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Corporate Hybrids Take the World Stage—Revisited

In May 2024, we published a white paper on the globalization potential of corporate hybrid securities, highlighting how recent changes to Moody's rating methodology had significantly enhanced their appeal to U.S. corporate treasurers. We anticipated a convergence with European standards in the U.S. market and predicted the emergence of a two-tier structure: long-dated instruments with coupon step-ups, the structure already common in Europe; and the increasingly popular 30-year structures without step-ups, which are akin to European hybrids with 10-year first call dates.

A year later, we observe that the momentum for U.S. hybrids issuance has not only persisted, but even exceeded our expectations, with a total of $27bn issued in 2024. This growth included expected switches from preferreds to hybrids (e.g., by Dominion Energy) and expected capital expenditure funding (by most U.S. utilities), but also unexpected issuances to protect under pressure credit ratings (e.g., by Aptiv and CVS Health). Among other forecasts for 2025, we anticipate more new issuers to enter the market, leading corporate hybrids, long dominated by European companies, to become more evenly split between Europe and the U.S.

Executive Summary

- The corporate hybrid market, once Euro-centric, is witnessing a transatlantic shift as U.S. issuers increasingly participate following last year's changes to Moody's rating methodology.
- The combination of tax-shield advantages and ratings benefits with the 50% equity content creates favorable conditions for U.S. corporate adoption of hybrids, in our view.
- Standardization around the 30-year non-call (30NC) structure without coupon step-ups, alongside hybrids' diversification benefits and higher carry and yield for less credit risk, is boosting demand and appealing to a broad range of investors.
- In particular, we see growing demand for U.S. 30NC10 structures that align the loss of equity content under Standard & Poor's rating methodology with the first call date, akin to the European structure with coupon step-ups.
- This alignment between issuers and investors has created a potential "sweet spot" in the U.S. hybrid market that is distinct from European-style hybrids with coupon step-ups.
- Key themes in our outlook for 2025 include: more issuance (from both the U.S. and Europe, from European companies issuing in the U.S. and vice versa, from new sectors and, especially, to finance rising M&A activity); more demand (from U.S. investors in particular, but also from European investors); further consolidation of the U.S. market in the 30NC10 structure; and more structure innovation.

As we noted in our May 2024 paper, the corporate hybrid asset class has historically been predominantly European. Until the end of 2022, European issuers accounted for 85 – 90% of the total outstanding hybrids in developed markets.

This dominance can be traced back to 2013 – 14, when hybrids emerged as a solution for large European investment-grade-rated corporations to protect their credit ratings during periods of significant capital expenditure, operational challenges and/or debt-financed mergers and acquisitions. The equity-like feature of hybrids enable rating agencies to grant hybrids 50% equity content while their coupons receive the same tax-deductibility treatment as debt. This made hybrids an optimal treasurer's tool, as the overall effect of issuing them instead of a mix of senior debt and equity could lower both gearing and the weighted average cost of capital (WACC, see figure 1).

FIGURE 1. ISSUING HYBRIDS CAN LOWER THE WEIGHTED AVERAGE COST OF CAPITAL

A hypothetical corporate capital structure, with and without hybrid capital

Initial Capital Structure & Initial WACC	Debt	Hybrids	Equity
% Mix in the Capital Structure	40%	0%	60%
Corporate Tax Rate (U.S.)	28%	28%	0%
Cost of Capital	5.25%	7.00%	10.00%
Post-Tax Cost of Capital	3.78%	5.04%	10.00%
Weighted Average Cost of Capital	7.5%		

Capital Structure & Initial WACC - When Hybrids Replace Equity Issuance	Debt	Hybrids	Equity
% Mix in the Capital Structure	40%	15%	45%
Corporate Tax Rate (U.S.)	28%	28%	0%
Cost of Capital	5.25%	7.00%	10.00%
Post-Tax Cost of Capital	3.78%	5.04%	10.00%
Weighted Average Cost of Capital	6.8%		
Δ WACC with hybrids	-0.7%		

Source: Neuberger Berman. For illustrative purposes only.

