White Paper | **March 2025**

NEUBERGER | BERMAN

LINUS CLAESSON
Portfolio Manager—Investment Grade

ROBIN USSON
Senior Research Analyst—Investment Grade

ZHANPENG GUO
Portfolio Analyst—Investment Grade

Corporate Hybrids: What Are They?

Non-financial corporate hybrid securities have long been a feature of the European fixed income market. Their unique structure has attracted both issuers and investors, enabling the sector to grow rapidly over the past decade. U.S. dollar issuance also picked up significantly during 2024. In this article we explain what corporate hybrids are and why we think more investors should get to know them.

What are hybrid securities?

The non-financial corporate hybrid securities market is worth more than $300bn.[1] For comparison, that is larger than the BB rated euro high yield bond market.

Corporate hybrids are bonds that **combine features of both debt and equity:**

- Long-dated or perpetual but callable, typically five to 10 years from issuance
- Subordinated to senior bonds in the capital structure of companies and senior to equity
- Coupons are deferrable without triggering an event of default

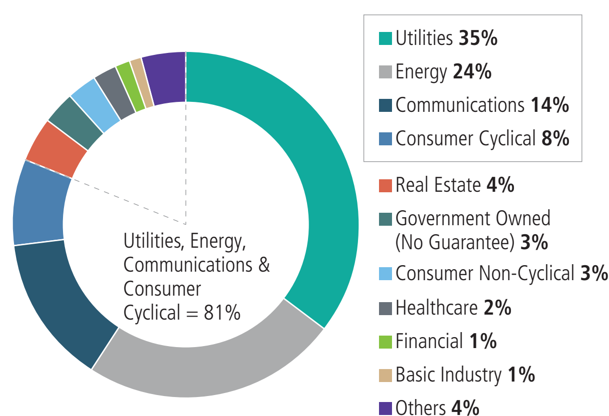
Who issues them?

Hybrids are generally issued by **high quality, investment grade, non-financial** corporates:

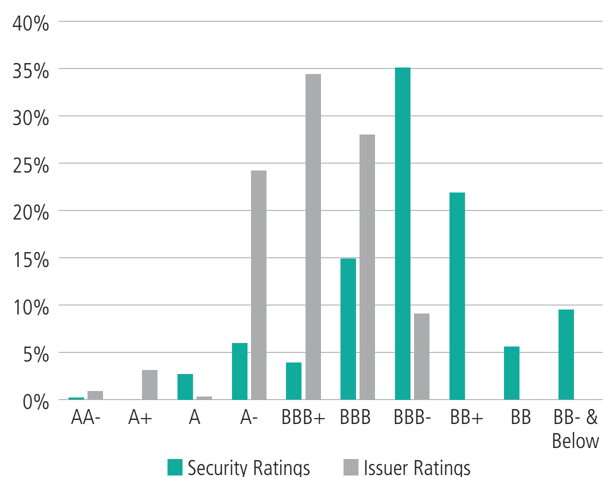
- **Utilities** is the biggest sector and **Communications** is the third-biggest: These sectors benefit from highly defensive characteristics, supported by stable, regulated and contracted earnings
- **Energy** is the second-biggest sector: These issuers are mainly integrated energy giants, supported by free cash flow breakeven points comfortably below current commodity prices
- Issuer ratings are clustered between A- and BBB at the senior unsecured level; an issuer's hybrids are typically **rated two to three notches below its senior bonds**, which means the bulk of the asset class rated between BBB and BB+
- Issuance has historically been concentrated in euro markets, but **the U.S. dollar market has been growing quickly** following revisions to the Moody's hybrid-rating methodology in 2024: the current split is 54% euro, 40% U.S. dollar and 6% other

CASH-FLOW GENERATIVE ISSUERS, INVESTMENT-GRADE RATINGS

Corporate hybrid issuance by sector



Credit ratings of outstanding corporate hybrids and issuers



Source: Neuberger Berman global investable universe. Data as of February 28, 2025. Credit quality ratings are based on the highest rating of three agencies (to the extent rated): Moody's, S&P and Fitch. For issuers or securities that are rated by two or more of the three agencies, the higher rating is used. All ratings are expressed using S&P nomenclature.

