THE CASE FOR HYBRID BONDS

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Nicolò Bocchin, *Global Head of Fixed Income*

Maroun Jalkh, *Head of Institutional and Wholesale, Middle East and Asia*

Corporate and Financial Euro-denominated Hybrid Bonds remain a little-known asset class and are not well represented within global investor allocations.

This paper aims to provide insights on the specifics of these instruments and highlights their significant relevance in the current investment cycle.

As early as 2013, Azimut was among the first international asset managers to see the value and opportunity of Hybrid Bonds and to launch a dedicated, highly diversified, Luxembourg domiciled UCITS fund focusing on the asset class.

This paper also discusses the key characteristics of Hybrid Bonds, as the flagship Azimut Hybrids Fund has now crossed 10 years of track-record and a $1.6 billion milestone in AUM.

Data as of 31 Oct 2024, unless otherwise stated

1. INTRODUCTION

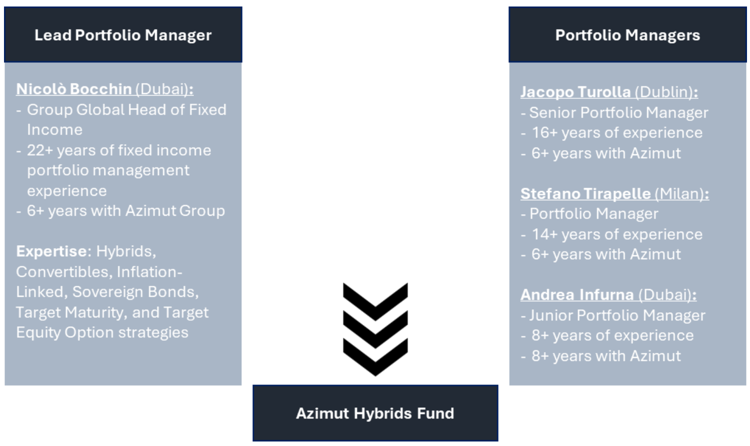
In 2013, Azimut launched one of the world's first UCITS funds dedicated exclusively to **Euro denominated Corporate and Financial Services Hybrid Bonds**. This marked a shift away from an industry trend which had primarily focused on subordinated bonds issued by the financial sector.

This pioneering stance was triggered by rating agencies and regulators redefining the regulatory framework for Subordinated Debt issuances and set a new standard prospectus for Euro-denominated issuances. Under these provisions, and subject to Moody's and S&P's rating, **Euro Hybrid issuers were offered clear regulatory and accounting advantages** until the first call, detailed below:

De-leverage	Issuances are structured to be booked as equity from an accounting perspective (up to 50%)
Preserve issuer financial profile	Only 50% of the issued amount is allocated as debt, limiting the impact on financial ratios
Fiscal savings	Coupons are deductible from taxable income, generating a tax advantage

Unsurprisingly, the universe of Euro-denominated Hybrids grew steadily in the aftermath, reaching a volume close to 200 billion in 2024[1]. Consequently, the market breadth substantially improved, moving from a few highly leveraged utilities sector to a widespread sector and geographical diversification, which today includes a large variety of **blue chip, investment grade, listed, global issuers**.

The Azimut Hybrids Fund benefited from the environment, and today boasts **assets of U$D 1.6 billion** with a highly diversified investor base globally, managed by a seasoned team and headed by Azimut Group's Global Head of Fixed Income, Nicolo Bocchin.



[1] Source: ICE Indices, sum of GNEC and HWEC full market values

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2. WHAT ARE CORPORATE HYBRID BONDS?

Corporate Hybrid Bonds are subordinated debt instruments issued by non-financial companies. Typically, Hybrid Bonds have the following features:

- they combine the characteristics of debt and of equity, as illustrated in the graph below
- they are subordinated, as opposed to Senior Bonds.

***Corporate Bonds do NOT offer a convertibility option and are not comparable to Contingent Convertible Bonds** (CoCos)*.