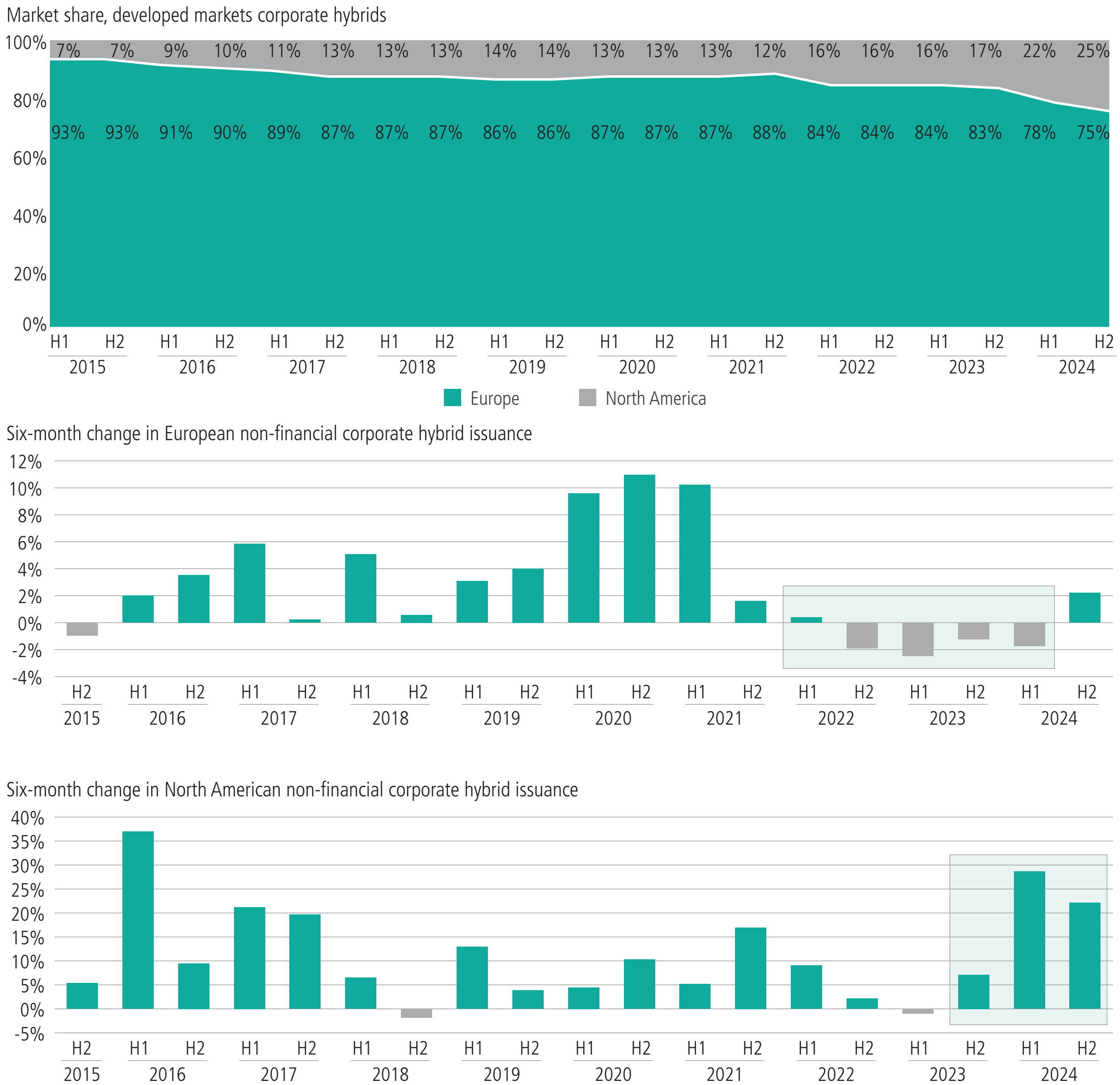
[1] Linus Claesson and Robin Usson, "Corporate Hybrids Take the World Stage" (May 2024), at https://www.nb.com/en/link?type=article&name=whitepaper-corporate-hybrids-take-the-world-stage.

European investors were receptive to these newly issued hybrids, as the market quickly standardized to a structure that enforced the loss of equity content at the security's first call date, thereby mitigating the risk of extension by the issuer and helping investors to manage duration risk. European hybrid structures had found the "sweet spot" that balanced the needs of investors and issuers.