[1] As of January 31, 2025. Source: Neuberger Berman global investable universe.

Why do they issue them?

Issuers like hybrids because they **lower their weighted average cost of capital (WACC):**

- Hybrid capital is more expensive than senior debt but significantly cheaper than common equity
- Hybrid coupons are fully tax-deductible like coupons from any other debt security, but unlike equity dividends
- Being debt instruments, hybrid securities are non-dilutive

Hybrids can also help to **enhance issuers' credit ratings:**

- Hybrids' equity-like characteristics mean that credit rating agencies treat them as part equity when assessing issuers' capital structures and balance sheets
- Approaches differ, but Moody's, S&P and Fitch typically assign **50% equity content** to the issued hybrid capital (with some variance depending on the structure)
- As part equity, hybrids reduce issuers' leverage metrics relative to the same capital being raised via senior bonds, and as loss-absorbing capital they decrease risk for the issuer's senior bondholders

In extremis, the ability to defer coupons for a certain period without a default and the option to leave hybrids outstanding after their first call date gives issuers flexibility in the event of financial difficulty. These coupon deferrals and "extensions" have been extremely rare. Generally, coupon deferrals come with a cumulative deferral clause and a "dividend pusher", meaning it is not a cheap option for the issuer (see the table below).

Why do investors like them?

Corporate hybrids offer **high-yield-like returns but with higher credit ratings, on average,** than the high yield market. With first call dates at five or 10 years, hybrids are typically **shorter in duration than investment grade senior bonds**, whereas the coupon-deferral risk and especially the extension risk associated with corporate hybrids result in **yields that have always been higher than those on senior bonds** from the same issuers. We believe this premium offers an attractive investment opportunity because these risks are **substantially mitigated.**

Risk	Details	Mitigating Factors
Coupon Deferral	Coupons can be deferred at the discretion of the company without triggering a default. These deferred coupons can be non-cumulative or cumulative depending on the structure of the security.	• Deferral is only a concern with distressed credits. • Issuers tend to be investment-grade, with the means to pay and a history of paying. • There has never been a missed coupon by an investment grade issuer throughout the history of the asset class. • Deferred coupons are typically cumulative and any arrears are automatically paid should the issuer pay a dividend (a "dividend pusher").
Extension Beyond First Call Date	Hybrids are generally issued on the premise that they will be called at their first call date, typically five or 10 years after issuance; but they can be left outstanding.	• Extending is reputationally damaging and may affect future access to capital. • Structures typically include features that reduce extension risk. • Extended hybrids generally lose rating agencies' part-equity treatment, meaning it becomes 100% debt, and retaining a hybrid without that benefit is typically prohibitively expensive for the issuer. • From 2013 – 2024, 99% of corporate hybrids from investment-grade issuers were called at the first call date.
Special Event Call	Issuers can call hybrids early (most often at a price of 100% or 101%) under pre-specified circumstances, such as changes in accounting treatment, rating agency methodology, taxation or after the majority has been bought back via a tender (clean-up clause).	• Calling early is reputationally damaging and may affect future access to capital. • These call options are only a risk for hybrids trading significantly above par. • These risks are often manageable and well-telegraphed in advance.
Subordination	In the event of bankruptcy, holders of senior bonds have first claim on the company's assets; this means the recovery rate for hybrids will be significantly lower than that for senior bonds.	• Issuers tend to be high-quality and investment-grade. • Active managers can further mitigate this risk by selecting stronger issuers.

Does the rate environment make hybrids riskier?

This is a common misunderstanding. If anything, higher rates relative to recent history **offer investors further mitigation of extension risk, in our view.** This is because extension risk in hybrids is primarily driven by the reset spread economics rather than interest rates themselves. Should an issuer fail to call a hybrid, its **coupon resets** to the prevailing swap rate plus a coupon "step-up," making it more expensive than it was before the call date. If the new coupon is more expensive than a new senior bond would be, the incentive to call the hybrid is very high; therefore, when rates are higher, the incentive to call hybrids tends to be higher.

Are hybrids like "CoCos" or banks' "AT1" bonds?

