MORRISON
FOERSTER

HYBRID CAPITAL

PART I & PART II

March 2019

Hybrid Capital

In certain situations companies may feel the need for a financial instrument that possesses a non-dilutive feature like debt, but still provides flexibility on the balance sheet like equity.

Potential benefits of hybrid capital:

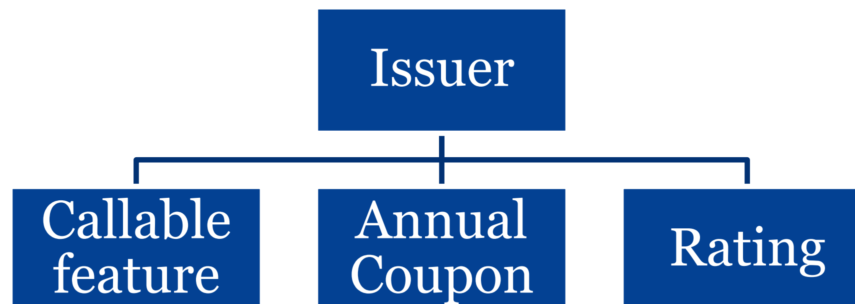
- Tax
- Regulatory treatment
- Accounting treatment
- Impact on credit rating;
- Impact on covenants: companies will have their own target capital structure – i.e. debt-to-equity ratio.

Part I: Perpetual Bonds - background

- *Bonds/Medium Term Notes* are treated as 100% debt – i.e. non-dilutive
- *Shares* are treated as 100% equity and dilutive.
- *Hybrid capital* acts as a debt instrument but can be classified as equity (depending on its degree of permanence and seniority) – i.e. somewhere in the middle on the debt and equity spectrum; detailed term s of the perpetual bonds will be critical in assessing where exactly on this spectrum will specific perpetual bond issuance lie
    - *Accounting: IAS 32* – to obtain equity treatment under IFRS, a perpetual bond should not be puttable by the investor (i.e. no obligation to redeem)
    - *Tax*: perpetual bonds have tax-deductible coupon payments, while share dividends cannot be deducted.
    - *Regulatory capital*: for issuers who are subject to regulatory capital rules, the determination of how the bonds will be classified under the regulatory capital rules is critical.
    - CAUTION: Transactions labeled as debt for accounting and tax purposes can still be regarded as equity for rating purposes, and vice versa!

Part I: Perpetual Bonds - structure

- Perpetuals are bonds with no maturity date – can last forever.
  - Typically perpetual bonds would have a **callable feature** giving the Issuer a right to terminate the obligation and pay back the bondholder at a predetermined price on certain dates or in certain periods defined in the bond documents (often 5 or 10 years from issuance).
  - Perpetuals have the same basic features as ordinary bonds: Issuer issues the perpetual bond and agrees to pay interest (coupon) pursuant to the bonds (typically paid annually). If the Issuer gets into financial difficulties, it may reduce the coupon or not pay any interest at all. Often coupon is stepped up if call option not exercised.
  - Often perpetuals will be rated by one of the large rating agencies.



Part I: Perpetual Bonds – use cases

- Perpetual bonds have been issued to fund mergers and acquisitions and/or capital expenditure
  - *Equity* classification means that perpetual bond can be used to maintain the issuer's credit rating (avoiding increase in leverage)
  - Number of perpetual bonds come from *industries that are capital intensive*: public utilities, oil and gas, manufacturing and real estate
  - There are examples of perpetual bonds being issued by state owned enterprises