Globalization Now at Full Speed

The dominance of European issuers started to come to an end with the onset of quantitative tightening from 2022 to 2024. North American issuers started to gain market share as the European market contracted and the U.S. market expanded, marking the beginning of a more globalized corporate hybrid landscape (figure 2).

FIGURE 2. NO LONGER A "EUROPEAN" ASSET CLASS



Source: Bloomberg, Neuberger Berman.

European issuers initially struggled to adapt to the higher cost of funding after a decade of zero to negative interest rates. In response, some issuers redeemed their hybrids without replacing them.[2] Even so, the market is far from saturation, and the overall trend remains upward despite some cyclicality: figure 2 shows the European market returning to growth in the second half of 2024 with renewed issuance and new market entrants.

Why Are Corporate Hybrids Now So Interesting for U.S. Issuers?

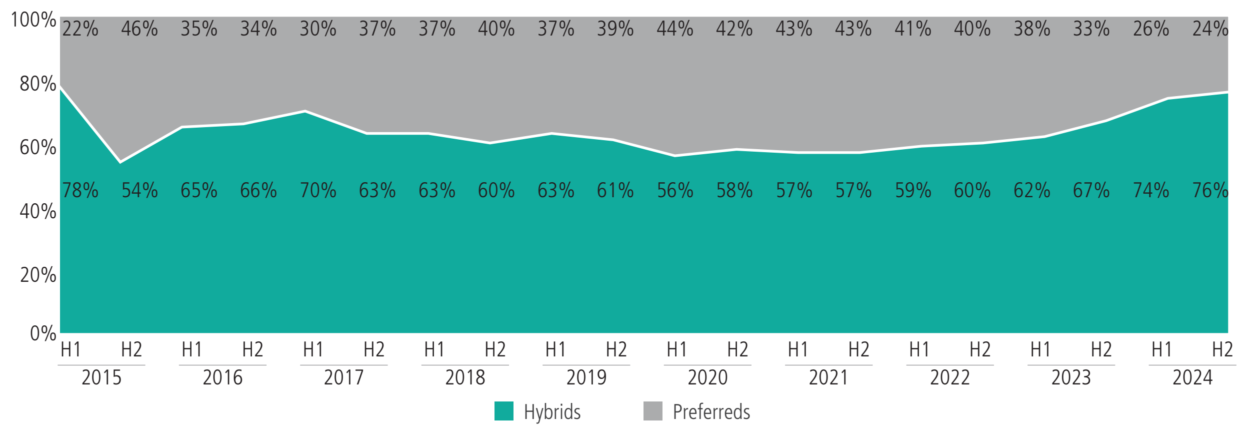
When we published our May 2024 paper, we argued that a change in Moody's hybrid rating methodology, which gave hybrids the same 50% equity content as preferred securities alongside the cost advantage of tax-deductible coupons, would lead to more adoption among U.S. investment grade issuers (subject to their suitability for issuers' broader capital structure goals).

As we have noted, corporations are motivated to issue hybrids for two primary reasons: to reduce their WACC and to preserve credit ratings.

Under Moody's new methodology, U.S. issuers making the "WACC trade" or "tax-shield trade" redeem non-tax-deductible preferred securities and replace them with tax-deductible corporate hybrids, while receiving the same rating benefit with the 50% equity content. Issuers like Energy Transfer and Duke Energy made that trade in 2024, and other issuers have flagged plans to do so (figure 3).

FIGURE 3. NORTH AMERICAN NON-FINANCIAL CORPORATE PREFERREDS – A DYING BREED?

Market share, North American non-financial corporate hybrids and non-financial corporate preferred securities



