

The evolution of corporate hybrids: From niche to mainstream



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KEY TAKEAWAYS:

1. **Corporate hybrids gain traction in US market.**
2. **Benefits for issuers and investors.**
3. **Risks and mitigators.**

Corporate Hybrids (frequently referred to as junior subordinated bonds) are an increasingly utilized source of financing for US non-financial corporations and offer benefits to both issuers and investors alike. Until recently, these bond structures, which have a well-established history in European markets, have remained a somewhat unknown and nuanced part of the US corporate debt market. However, as we will discuss below, recent changes to rating agency methodologies from Moody's in 2024 has led to a growing inclusion of these instruments in corporate capital structures and increased standardization and applicability as the market evolves from niche to mainstream.

The growing application of corporate hybrids

Corporate Hybrids are mostly dated (e.g. 30-year maturity) junior subordinated, deferrable debt securities typically issued by predominantly high-quality, investment grade, non-bank institutions. These days, hybrid securities are issued with set maturities and a first call date 5 or 10 years from issuance and usually carry a rating that is 1-2 notches below senior debt of an issuer. Due to their subordinated position in the capital structure, they also tend to carry higher coupon rates and spread premiums to senior debt.

From an issuer's perspective, these securities were historically used to raise capital at a significantly lower cost to, and without the dilutive effects to shareholders of, issuing equity. Furthermore, in most jurisdictions, corporate hybrids are fully tax deductible, unlike equity dividends, creating another attractive feature relative to issuing equity.

However, from a debt financing perspective, prior 2024, ratings agencies typically applied only a 25% equity content to these bonds. Meaning that 75% of the amount issued would be reflected as debt in leverage and other credit quality metrics,

resulting in only marginal balance sheet benefit to issuing senior debt (though at a higher interest rate.) So, while they offered a lower cost of capital to equity, the higher cost to senior debt and limited equity component meant hybrids were generally a less efficient source of financing for companies. As a result, the corporate hybrid market in the US remained relatively small.

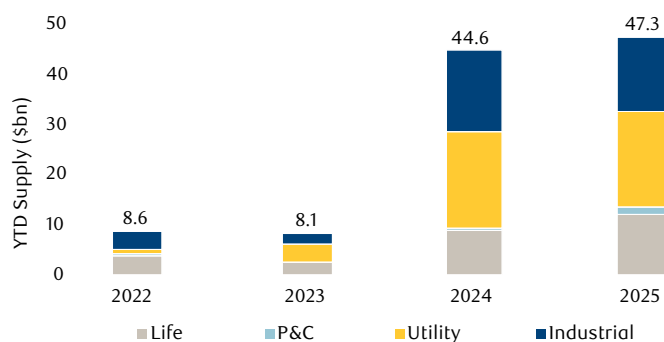
This all changed, however, in 2024 when Moody's increased the amount of equity content that would be applied to these securities from 25% to 50%. With only 50% of the On the other hand, these bonds do offer value relative to broader investment grade and even high-quality high yield markets (illustrated by the gray area below.) total capital borrowed categorized as debt on the balance sheet, corporate hybrids now look much more compelling for borrowers as they can be used as a lever to protect credit ratings. The combination of these factors has resulted in a spike of corporate hybrid issuance by US companies over the last two years. The initial wave of supply centered around utilities and energy pipeline issuers, many of which faced large capital expenditure programs that could otherwise dilute the credit profile in the years ahead. While these sectors remain dominant in recent primary issuance, we've seen a broadening of hybrid appeal across other sectors of late.

We've now seen deals from issuers in the telecom, healthcare, and cyclical sectors, with M&A funding and/or credit rating strengthening efforts driving these deals. As we expect merger activity to remain elevated for some time, we would expect this sector broadening trend to continue.

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On one hand, this makes sense given we are in an environment of high yields and tight spreads—so an issuer may not incur that much higher of a cost by issuing a corporate hybrid versus an unsecured bond. Combined with their favorable equity treatment, they could even make them a more attractive option from an overall balance sheet management perspective.