Like the "Additional Tier-1 Capital" (AT1) or contingent convertible ("CoCo") instruments issued by banks, corporate hybrids are long-dated, callable, subordinated and pay deferrable coupons. However, we believe the differences are more important:

- Corporate hybrids have **strong incentives to call** at the first call date given the loss of favourable rating agency treatment after the first call date—not the case for CoCos.
- In the event of a deferral, coupons for a corporate hybrid would be **cash-cumulative and compounding**—not the case for CoCos.
- **No regulator can intervene** to prevent hybrid coupon payments or force their conversion to equity, as they can for CoCos.
- Corporate hybrids are **included in the major fixed income indices,** allowing for added liquidity, and tend to trade with a materially **lower volatility** relative to CoCos.
- Reflecting these differences, corporate hybrids are rated **one or two notches** below the corporate issuer's rating, whereas CoCos are typically rated **three notches** lower.

Are U.S. issuers' hybrids different from European issuers' hybrids?

Yes, U.S. and European securities exhibit different hybrid structure characteristics.[2] The main differences are found in three areas: legal maturity, effective maturity, and coupon deferral mechanisms.

Legal Maturity

- **European-style hybrids are issued as either perpetual instruments (non-dated) or dated instruments,** historically with maturities of 60 years and, more recently, 30 years. The choice is based on the International Financial Reporting Standards (IFRS), which allow perpetual instruments to be accounted for as equity.
- **U.S.-style hybrids, in contrast, are exclusively dated instruments;** maturities have ranged historically between 40 and 60 years but the more recent trend has been for 30-year maturities.

Effective Maturity

- When assessing corporate hybrids, the rating agency Standard & Poor's (S&P) defines effective maturity as the earlier of the legal maturity or the date at which a material incentive to call the security arises—which is when the coupon step-up exceeds 25 basis points. In European-style hybrids, step-ups are typically set to reach 100 basis points after 25 or 30 years, via a first step-up of 25 and a second of 75 basis points, which means **effective maturity falls upon the second step-up.** S&P removes a hybrid's equity content 20 years before effective maturity, and European-style hybrids have been structured so that the second step-up occurs 20 years after the first call date and equity content is therefore lost at the first call date.
- **U.S.-style hybrids do not typically have step-ups,** meaning they do not automatically lose equity content at the first call date.

Coupon Deferral Mechanisms

- **European-style hybrids generally allow unlimited coupon deferral periods,** though some recent instruments have introduced caps, typically of five years.
- U.S.-style hybrids impose a stricter limitation, with a **maximum coupon deferral period of 10 years.**

[2] For more detail on the differences between U.S.- and European-style hybrids, and the ongoing convergence of the two markets, see Linus Claesson and Robin Usson, "Corporate Hybrids Take the World Stage—Revisited" (January 2025), at https://www.nb.com/en/link?type=article&name=whitepaper-corporate-hybrids-take-the-world-stage-revisited.

Other Features

• **U.S.-style hybrids may incorporate coupon floors,** which serve to mitigate extension risk in a declining interest rate environment—a feature not commonly seen in European-style hybrids.

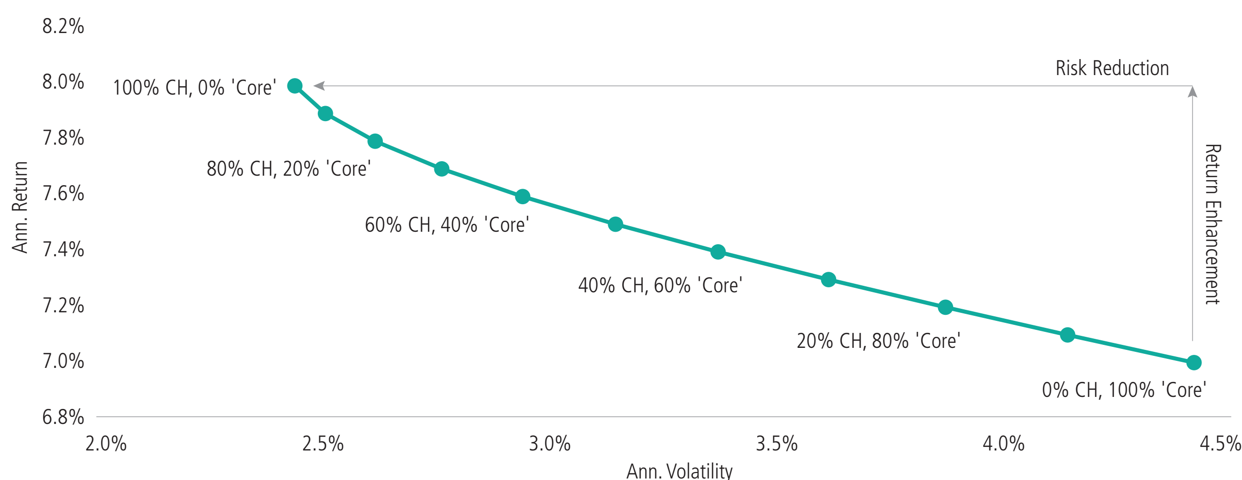
Can hybrids diversify a traditional bond portfolio?