Debt	Payment of a coupon
	Issuances are rated by rating agencies (Moody's and S&P)
Equity	The coupon payment can be deferred, like dividends
	The issuance has no maturity date, but call dates in favour of the issuer

Corporate Hybrid Bonds have important differences with CoCos - the most advanced form of subordinated bonds issued by the financial sector (banks and insurance companies) - with whom they are often, **though not rightfully**, compared.

The most obvious differentiating component is the **non-convertibility** of Corporate Hybrids. As the illustration below highlights, Corporate Hybrid Bonds offer a safer profile to investors:

Hybrid Bonds	Coupons **CANNOT** be cancelled (only postponed)	The bonds **cannot** be converted into equity	There can be **no notional cut**	Average volatility of 3% - 4%
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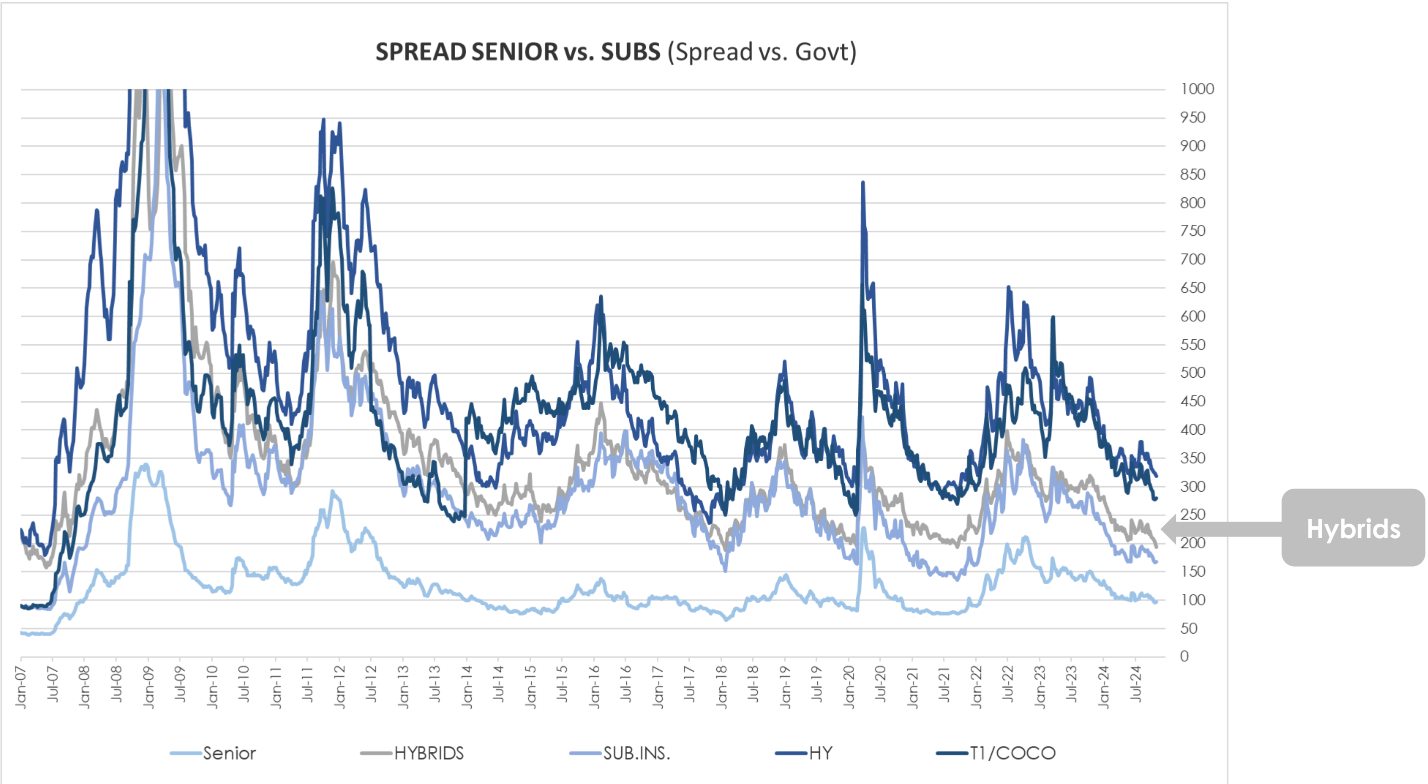
CoCos	Coupons can be cancelled	Can be converted into equity	Issuer can negotiate a notional cut	Average volatility of 6% - 7%