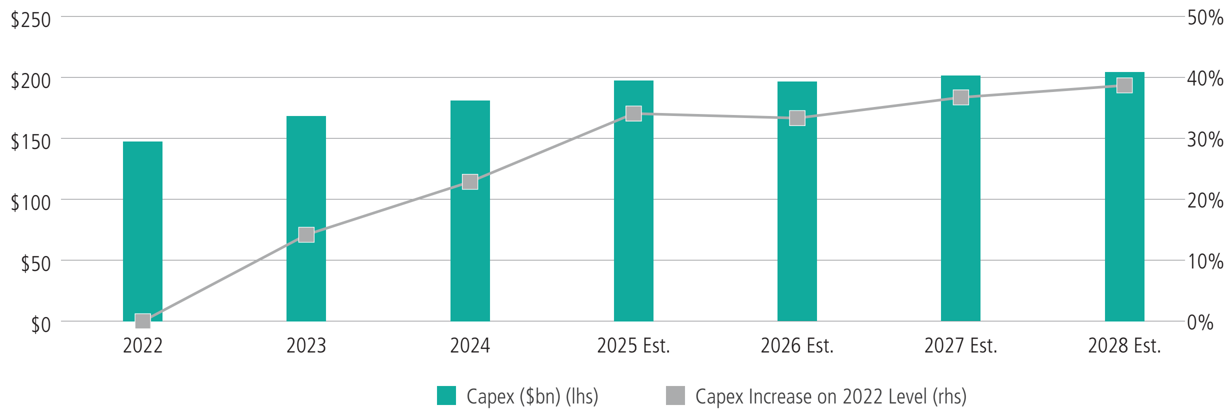
Source: Bloomberg, Neuberger Berman.

The "rating arbitrage trade" appeals to sectors with high capital expenditures, such as utilities and telecommunications, as well as companies that need to fund mergers and acquisitions or address weak credit fundamentals that threaten downgrade pressures.

Supporting Capex Efforts. Capex at North American utilities has risen by 30 – 40% since 2022, to fund decarbonization, electrification and, more recently, the AI/data center boom (figure 4). We estimate that North American utilities need to raise another $110bn in 2025, and that around $15 – 20bn of that will be via index-eligible corporate hybrid issuance.

[2] All other things being equal, redeeming hybrids without replacing them would cause a deterioration in an issuer's credit outlook, but Standard & Poor's regards redemptions of up to 10% a year as "immaterial." That said, the past three years have seen some European issuers redeem more than 10% of their outstanding hybrids without replacing them.

FIGURE 4. NORTH AMERICAN UTILITIES ARE IN A CAPEX SUPERCYCLE

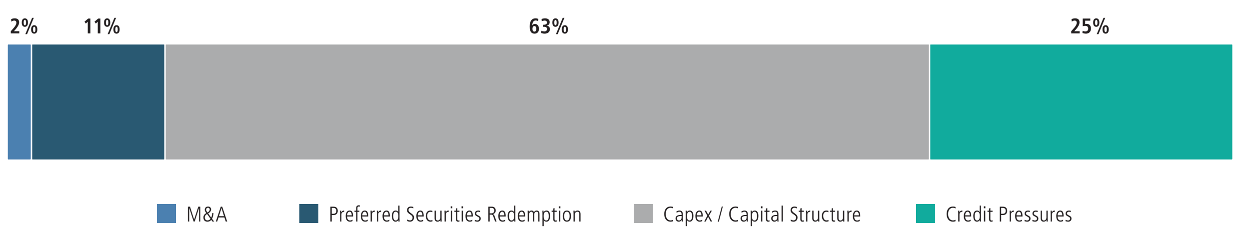


Source: Barclays, Neuberger Berman.

Addressing Credit Pressures. In 2024, companies in sectors like automotive (e.g., Aptiv) and health insurance (e.g., CVS Health) introduced hybrids to inject equity and realign their leverage ratios with current credit ratings, either pre-emptively or as a corrective measure.

Financing M&A. The global value of mergers and acquisitions rose by approximately 11% in 2024, a notable recovery from the 2022 – 23 downturn, when dealmaking fell below $3tn for the first time in a decade. We note that large-deal M&A is closely tied to CEO and board confidence, which has been bolstered by optimism about potential U.S. policy changes such as lower corporate taxes, deregulation and reduced regulatory merger scrutiny. Dealmakers anticipate a return to the $4tn+ M&A volumes typical of the pre-pandemic years in 2025. While corporate hybrids have not yet been widely used for M&A (figure 5), we anticipate their growing presence in discussions, particularly if M&A funding shifts to include more debt.

FIGURE 5. SPLIT OF ISSUANCE RATIONALE FOR NORTH AMERICAN NON-FINANCIAL CORPORATE HYBRIDS



Source: Prospectuses, Neuberger Berman. Data as of January 6, 2025. The graph above shows our best estimates based on companies' comments at the time of issuance. For illustrative purposes only.

