real, Iberdrola: The instruments in the US market were not our preference. The main difficulties were that they had preferred and junior subordinated instruments. With junior subordinated instruments, Moody's only grants

25% equity credit. Additionally, for preferred instruments, the coupons are not deductible.

Now, we have a new junior subordinated instrument. With this, we can achieve a 30 year tenor, the deductibility of the interest and a 50% equity credit component in the transaction with Moody's.

For us, another element to consider is that we are accounting the hybrids as equity as we are doing perpetual transactions. However, this 30 year transaction would need to be accounted as debt, which is a change for us. We follow this market closely and if there is an opportunity for arbitrage compared to the euro market, it is something we will consider because we have assets in dollars. Therefore, we can say that the sterling and dollar markets are natural markets for us.

Tempel, Lufthansa: We account for our hybrids as debt so we would be theoretically more agnostic to the US market, as we also did the 30 year non-call six structure in January. However, Lufthansa has in the past only issued euros, both senior and hybrid, because that is the most cost-attractive funding market for us. We obviously monitor all the different currencies, but so far the euro market has been sufficient from a market capacity perspective and very attractive in terms of interest rates, but especially spreads.

The dollar market comes with another cost of documentation and so far we haven't see any value of going there. And I don't expect in the foreseeable future any change to that, given where our spreads are in the euro market.

Real, Iberdrola: We follow different markets to analyse potential arbitrage. We had US debt in the past. So it could be an opportunity if the pricing becomes interesting to us in the future.

However, for hybrids there is another technical issue to consider when it is fully accounted as equity. When we execute the cross-currency swap, we may not be able to achieve hedge accounting. This could introduce volatility in the P&L, presenting another obstacle to issuing hybrids in other currencies.

Baratta, BNP Paribas: I have a question. You clearly mentioned that you have to monitor cost arbitrage as part of the job. But intrinsically you have a bias for using the European market, your transactions have all been incredibly successful and well oversubscribed. But do you feel an over-reliance on the European market at the moment or not?

Real, Iberdrola: When the euro market is a bit wide, we will try to diversify. This is something we did in the senior debt market in the second part of the year. We issued in sterling, Australian dollars, Swiss francs and Norwegian kroner.

We follow all the markets closely. It's about looking at the arbitrage opportunities, knowing the levels and interest from investors from different markets, and trying to do the best. In many cases, the best for us is to have the opportunity to diversify at a lower cost.

Tempel, Lufthansa: To mirror what Ignacio has just said, there is a value in diversification if you play different currencies, different markets. But the premium shouldn't be too high. But right now where we trade, especially to peers, and where spreads are trading, it's hard to see the diversification play into other currencies for arbitrage or for just pure diversification. But yes, we are monitoring that always and, so far, the opportunity hasn't appeared.

Vagaggini, Enel: I would give the same answer. Of course diversification, arbitrage, look at different markets to exploit pricing advantage.

De las Cavadas, BBVA: I actually had a question as well for Leonardo if I may. How do you see the increase in the stack of hybrids going forward? Throughout this period, we've seen issuers sticking to the same level of hybrids. Could lower rates incentivise to do more hybrids down the line?

Vagaggini, Enel: In January we issued a new layer because, first of all, of the big spare capacity we have from rating agencies — we had €19bn of spare capacity — and also it was a good moment to issue hybrid capital because of the level of the senior-subordinated spread. So there were tactical reasons to issue more hybrids to reinforce our capital structure.

Tempel, Lufthansa: We are quite happy with our capital structure as it is right now. Is it an option to increase in the future? Obviously, you never know what happens, but I think you have to be cautious to increase because it's easier to increase than to decrease. And that's purely why we did the refinancing because we needed to keep up the option, especially with the S&P methodology, and obviously our commitment to the product. But yes, it's a permanent element of the capital structure, you have to be cautious to increase because you are obviously increasing refinancing risk as well.

Real, Iberdrola: And the same goes for us. We have €8.2bn, which is roughly half the capacity we have from S&P. GC

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