As evidenced, Corporate Hybrid Bonds bring a diversification proposition in terms of asset allocation, as they have different risks and dynamics than CoCos. This translates into an interesting risk compensation, which is **lower than Cocos** but **more compelling** in terms of risk adjusted returns **than senior instruments of the same issuers**.

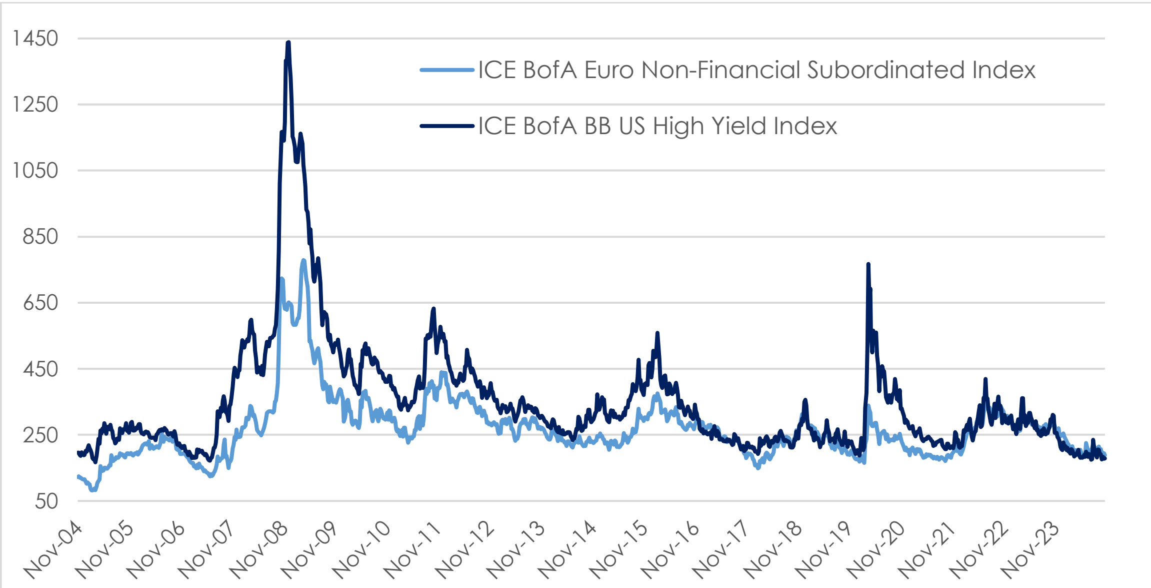


Source: Bloomberg, ICE Indices, elaborated by Azimut

3. HOW DO HYBRID BONDS COMPARE TO HIGH YIELD BONDS?

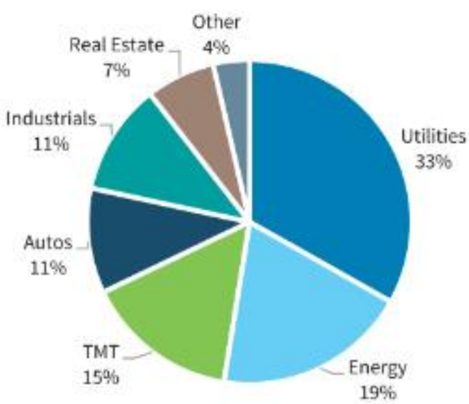
Hybrid Bond issuers typically have a high-quality financial profile, as they are primarily **IG rated**. This marks a considerable difference from the High Yield market, where issuers frequently have a significantly less robust financial profile. **Solid IG-rated, blue-chip listed companies that generate consistent operating cash flow: these are the firms which generally issue Hybrid Bonds.**

