

Exploring the TUI Hybrid

- Tui last week brought a new instrument to the credit market – a corporate hybrid from a sub investment grade issuer. The deal priced at 8.625% and traded up to close the day at around 101.5.
- In this note, we explore issues raised by a high yield hybrid:
 1. A recap on the mechanics of corporate hybrids
 2. Differences between this hybrid and others recent issues
 3. The appropriateness of hybrids for HY issuers
 4. Using the JP Morgan Pricing Framework on Tui
- We believe that this structure does make sense for certain types of HY issuers – including Tui, and can offer value to investors as well as to issuers. There are certain unusual risks in the structure but we believe they are price-able risks.
- We think that the Tui structure has certain key strengths which are supportive for investors. The coupon deferral provision, change of control clause and replacement language are all stronger than in most of the HG hybrids, making it appropriate for HY in our view.
- We believe that our framework can be applied to HY issuers as easily as to HG. The pricing came around fair value on our core assumptions, but we think this is conservative for a number of reasons. We think the Tui hybrids are decent value.

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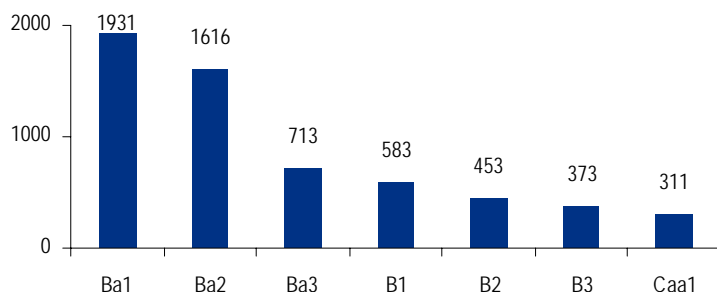
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Figure 1: Sensitivity of JPM model fair value to Coupon Deferral trigger

Z spreads based on a Ba2 senior rating, Call trigger at Ba3, and other assumptions



Source: JPMorgan

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Corporate hybrids – a brief recap

Back in July, we published a guide to the new wave of ‘corporate hybrids’ in order to help answer investor questions on what these securities are and how they work (see *All you ever wanted to know about corporate hybrids but were too afraid to ask*, S Dulake, O Keenan, July 2005). We have added to this with *A Framework for Pricing Corporate Hybrids* (J Goulden, O Keenan, September 2005) and a piece looking at *Questions and answers on our pricing model* (J Goulden, O Keenan, October 2005).

The advent of a new breed of high yield hybrid poses a new set of questions. However, before we tackle these, we should perhaps readdress some of the basics for any investors who were not previously involved in the hybrids arena.

Why issue hybrids?

Corporate hybrids are obligations issued by non-financial corporates which are structured like debt, but have features which enable them to receive “equity credit” from the rating agencies. It was a change of policy from Moody’s which gives more equity credit for certain features that has triggered the recent wave of issuance.

The instruments have fixed coupons and can be redeemed for fixed amounts, but they are deeply subordinated, have the possibility of passing or deferring coupons in certain circumstances and give companies calls on the debt rather than having compulsory maturities. The ability to achieve equity credit without issuing new equity and diluting existing shareholders might be particularly attractive to a company that is, for example, keen to bolster its balance sheet in an attempt to maintain its ratings profile. This might be relevant in the context of potential M&A transactions that would threaten current ratings if conventionally funded through senior debt issuance alone. It could be particularly significant for privately or state-owned enterprises without access to the equity markets.

Hybrid capital may also lower the weighted average cost of capital for the issuer – a typical “basket C” transaction is treated as 50% debt, 50% equity at Moody’s but has a lower cost than the equivalent amounts of senior debt and common equity. This advantage is boosted by achieving debt treatment from a tax perspective. All the existing current issues have achieved debt treatment in their relevant jurisdictions, and we believe that all innovative Tier 1 issues from banks have achieved debt treatment, so this should also be possible for corporates. In some jurisdictions it may be necessary to structure the hybrid as an ultra-long maturity instrument rather than a perpetual, as we have seen in the case of Dong, for example.