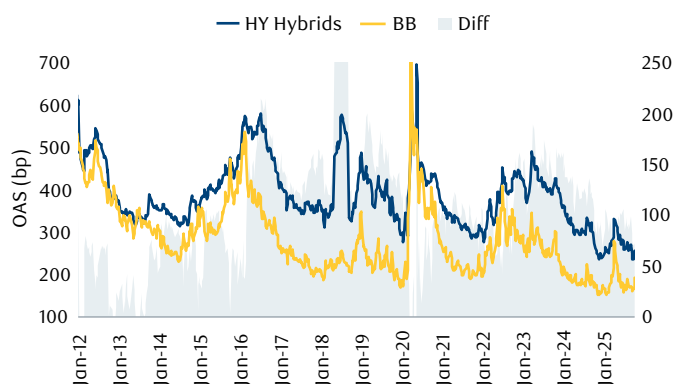
Chart 1: The growing supply of hybrid securities



Source: Barclays, RBC GAM, as of 9/30/2025.

On the other hand, these bonds do offer value relative to broader investment grade and even high-quality high yield markets (illustrated by the gray area below.)

Chart 2: Compelling value of hybrid securities

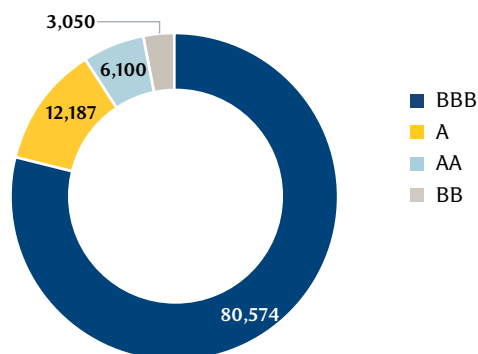


Source: Barclays, RBC GAM, as of 9/30/2025.

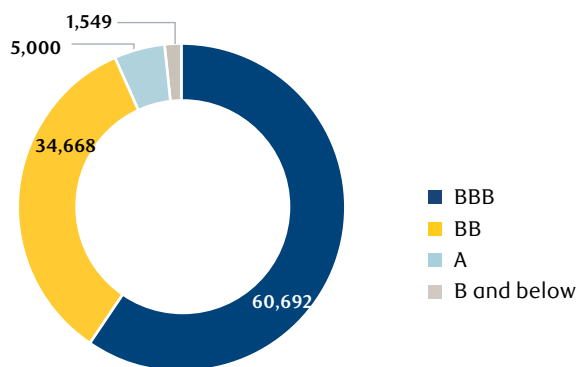
Corporate Hybrid market is a primarily IG rated universe

In part, the historically higher cost of capital has meant that the universe of corporate hybrid issuers was limited to only very high-quality companies with robust and diversified capital structures and unencumbered access to capital markets.

Chart 3: Credit quality by issuer rating



Bond Rating % of Total Face Value



Source: Bloomberg, BAML indices HNEC and GNEC. As of 10/31/2025.

Today, the universe remains a high-quality cohort of primarily investment grade issuers, but with greater breadth, diversification and liquidity making it an increasingly attractive, and accessible, market to invest in. From an investor's perspective, hybrids offer higher yields, and more spread compared to senior unsecured bonds, but with the same (low) default and credit risk exposure of an investment grade issuer, a key benefit of the space.

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As broad market spreads remain tight, this presents a unique opportunity to earn some additional spread without significantly increasing overall credit risk in portfolios. In this respect, we note that most of the issuers coming to the junior subordinated debt market are issuing deals at spreads wider than generic BB valuations in the high yield space, something that represents an opportunity in our view.

Risks and risk mitigators for the corporate hybrid market

Now, these securities do come with risks that senior bonds don't face, namely their lower rank in repayment priority, potential for non-calls (or extension risk), as well as allowance for coupon deferrals. Both seniority classes also face credit rating downgrade risk.