A comparison of the spread behaviour of European Corporate Hybrids and US BB-rated bonds shows the resilience of the former at times of heightened volatility. It should also be noted that this is an unfair comparison, because hybrids within this index exhibit on average a BBB- rating (from BBB+ issuers) while the US index below has on average a BB rating (ICE Indices).



Source: Bloomberg

The most represented sectors for Corporate Hybrids tend to be defensive:



Source: Bloomberg, Barclays Research

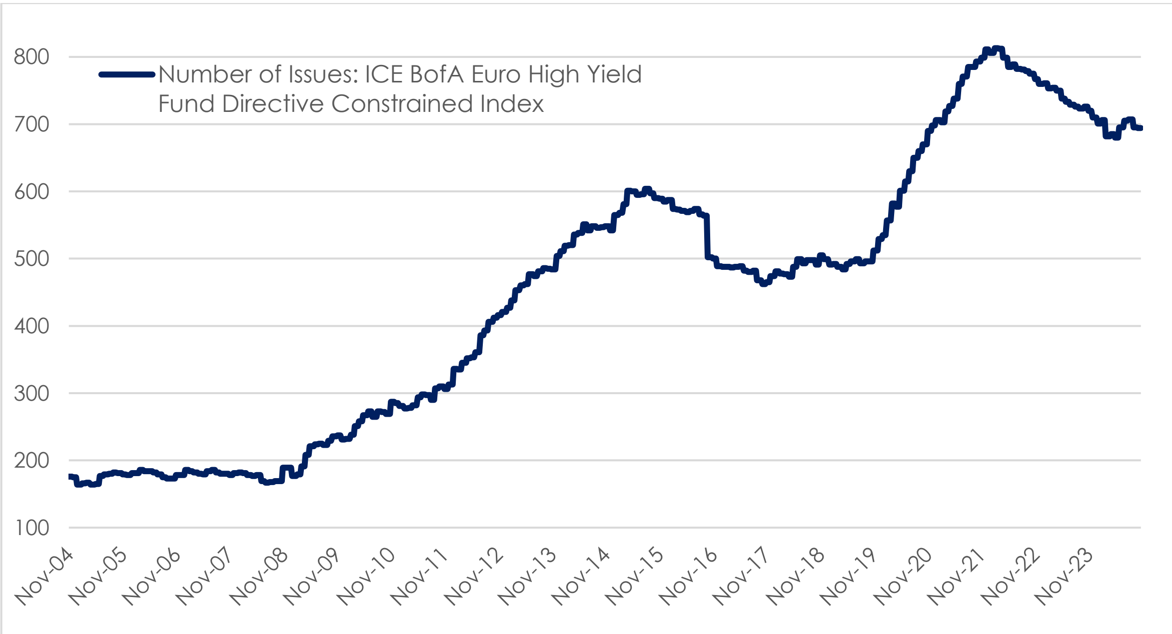
Finally, the Euro-denominated Hybrid Bond **issuers are listed**, providing investors with easy access to company information.

The main similarities and, most importantly, differences are highlighted below:

Asset Class	Total Market	Issuer Ratings	Coupon Features	Equity Conversion	Notional Cut	Seniority	Average Volatility
European Corporate Hybrid Bonds	€200bn	IG	Postpone only	No	No	Sub	3.5%
Cocos	€250bn	IG	Cancellation	Yes	Yes	Sub	6.5%
European High Yield	€415bn	HY	N/A	No	No	Senior Unsecured	7.5%