How do the rating agencies analyse these securities?

Moody’s and S&P take a fairly similar approach to discerning the “equity content” of hybrid securities, but there are small differences in the importance assigned to various features of individual hybrids. However, they take very individual approaches to adjusting financial ratios for hybrids.

In the Moody’s scheme, hybrid instruments are classified according to where they fit on the “debt-equity continuum”. The three key features of equity for Moody’s are:

1. absence of maturity;
2. no requirement for ongoing payments; and

3. ability to absorb losses for creditors

Moody's new instrument committee scores a new hybrid instrument against each of these criteria, assessing its "equity value" as none, weak, moderate or strong. These three scores, together with analytical input with regard to use of proceeds and the overall flexibility of the security, place the hybrid into one of five baskets (A-E). For example, basket D treatment implies 75% equity credit. It is this measure that is used to adjust the financial statements, so a basket D hybrid is treated as 75% equity on the balance sheet, with 75% of the coupon classified as a fixed charge rather than interest. Assuming that hybrid proceeds are used (at least initially) to reduce senior debt, it therefore has a 75% "deleveraging" effect.

Table 1: Treatment of hybrids for ratio purposes at Moody's

Basket	A	B	C	D	E
Treatment	100% debt 0% equity	75% debt 25% equity	50% debt 50% equity	25% debt 75% equity	0% debt 100% equity

Source: Moody's

S&P uses a fairly similar approach to classifying hybrids according to their ability to mimic the features of equity in protecting creditors and credit quality (although it seems to assign additional importance to the expected permanence of the hybrid in the capital structure). Hybrid instruments are assigned "equity credit" of between 0% and 100% based on the features of the instrument.

However, S&P does not bifurcate the hybrid between debt and equity for the purposes of ratio analysis. Rather, the ratios are calculated with the instrument treated as debt or left out of the analysis of financial liabilities ("equity treatment"), and both sets are then considered by the rating committee, although with the emphasis falling on one set or the other, depending on how equity-like the instrument is considered. S&P recently decided to stop publishing the percentage equity-treatment.

Under IFRS, how are these instruments treated?

The relevant rules for accounting for hybrid capital under IFRS are in IAS 32. The standard states the instrument is classified as a financial liability or as an equity instrument in accordance with the substance of the contractual arrangement. If there is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or liabilities on potentially unfavourable terms, then the instrument is a financial liability (see IAS 32 para 11 and para 15-16). Coupons on financial liabilities are interest payments for the income statement and cash flow statement, while coupons for equity-accounted instruments will be regarded as dividends.

To summarise, if the economic reality is that the notes are perpetual and the issuer does not have to pay interest, it is equity; otherwise it is debt for accounting purposes. In effect, the notes are in a grey area (e.g., although the rule says that a redeemable note must be a financial liability, one could argue that redemption in 1,000 years is perpetual in economic substance).

In the case of Tui, equity treatment is the implicit intention of the issuer. In fact, upon loss of IFRS equity treatment, the issuer may redeem the hybrids at a make-whole amount, provided that it has replaced the bonds with similar hybrid securities,

capable of obtaining IFRS equity treatment. A similar clause is designed to protect the tax deductibility status of the bonds.

How do the claims of holders of hybrid securities rank in comparison to holders of other securities?

It is clear that hybrid securities are deeply subordinated instruments but it is not completely clear if they are debt or equity in the context of insolvency or a company restructuring. The extent of subordination is usually captured within the terms governing the particular security. Hybrid securities are usually described as “direct unsecured and subordinated” obligations of the issuer and then the terms go on to specify how the hybrids rank in relation to other obligations.