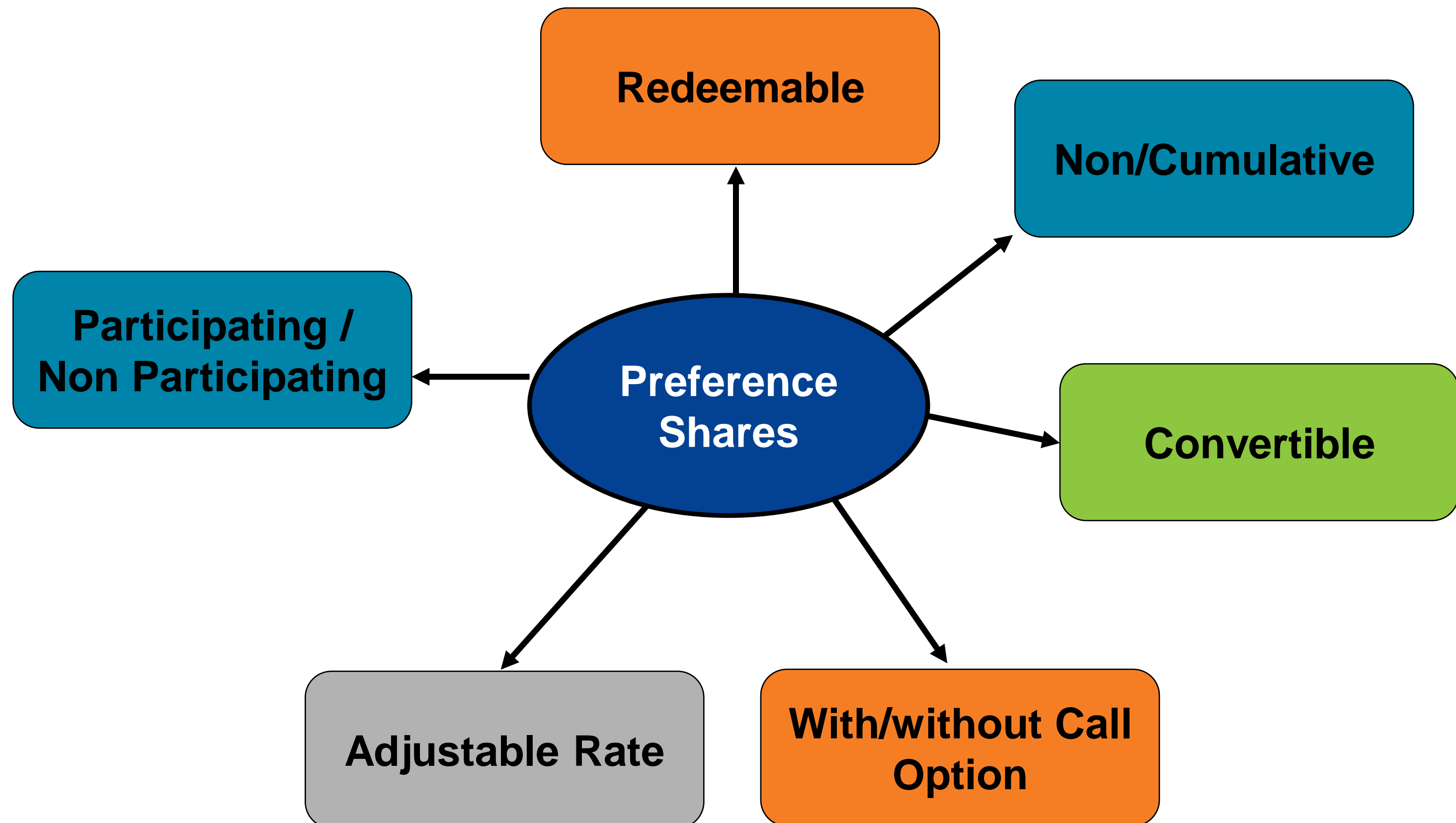
Recent 'issues' and issuances:

- January 2019 – **Bank of China** issued USD 5.9bn perpetual bond at a yield of 4.5%
- February 2019 – **Banco Santander SA** decided not to call EUR 1.5bn of perpetual contingent-convertible notes

Part II: Preference Shares - background

- Non-redeemable preference (or 'preferred') share is another type of 'perpetual' financial instrument – as with the perpetual bonds, substance of the contract prevails over legal form of the instrument for purposes of the accounting analysis
- **Ordinary share** – no obligation to pay cash or other financial assets (100% equity); default type of shares of a company – carry voting rights and rights to dividends and give right to participate on a winding up in any excess assets.
- **Preference shares** – if distributions to holders of the preference shares are at the discretion of the issuer, the shares will be treated as equity instruments (for accounting purposes); if however distributions are mandatory, the shares will be classified as financial liabilities.
- Preference shareholders have typically a higher claim on assets (repayment of capital if company is wound up) and earnings (dividends) than ordinary shareholders. Typically preference shareholders are paid fixed-rate dividends before dividends are paid to ordinary shareholders but non-payment of dividend won't trigger event of default.
  - Tax treatment? (dividends not tax deductible??)
  - Impact on ratings?

Part II: Preference Shares - features



Part II: Preference Shares - structure

- Some limitation imposed by the corporate law of the jurisdiction where company incorporated (e.g. Companies Act 2006 in the UK) and by the regulator (for any preference shares listed on LSE , the FCA)
- **Investor associations** (such as the Investment Association in the UK) set out guidelines to define good practice by listed companies - listed companies either have to follow such guidelines or voluntarily abide by them to ensure that certain types of investors (e.g. large pension funds or asset managers) will be able to invest in their financial instruments

Part II: Preference Shares – use cases

Some of the more liquid preference shares traded on London Stock Exchange (nearly 400 preference share instruments listed on LSE):

- **Aviva** (8.75% cumulative irredemable preference shares)
- **BP** (8% cumulative irredemable preference shares)
- **Lloyd Bank** (9.25% non-cummulative irredemable preference shares)
- **Northern Electricity** (8.061% cummulative irredemable preference shares)

Contact Details

Vladimir Maly
Tel: +44 20 7920 4031
Email: vmaly@mofo.com

MORRISON
FOERSTER