Yes. Corporate hybrids have a unique profile. The lower table below shows that, over the past two years, hybrids exhibited lower correlation with equities than high yield senior bonds, but a lower correlation to government bonds than investment grade senior credit.

That diversifying profile becomes evident as we gradually add corporate hybrids to an illustrative fixed income portfolio that is split 60% investment grade and 40% high yield, once again surveying performance over the past two years. **For every 10% marginal allocation to hybrids, the return of the blended portfolio rises and the volatility declines.**

HYBRIDS CAN DIVERSIFY A FIXED INCOME PORTFOLIO AND A MULTI-ASSET PORTFOLIO

Annualized return and volatility of fixed income portfolios with rising allocations to corporate hybrids, March 2023 to February 2025



Correlation of monthly returns, March 2023 to February 2025

	Hybrids	HY	IG
Hybrids	1.00		
High Yield Bonds	0.70	1.00	
Investment Grade Bonds	0.51	0.73	1.00
Government Bonds	0.38	0.57	0.93
Additional Tier-1 Capital ($)	0.62	0.53	0.16
U.S. Equities	0.40	0.64	0.39
Developed Market World Equities	0.47	0.73	0.45

Source: Bloomberg, Neuberger Berman. Data as of February 28, 2025. The "core" portfolio in the top chart is illustrative and consists of 60% investment grade bonds and 40% high yield bonds. Indices used: Bloomberg Global Corporate Hybrids 3% Issuer Cap Index (Corporate Hybrids); Bloomberg Global High Yield Total return Index (High Yield Bonds); Bloomberg Global Aggregate Corporate Index (Investment Grade Bonds); Bloomberg Global Aggregate Government Index (Government Bonds); Bloomberg European Banks CoCo Index (Additional Tier-1 Capital); S&P 500 Index (U.S. Equities); MSCI World Index (Developed Market World Equities). Indexes are unmanaged and are not available for direct investment. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Index Definitions

The **Bloomberg Global Corporate Hybrids 3% Issuer Cap Index** tracks the global market in non-financial corporate hybrid securities denominated in multiple currencies. The weighting of any single issuer is limited to 3%.

The **Bloomberg Global High Yield Index** is a multi-currency measure of the performance of the global high yield debt market which brings together the Bloomberg U.S. High Yield, Pan-European High Yield, Emerging Markets Hard Currency High Yield Indices.

The **Bloomberg Global Aggregate Corporate Index** measures the performance of corporate bonds from the Bloomberg Global Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded worldwide.

The **Bloomberg Global Aggregate Government Index** measures the performance of government bonds from the Bloomberg Global Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded worldwide.

The **Bloomberg European Banks CoCo Index** tracks the performance of contingent convertible securities, issued by European financial institutions, that qualify as Additional Tier-1 bank capital.

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **MSCI World Index** tracks the performance of large- and mid-cap stocks across 23 developed markets countries.

This material is provided for informational and educational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types.

This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Diversification does not guarantee investment returns and does not eliminate the risk of loss. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-global-communications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

AA0077 03/25 2259775 ©2025 Neuberger Berman Group LLC. All rights reserved.

www.nb.com