One of the interesting things to note is that while it is clear where hybrid securities rank relative to other debt, their ranking in relationship to equity may vary. In fact, language in the various issuances may be quite different. There are provisions that suggest the hybrid securities are senior to equity because either the language around subordination is in respect to other obligations only (with no mention of equity) or it specifies that the particular security ranks in priority to all classes of share capital. There is also language, however, that states the security ranks in priority to common stock, which leaves the position in respect of preferred stock unclear.

For Tui these securities rank junior to all other present and future obligations of the issuer. If there are any deferred coupons outstanding at the date of insolvency, they become due but rank “*pari passu* with claims of shareholders” in claims on liquidation proceeds. We doubt this would make any economic difference to recovery, but presumably gives comfort to the rating agencies that the coupons really are “non-cash” cumulative.

Why is this Hybrid different from all other Hybrids?

Somewhat to our surprise, no standard structure seems to have emerged for corporate hybrids – each issue has contained new features which need to be considered in assessment of value. Tui is striking for being sub-investment grade but also for its unusual provisions around coupon deferral.

Coupon payments

The Tui hybrid will pay fixed coupons of 8.675% for the first seven years. The bond then becomes callable, but if it is not called, the coupon will switch to a floating rate at €+730. The bond is callable in each of the quarterly coupon dates after this.

Some hybrids have coupons that get deferred when some trigger financial ratio is reached, but TUI does not have this. Rather, Tui can defer coupons at management option provided that it has not paid a dividend (or engaged in a share buyback) since the most recent AGM. This “dividend pusher” arrangement is similar to a number of other issues. If a coupon is deferred it is cumulative but not compounding. The company can settle arrears at any time and is obliged to do so within one year of making a dividend payment or repurchasing equity.

However, TUI cannot pay deferred coupon using corporate cash. It must instead use the proceeds of new equity or new hybrids to make the payments. This alternative coupon settlement mechanism is quite similar to that found in the recent Henkel issue, but the language in the Tui prospectus is quite strong. Where Henkel had the option of settling the coupon with more hybrids (a PIK structure), Tui hybrid holders

will only receive cash. In addition, Henkel need only make a single attempt to raise cash from equity where the Tui prospectus specifically states the obligation does not lapse due to difficulties in issuance and the company is obliged to “endeavour to meet the preceding conditions as soon as possible”.

Change of Control Provisions

Given the level of subordination and lack of covenants, hybrid holders are justifiably concerned about LBO-type scenarios. However, hybrid securities cannot have change of control put provisions because the agencies would remove equity treatment - obviously it is not supportive for senior creditors to have loss-absorbing capital that could disappear just when it was most needed.

Tui has addressed the concern by inserting a 500bps step-up in the coupon following a single party acquiring more than 50% of the voting capital and a rating falling by at least one notch as a result. Following a change of control, Tui also has the right to call the bond at par plus accrued (including coupon arrears). Given the size of the step, we think the economics of this situation are not dissimilar to a weak par put because a potential leveraged acquirer would be highly motivated to use the call.

The change-of-control 500bps-step mechanism first appeared in the Thomson hybrid issued in September. It was widely regarded (including by us) as having little value to investors. However, this is because Thomson’s coupons are deferrable on a *non-cumulative* basis - the coupon may step to 10.75% but the company need not pay it. In the case of Tui, the coupon steps to 13.625% (or the stepped floating rate plus 500bps if this is beyond the first call date) and the company need not pay it *on the due date*. However, if it ever wants to resume paying dividends it will ultimately have to clear the arrears. Again, we think this would encourage any potential acquirer to redeem the hybrids.

Call & Step Up

The Tui bond is callable in seven years at par. If the company chooses not to call it then the coupon switches to a floating rate with a coupon of €-730 (set as the issue spread plus 200bps). The bond is also callable every quarter after the switch to floating. The “step-up” of 200bp compares to 100bps in the HG hybrids. We think the larger step for Tui reflects the higher issuance spread as the step is designed to provide a motivation for the company to call without forcing it to do so.