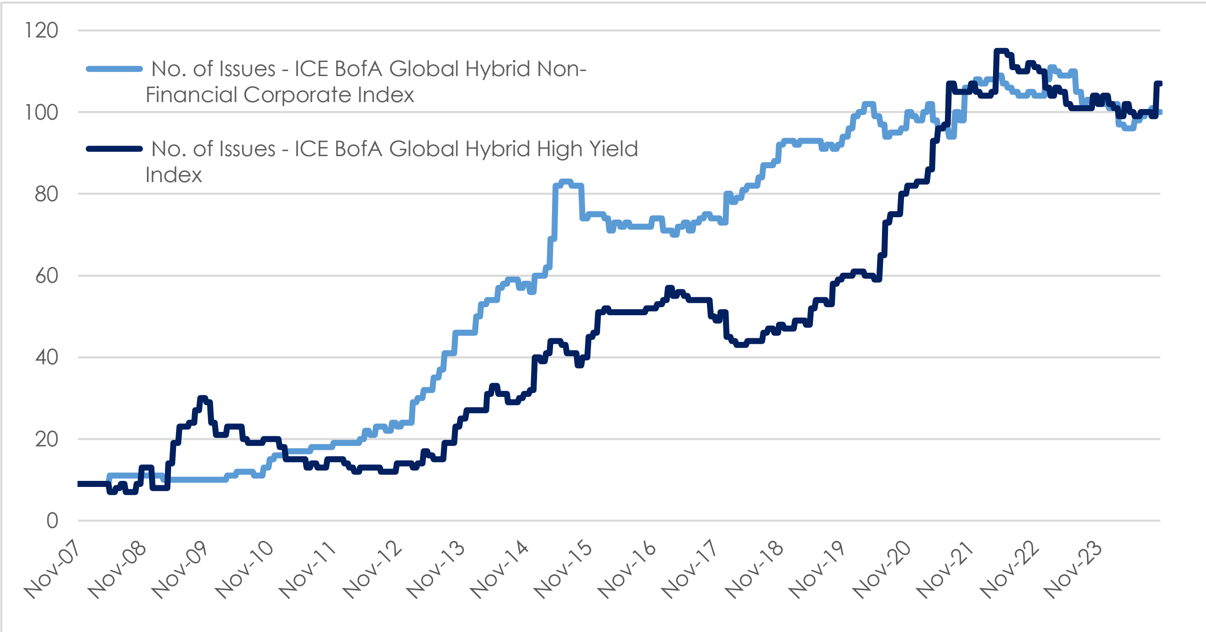
Source: ICE Indices, GNEC and HWEC for Hybrids (ENSU for volatility), COCO for CoCos, HE0C for HY

Although the High Yield universe is larger, the volume of new issuances has been subdued, after the shock in rates in 2022, the spike in credit spreads and the increase in the global default rate.



