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Conversations with…

Julian Marks, Managing Director, Global Credit Portfolio Manager

Neuberger Berman Corporate Hybrid Bond Fund

An expanding universe of yield for investment grade credits

In an otherwise low-yield environment for investment grade corporate bonds and government issues, investors are looking to balance a desire for higher yield with a preference for high-quality credits. By virtue of their equity-like characteristics, hybrid bonds can support incremental yield relative to senior unsecured debt while providing access to non-financial investment grade issuers. The recent growth of the corporate hybrid market has been significant and is attracting increased attention from both issuers and investors. We asked Julian Marks, Global Credit Portfolio Manager, to explain the characteristics of the hybrid bond universe, the drivers of its growth and the role it plays in credit investing.

How do hybrid bonds differ from traditional bonds or equities?

Hybrid bonds combine characteristics of traditional bonds and equities. Like bonds, hybrid bonds pay regular coupons; however, issuers have the flexibility to defer payments in certain cases. Like equities, they are subordinate in the capital structure, so in the event of a default there may be no recovery of principal.

You can also compare hybrid bonds to other forms of subordinated debt. For example, subordinated bank debt in the form of contingent convertible bonds (CoCos) are generally used by issuers in the banking sector, are *excluded* from major bond market indices and are structured to meet regulatory dictates. In contrast, corporate hybrid bonds are used by non-financial issuers, are *included* in the major bond indices and are shaped by credit rating considerations.

Why do corporate issuers sometimes choose hybrid financing over other instruments?

Companies issue hybrid bonds for multiple reasons, including bolstering their capital levels, lowering their weighted average cost of capital, diversifying their funding sources and managing credit ratings.

Due to their equity-like characteristics, hybrid bonds are less burdensome than senior bonds on core capital ratios. In calculating debt load, credit rating agencies Standard and Poor's, Moody's and Fitch treat hybrid bonds as 50% debt and 50% equity. In this way, being used as a substitute for some equity allows hybrid issuers to reduce their blended cost of capital as hybrids provide balance sheet flexibility and improved credit metrics.

Hybrid capital is designed to be cheaper to issue than common equity while preventing ownership dilution. Furthermore, coupon payments are tax-deductible, unlike dividends on equity capital. Terms on hybrids are more flexible than on senior unsecured debt; for example, an issuer can defer coupons without triggering a default, although coupons are cumulative and companies cannot pay dividends or buy back shares in this situation. *In fact, the incentives for paying coupons are so strong that there has never been a missed coupon on a rated corporate hybrid bond.*

What is driving the rising issuance of hybrid bonds?

The major non-financial, investment grade, capital-intensive sectors, such as utilities and telecoms have traditionally been the big issuers of corporate hybrid bonds. Strong credit ratings and good access to senior debt markets are extremely important to these sectors. However issuance has become increasingly widespread in recent years. Several recent M&A deals in Europe, including those featuring names such as Vodafone and Unibail, have included corporate hybrids. As one would expect, issuance has also proved to be particularly favourable to issuers whose equity values are temporarily depressed, such as large oil companies recently, or whose ownership structure constrains their ability to access equity capital.

As of October 2018, the corporate hybrid bond market is worth circa $165 billion; however, we expect this value to roughly double in the next five to six years. As mentioned, issuers are turning increasingly to hybrid bonds to help with funding of merger and acquisition transactions, catalysed by an economic recovery in Europe in 2018. We expect M&A to remain a key driver of corporate hybrid issuance going forward. New issues are also being driven by refinancing needs, when existing hybrids reach their first call dates.

What role do hybrids play in diversifying a credit portfolio?

Issuers of hybrid bonds have a very specific profile: they are non-financial companies and are predominantly investment grade, globally recognised and Euro-denominated. These companies tend to be stable dividend payers–*which again, protects the hybrid coupon*–such as utilities and telecommunications providers. So from a diversification perspective, hybrids can provide a unique combination of economically defensive characteristics paired with relatively attractive yield.

From the investor's perspective, the higher yield helps compensate for the risk associated with a lower seniority of the hybrid bonds within the issuer's capital structure and other features. In many cases, hybrid bond investments currently present the prospect of investing in investment grade companies while earning returns commensurate with the high-yield market. Hybrid bonds currently provide a spread that is on average roughly five times higher than that of senior bonds offered by the same issuer.

Hybrids bonds are included in the major fixed income indices and are highly liquid, so they can integrate well into a balanced credit investment strategy.

What was rationale for creating the Neuberger Berman Corporate Hybrid Bond Fund?

Working as a Financials research analyst earlier in my career, I became very familiar with the structures of bank subordinated debt under various regulatory regimes through the years. The similarity of pre-2007 bank subordinated bonds to hybrid bond structures gave me a head start in evaluating the hybrid bonds of non-financial issuers.

In 2015, when we launched the Neuberger Berman Corporate Hybrid Bond Fund, a UCITS-compliant fund, we were already significantly overweight corporate hybrids in our Investment Grade funds. Our research team dedicated to Investment Grade credit

brought great familiarity and a history of engagement with Investment Grade issuers, as well as expertise on the structures. It made sense to leverage those capabilities into a vehicle for pure exposure to the hybrid market.

What are your governing ideas when constructing the portfolio?