Replacement language

The rating agencies place a good deal of store by “replacement language” in which the issuer either states or covenants that subordinated hybrids will be a permanent part of the capital structure. Most of the investment grade hybrids only contain a statement of intention with regard to replacing a called hybrid with new subordinated debt or equity. Suedzucker is the only exception – and Tui has used this language. Tui may *only* use the call provisions in the hybrid if it has issued new equity or new hybrids as funding for the redemption.

For the senior bondholders this is clearly positive, as it limits the potential erosion of its ‘equity’ cushion. However, it does pose the question of whether a future call is possible, given that there needs to be willingness from the market to accept new hybrids or shares, not just the wishes of the company to retire the bonds. In our view, “hard” replacement language must reduce the probability of the call being used. However, we think investors should bear in mind that this not necessarily such bad news for hybrid holders - a healthy Tui paying the very high stepped coupon only because it cannot sell hybrids and is unwilling to sell equity could mean a very attractive stream of cash flows to the hybrid holders. We think hybrids in this case

would trade close to par as the spread would be attractive but the rally capped by the quarterly call.

Does it make sense for high yield companies

We don't see any reason to think that hybrid capital makes any less sense for high yield companies than it does for high grade – indeed the addition of subordinated debt is a much more familiar structure in high yield. However, this is offset by the fact that hybrids are something of a play on lack of event risk – we believe these securities will perform best on credits where there is little newsflow and spread volatility (in that sense, it is the opposite of the "positive event risk" play that PIK notes are designed to have). In essence this is just a statement that holders of hybrid securities can participate in any credit quality upside, by virtue of the lack of short call.

In addition, the type of company would make a major difference. For example, this type of capital might be particularly appealing for companies without access to the equity markets. Certainly this has been the attraction for companies like Vattenfall, Dong and Suedzucker. However, for HY companies owned by equity sponsors, we think this kind of deal would not be well received – we don't believe bond investors would be happy giving this level of optionality to an equity sponsor. In particular, a structure such as Tui theoretically gives the equity owners the possibility of paying one large dividend and then leaving the coupons to accrue. This, in effect, would be a pay-in-kind (PIK) note. Indeed, with the coupons not compounding, we think it could even be construed as 'cheap' PIK.

Another additional problem is that HY companies cannot achieve as much equity credit as HG companies. For example, to get 75% equity credit at Moody's (like Bayer, Vattenfall and Henkel) hybrids need to have an automatic deferral trigger – we don't believe this is likely to be practicable for a HY company. Tui has achieved only basket B (25% equity credit) treatment at Moody's and the agency stated that the hybrid will have a marginal impact on credit ratios. S&P has classified the instrument as "intermediate" and will look at ratios both with and without the hybrid in debt, which is probably a larger benefit.

As was the case with Henkel, it is possible that hybrid securities could be used by a high yield company to fund a pension deficit. This would have the effect of subordinating what regulators would view to be a senior liability.

We would not be surprised to see more high yield issuers come to the market with hybrids, but we think they will be limited to larger, usually listed companies with rating in the mid-high BB area. This type of company will usually have a strong commitment to paying regular dividends, giving the "dividend pusher" more value. In addition, for companies rated below this, we think the "step-up" would have to be very large in order to assure investors it would be used, which would make the rating agencies uncomfortable. A stepped hybrid is supposed to be viable long term financing in order to provide cushion for senior holders - at spreads much wider than 730bp, this would be hard to argue in our view.

The JP Morgan Framework for Pricing Hybrids

Again, this was the subject of a previous research note (see *A Framework for Pricing Corporate Hybrids*, J Goulden, O Keenan, September 2005), although we provide a brief reminder of the key concepts.