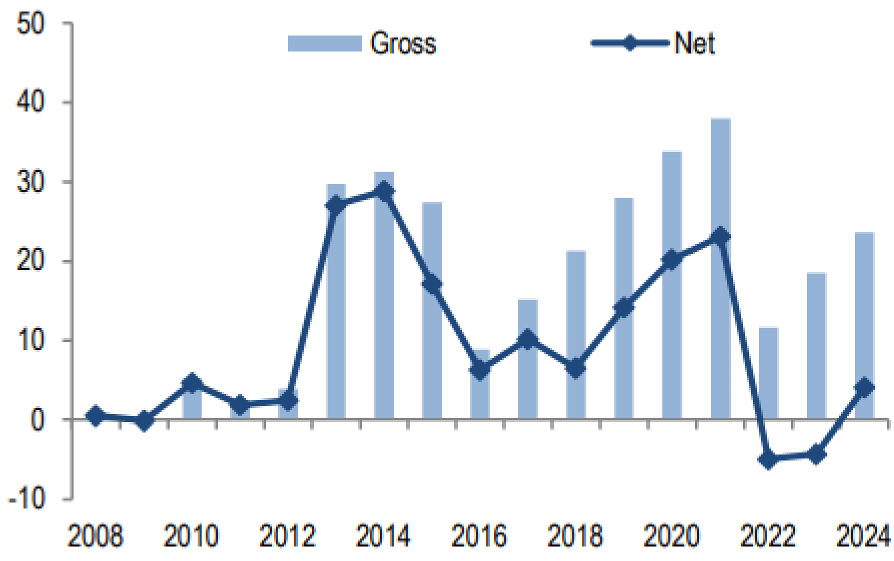
Source: Bloomberg

Euro Corporate Hybrids instead are showing some resilience: the number of issues is quite stable, driven slightly lower only by issuers calling their bonds in advance, to take advantage of market opportunities.



Source: Bloomberg

However, after 2 years of slowdown (see Net New Issuance of Corporate Hybrids (EUR bn) in the chart below), it looks like the asset class is growing again.



Source: Bloomberg

4. WHAT ARE THE RISKS ASSOCIATED WITH EURO CORPORATE HYBRIDS

As with any financial investment, European Hybrid bonds have a number of risks that can largely be mitigated by the high quality of the issuers and by applying a sound investment process.

Risk Type	Risk Description	Risk Mitigators
Credit	Credit risk is the main common risk to all Fixed Income instruments.	This risk is low in the Euro Hybrid Bonds universe, as issuers are exclusively Investment Grade, with solid or improving financial
Interest rate	Like all Fixed Income instruments, a Euro Hybrid Bond with a first call date further in the future would be more sensitive to interest rate fluctuations.	Euro Hybrid Bonds have typically a shorter duration than Senior Bonds.
Sub-ordination	Should the issuer default, the rate of recovery for the holders of Hybrid Bonds is typically low as Senior Debt takes priority.	Defaults by IG issuers are rare. The only non-called or defaultiedbonds were from Not Rated or HY issuers. Typically those would not be selected for Azimut's Hybrid Bonds Fund.
Extension	Azimut treats Hybrid Bonds to their first call date, even though they are perpetual securities, to fit the rating agencies' requirements.	Not calling the bond would mean it loses the equity content, leaving the issuer with a Senior Bond and an expensive coupon given the reset at the initial spread plus a step-up. Reputational risk is also an important factor: issuers do not want to disappoint the investor base, which most of the time is the same that buys their Senior Bonds.
Deferral	The coupon payment or deferral decision is in the hands of the issuer.	Very low during periods of economic growth. Also, a sound diversification of an investor's portfolio allows for lowering the negative effects of such occurrence.
Volatility	Hybrids are positively correlated to the equity markets. During periods of risk aversion, share prices fall and the credit spread on hybrids widens, as yields rise, and hybrid prices fall.	Managing volatility can be done via both a high diversification and a thorough monitoring of durations to call.

5. AZIMUT HYBRIDS FUND

Azimut Hybrids Fund aims to take full advantage of the opportunities presented by the European Hybrid Bonds market, namely offering investors:

- above Investment Grade returns
- lower volatility than Bank Hybrids
- significantly lower risk profile than High Yield Bonds
- an untapped diversification to their portfolio

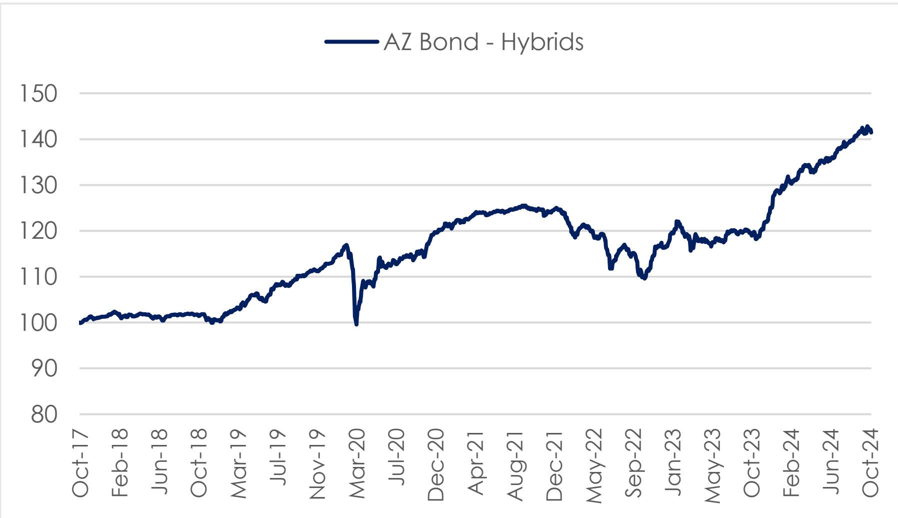
To that end, the Fund's portfolio is thoroughly calibrated and monitored, presenting a set of unique key features, as described below:

	Fund Characteristics		Impact for Investor
Exposure	Close to 100% IG or high profile non-rated companies	Exposure to banks and insurance, through Tier 2 and CoCos (20% limit)	• Unique diversification within Fixed Income allocation • Low credit risk
	90%+ of issuers are listed on a stock exchange	Issuers have an IG rating while 50%+ of the securities may have a HY rating	
Diversification	150+ issuers in the portfolio, from 20+ countries, maximum 3% of the NAV per issuer	200+ securities in the portfolio	Low risk thanks to high diversification
Liquidity	Solid retail investors base (around 80%) since the launch of the Fund	Growing international investor base (around 20%), mainly from Asia and South America	Low risk of liquidity squeeze or run-off on Hybrids or on Azimut fund
Expertise	10+ years track record and USD1.6 bn of assets	Highly experienced portfolio management team	• Solid asset class expertise • Daily liquidity • Stable and transparent regulation • Easy registration in major jurisdictions
	Multinational asset manager, with USD110 bn of AuM	UCITS V, Luxembourg domiciled mutual fund	
Practical information	Inception: Sept 2013	Fees: • Retail: 1.20% • Institutional: 0.80%	• USD-hedged share class offers a positive 1.2%+ carry p.a., due to structural differential in rates between USD and EUR • Access by USD investors without currency risk
	Multiple share classes: • €, $, £, ¥ • Accumulation, Distribution	Institutional classes: USD Acc: LU2058551578 USD Dis: LU2058551651	

As, structurally, USD interest rates are higher than Euro's, **the systematic hedging of the USD share class generates a carry effect, currently close to +1.6%,** which positively affects the yearly performance and the yield of the USD hedged share class, making it a clear and efficient alternative to investments in the HY space.

Azimut Hybrids Fund - Portfolio and Performance Data[2]

Number of Issuers	157
Number of Securities	250
YTM USD	6.9%
Average Duration	7.5
Average Credit Rating	BBB-



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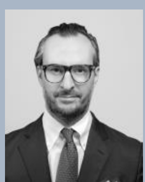

Nicolò Bocchin, Global Head of Fixed Income
Nicolò joined Azimut in 2018 as Senior Portfolio Manager, Head of Fixed Income. Today, as Global Head of Fixed Income, he chairs Azimut Group's Global Fixed Income Committee and coordinates a team of fixed income professionals across Azimut's global offices. Nicolò manages public credit strategies, mainly focusing on subordinated debt, emerging market bonds and convertible securities. Prior to Azimut, Nicolò spent 16 years at an Italian asset manager, most recently overseeing the credit desk.

Maroun Jalkh, Head of Institutional & Wholesale, Middle East & Asia
Having first joined Azimut in 2017, Maroun is the CEO of Azimut's Abu Dhabi office, and Head of Institutional and Wholesale for the Middle East & Asia. Maroun has 20+ years of experience in the private banking and investment management industry throughout various senior positions in Europe and the Middle East. Prior to his role with Azimut, Maroun headed the European institutional sales for ABN AMRO wealth and asset management business.

[2] As at 31 Oct 2024, performance of ISIN: LU2058551578

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