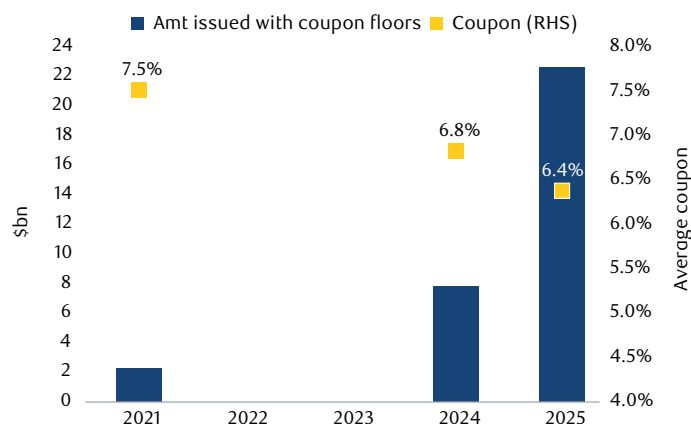
Lower repayment rank: these bonds rank lower in the capital structure than senior unsecured bonds, meaning that in the event of default, they have a lower likelihood of repayment. While this risk is real, and something investors need to be mindful of, we believe that the high-quality profile of issuers in this market is a mitigating force as the likelihood of default for investment grade companies has historically been very low.

Extension risk: corporate hybrids are typically issued and priced under the presumption, but not a requirement, that they will be called at the first call date. Historically, extension risk has been a concern as the decision of whether to call or not call these securities was solely an economical one for the issuer. Unlike in Europe where almost all corporate hybrid deals have been called at the first call date, this has not been the case in the US, where investors had limited protections against the risk that the bonds are not called at the first call date and repriced (down) accordingly.

It also made these securities challenging to invest in as the lack of incentive to take out the bonds at the call date meant investors could be left with a significantly longer maturity bond than they expected. However, with the increased level of equity content and importance of that in the efficiency of these securities as a source of capital, has helped reduce this risk.

The reason for this is because a failure to call within a certain time frame (typically 20 years prior to maturity) results in the loss of equity content for the bond. The result being a potential negative impact to an issuer for not calling these bonds at the call date, has increased, and therefore, the likelihood of them not calling the bonds at the first call date has decreased.

In addition to this, another recent trend in the new supply of these bonds has been the increased inclusion of coupon floors (chart below). Since we expect future government yield levels to trend lower, reflecting current restrictive Fed monetary policy, the future cost of extending the bond is likely to be greater than it would have been without a coupon floor. This, in turn, reduces the likelihood that an issuer would economically benefit from leaving the bonds outstanding.

Chart 4: Increasing prevalence of coupon floors in new corporate hybrid issues

Source: Barclays, RBC GAM, as of 9/30/2025.

Coupon deferral risk: by nature, these securities allow for an issuer to defer payment of coupons at the issuers' discretion. However, if coupons are deferred, the issuer must also cease paying dividends to equity shareholders or executing any share buybacks. Coupon deferrals can also be detrimental regarding issuers ability to access debt markets in the future. These factors have been, and we expect will continue to be, effective deterrents to this type of behavior. The result has been a very low prevalence of coupon deferrals occurring.

Downgrade risk: issuers downgraded to junk ratings at the senior level lose equity credit applicable to the junior subordinated securities across some of the rating agencies. You could also see notching increase from the initial 1-2 notches given rating practices in the high yield market, reflecting lower recovery rate expectations. This can increase pressure on the prices of these securities as investors consider typically higher funding cost in the high yield market and the likelihood that these bonds could represent a relatively cheap source of funding compared to standard high yield spread/yield levels, especially for deteriorating credits. This also means that the extension risk becomes more acute. This is exactly the reason why we typically shy away from issuers with clearly deteriorating credit profiles when considering junior subordinated debt opportunities.

Because of these risks, corporate hybrids have been an unloved and mostly ignored, part of the US fixed income opportunity set. As the market continues to grow, mature, and standardize, we expect it to become more familiar to investors and increasingly represented in portfolios. Until then, we think there will continue to be opportunities to take advantage of mispricings inherent in this less efficient asset class and for portfolios to benefit from an improved risk-reward profile of these securities.

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