Naturally, any instrument with credit risk has uncertain cashflows due to the possibility of default. With corporate hybrids, we have two other features that create additional probabilistic states: Coupon Deferral and Extension Risk. The challenge is to assign the probabilities to each possible state so that we can value the cashflows. We believe that a reasonable starting point is to say that the triggers for each of the mechanisms in corporate hybrids depend on the underlying financial state of the firm. This is our single most important assumption in building our valuation framework.

Our general approach will be to make future cashflows for hybrids dependent on (senior) rating states, and we use ratings transition matrices to assign probabilities of each future state. Our framework works on the assumption that a coupon deferred is lost permanently.

Valuation in Brief

We will look to value corporate hybrids as a set of cashflows with four distinguishing features:

1. Default risk – the firm can default over the life of the bond. Default probabilities will be taken from the transition matrices and a recovery rate will be paid on default.
2. Subordination – As corporate hybrids are subordinated to senior debt we will set the recovery rate lower than for regular bonds (our base case is to set it to zero).
3. Coupon deferral – Coupons on corporate hybrids can be deferred in certain circumstances and we set a rating state at (or below) which the company will defer its coupons.
4. Extension risk – Corporate hybrids have call features and we set a rating state at (or above) which the company will call the bond at the first call date (or quarterly thereafter).

Where do we think Tui should be trading?

To answer this we really need to take a view on where to set the triggers for coupon deferral and call. This is a very difficult decision to make, because the decision to defer coupons or call the bonds is based upon wider considerations. However, it is also an area where investors can study the company and create their own set of assumptions, and are free to disagree with our base case. The inputs we will use are as follows:

- Current senior unsecured rating: We will use Ba2, the lower of the two public ratings.
- Call trigger: In order to call in the future, Tui will have to issue new hybrid securities or sell new equity. To make this a viable proposition, we would argue that Tui would need to remain in the BB category. We assume a call if Tui is Ba3 or above, with no call below that.

- Deferral trigger: This is where analytical insight has the most value, in our opinion. For our base case we assume that a downgrade to B1 would cause Tui to start deferring coupons.
- Recovery rate: We use our standard assumption of 0%.

Using these assumptions we arrive at a fair value (asset swap) spread of 583bp, 55bp wide of the spread at par. Equivalently, this means that our model suggests that the hybrid should be priced around 9.25%.

So that investors can take their own view on the inputs, we show the sensitivity analysis in the table below.

Table 2: JPM model fair value spreads based on a Ba2 rating

		Deferral Trigger						
		Ba1	Ba2	Ba3	B1	B2	B3	Caa1
Call Trigger	Baa2	4,826	2,929	1,020	610	382	244	146
	Baa3	4,584	2,956	1,061	663	438	301	203
	Ba1	3,314	2,722	1,030	685	480	354	263
	Ba2	2,454	2,043	925	656	488	383	306
	Ba3	1,931	1,616	713	583	453	373	311
	B1	1,660	1,390	594	477	414	348	300
	B2	1,508	1,262	525	415	355	317	277
	B3	1,404	1,174	476	371	314	278	254
	Caa1	1,351	1,128	451	349	293	257	234

Source: JPMorgan

However, our view would be that this is a conservative valuation for the following reasons:

1. Tui's hybrid is classified as basket B by Moody's meaning it gets on 25% equity credit, reflecting the relatively "debt-like" nature of the instrument. Our model framework does not change to reflect this.
2. Our model assumes that coupons which are lost are lost permanently where in fact there is some chance that they will be recovered.
3. We are using the lower of the two senior ratings that the agencies assign.
4. We are assuming no value for the change of control clause, when we think it does have value in the structure.
5. We typically use long-term average rating transition matrices, which is not consistent with our view of below average default rates for at least the next year.

Another point to bear in mind is that it is often stated that hybrids should be priced to maturity rather than the call date. Given that the hybrid has started trading above par, this implies that the spread earned to maturity is actually slightly *higher* for the same cash price.

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