Why Are U.S. Corporate Hybrids Now So Interesting for Investors?

What remained uncertain to us when we published last year's paper was the pace at which this evolution of the U.S. hybrid market would happen. As we argued, "While the change at Moody's lays the foundation for a growing U.S. hybrids market that is both investor- and issuer-friendly, to realize that potential, we think the market needs to become much more **standardized** and **less fragmented** than it is today. In essence, it needs to become more 'European.'"[3]

The U.S. corporate hybrid market has in fact standardized in a flash. It has settled on the 30NC structure with no step-up, with a particular focus on the NC10: the NC10 attracts more investor interest because it aligns the first call date with the loss of equity content assigned by Standard & Poor's—the same incentive achieved by the coupon step-ups in typical European structures (figure 6). This standardization simplifies the investment process for investors and issuers alike, making it easier to draw in investors and stimulate demand.

FIGURE 6. EUROPEAN VS. U.S. HYBRID STRUCTURE

Like a typical European hybrid, the increasingly common 30-year U.S. hybrid loses equity content at first call date, despite the lack of coupon step-ups

European Style: PerpNC10 or 60NC10 with Step-Ups (first 25bps in year 10, 75bps in year 30)

Year	5	10	15	20	25	30	35	40	45	50	55	60
Coupon	Fixed Cpn		Fix Cpn + 25bps Step-Up			Fix Cpn + 25bps +75bps Step-Up						
S&P Methodology	50% Equity Credit		0% Equity Content - Hybrid treated as pure debt									

U.S. Style: 30NC10 without Step-Ups (same call incentive as European-style hybrid that have step-ups and a 10-year first call date)

Year	5	10	15	20	25	30
Coupon	Fix Cpn + 0bps Step-Up					
S&P Methodology	50% Equity Credit		0% Equity Content—Hybrids treated as pure debt			

Source: Neuberger Berman.

Our Outlook for 2025

We see eight key themes in the global corporate hybrids market for the coming 12 months:

1. **Increased M&A Activity.** We think that, absent a liquidity event, animal spirits could trigger record-breaking M&A activity. In our bullish scenario, we anticipate a potential $10bn+ supply of hybrids to finance M&A this year.

2. **Continued U.S. Issuance Growth.** While we project a 50/50 split of new European and U.S. issuance this year, we see a non-null chance that U.S. non-financial corporate hybrid issuance could outpace European issuance this year, particularly if our more bullish M&A scenario materializes.

3. **Cross-Market Issuance.** We think European issuers will tap into the U.S. market using the 30NC structure without step-ups. We also think at least one U.S. or Canadian issuer may attempt to introduce non-step structures to the European market—although we ultimately expect little to no traction.

[3] Linus Claesson and Robin Usson, "Corporate Hybrids Take the World Stage" (May 2024), at https://www.nb.com/en/link?type=article&name=whitepaper-corporate-hybrids-take-the-world-stage.

4. **Sector Expansion.** Following inaugural hybrids from a Healthcare Management Organization and an auto supplier, we expect to see further issuance from non-traditional hybrid sectors in the U.S., including more from these two sectors and potentially the manufacturing, aerospace and defense industries.

5. **The U.S. Sweet Spot Consolidates on 30NC10.** Investor demand for the first call to be in year 10 in the 30NC non-step structure has already been the strongest, and we think that will increasingly prove to be the sweet spot for U.S. Issuers, given how it aligns issuer and investor interests.

6. **Continued Demand Growth From U.S. Investors.** As well as growing recognition of the 30NC10 sweet spot, we see other factors stimulating U.S. investor interest in hybrids: for example, like preferred securities, they can offer higher yields without significantly increasing portfolio credit risk, but unlike preferreds, they are eligible for inclusion in fixed income indices.

7. **Continued Demand Growth From European Investors for U.S. Issues.** U.S. hybrids offer sectoral, single-name, and macro diversification, making them attractive to global investors, particularly European hybrid investors seeking exposure to different markets and sectors. Global investors can also exploit multi-currency arbitrage opportunities and structure differences.

8. **European Market Innovation.** At the more speculative end of our outlook, we think the European hybrid market could see an innovative structure with 100% equity content.

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