We emphasise the importance of a cautious and selective approach in our construction of corporate hybrid portfolios; many factors need to be considered when analysing these securities. Arguably, the most important one is to be comfortable with the credit profile of the issuer before making a decision on subordinated credit risk. A stable or improving credit profile not only reduces downgrade risk, but also increases the likelihood of the instrument being called at the first call date and significantly reduces the risk of coupon deferrals. Additionally, detailed analysis needs to be applied to the structure of each note on a case-by-case basis. We must fully understand the structure of the instrument, the quality of the issuer and management's strategy in order to ensure the compensation received is commensurate with the risk taken.

How do you manage risk in the hybrid bond portfolio?

Our best defence is to invest in high-quality issues at valuations that offer a compelling margin of safety. An investment grade credit rating connotes lower default risk. Hybrid credit ratings are typically two to three notches below the rating of senior debt of the same issuers, *but even so, most of the hybrid bonds in our portfolio are themselves investment grade.*

Hybrid bonds are typically long-dated, sometimes perpetual, but they are callable in the first five to 10 years. Issuers are incentivised to redeem hybrids on the first call date because after that, hybrid bonds become more costly for the issuer and weigh more on its cost of capital. In fact, most lose their equity content from S&P if they are not called at the first call date, so they effectively become expensive senior debt.

As stated above, management has the option to defer the coupon. However, during the period when an issuer is not paying the hybrid coupon, it is precluded from paying dividends or otherwise returning capital to shareholders. This makes deferment an unattractive option.

Most of the securities we hold in our portfolio have been issued by large utilities, telecommunication and energy companies. Usually, equity investors buy these stocks because they look for regular dividend payments. In the last 10 years, these companies have continued to pay dividends regularly, even during the last financial crisis.

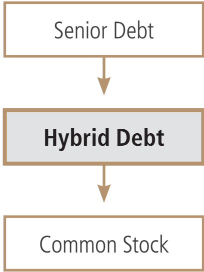
We are careful to limit exposure to peripheral euro zone issuers and *we do not buy any bonds from emerging market issuers.*

Potential Benefits of Corporate Hybrid Bonds

- Compelling opportunity in current low-rate environment
- Market growing rapidly, now circa $165bn[1]
- Average yields of over 4.16 compare very well with similarly rated senior bonds[1]
- Investment grade (IG), globally recognised issuers
- Mainly IG-rated, Euro-denominated bonds, included in fixed income indices
- Managed by IG credit team with a strong Euro credit track record

Strategy Focus

Simplistic Example of Contractual Priority (order of preference)



Source: Neuberger Berman as at 21 November 2018. Neuberger Berman, customised universe Bloomberg Barclays. Yield shown in EUR terms and is calculated based off the 12M FWD points for the currencies of the underlying securities of each respective index.

What does the future hold for the market for hybrid bonds?

In addition to significant increases in issuance, which I mentioned earlier, the pool of investment grade issuers is diversifying into additional non-financial industries—such as metals and mining, and chemicals—and into other geographies, including Canada and Australia.

Even as the hybrid market grows and diversifies, The Neuberger Berman Corporate Hybrid Bond Fund will endeavour to remain a step ahead of the hybrid benchmark in terms of geographic and industry diversification. We will remain focused on the highest quality issues structured to amply compensate investors for intrinsic and extrinsic risks.

AT A GLANCE

Neuberger Berman Corporate Hybrid Bond Fund

A focus on non-financial issues: The team invests only in non-financial corporate hybrid bonds as they believe that they offer a more compelling risk/return profile.

Quality portfolio: Focuses on high-quality issuers in stable sectors. Credits in the portfolio have an average rating of mid- to low BBB (the issuers themselves have an average rating of A-/BBB+), reducing the likelihood of defaults and helping to mitigate some of the risks associated with the subordination of hybrid debt.

Deep and fundamental research: A thorough credit assessment of each issue is carried out, as well as in-depth analysis of the issue's features, an essential step toward correctly determining fair value. The team gains unique insights from proprietary fundamental research conducted within the framework of a disciplined investment process.

Experienced and stable team: The two lead portfolio managers have an average of over 20 years' experience with a strong track record in Euro credit investing, and are supported by the firm's globally integrated fixed income platform of over 160 investment professionals. The team has participated in over 60% of all corporate hybrid deals within the primary market since January 2014.

Risk Considerations:

Market Risk: The risk of a change in the value of a position as a result of underlying market factors, including among other things, the overall performance of companies and the market perception of the global economy.

Liquidity Risk: The risk that the Fund may be unable to sell an investment readily at its fair market value. In extreme market conditions, this can affect the Fund's ability to meet redemption requests upon demand.

Derivatives Risk: The Fund is permitted to use certain types of financial derivative instruments (including certain complex instruments). This may increase the Fund's leverage significantly, which may cause large variations in the value of your share. Investors should note that the Fund may achieve its investment objective by investing principally in Financial Derivative Instruments (FDI). Certain investment risks apply in relation to the use of FDI.

Credit Risk: The risk that bond issuers may fail to meet their interest repayments, or repay debt, resulting in temporary or permanent losses to the Fund.

Counterparty Risk: The risk that a counterparty will not fulfil its payment obligation for a trade, contract or other transaction on the due date.

Operational Risk: The risk of direct or indirect loss resulting from inadequate or failed processes, people and systems, including those relating to the safekeeping of assets or from external events.

Currency Risk: Investors who subscribe in a currency other than the base currency of the Fund are exposed to currency risk. Fluctuations in exchange rates may affect the return on investment.

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