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Points to note when the proportion of hybrid securities in the issuer's capital structure increases

The following is the opinion of Japan Credit Rating Agency, Ltd. (JCR) regarding points to be considered in rating evaluation when the proportion of hybrid securities in the issuer's capital structure increases.

Hybrid securities for operating companies rated by JCR between April and December 2020 are at a high level of 15 in total number, over JPY2.4 trillion. As the influence caused by spread of COVID-19 has been extending in domestic and global economy, many issuers have been seeking to strengthen their financial bases by procuring hybrid securities. By actively raising funds through hybrid securities, some issuers have increased the proportion of hybrid securities in their capital.

In the evaluation of hybrid securities, JCR adopts a five-level scale: “Equivalent to stock/100%”, “High/75%”, “Medium/50%”, “Low/25%”, and “Equivalent to debt/0%. The respective percentages presented above correspond to JCR’s equity calculation of hybrid securities in financial analysis to calculate quantitative analytical indicators such as capital adequacy ratio or D/E ratio. While the percentages indicate the degree of equity-like characteristics for which 100% is assigned to common stocks, JCR believes that when hybrid securities account for a certain percentage of total equity, it is also necessary to qualitatively factor in the fact that the stability of the capital base is weaker than it otherwise would be. Many hybrid securities have conditions that allow for prepayments by call and such prepayment and refinancing decisions are subject to, among other things, step-up interest rates and degradation of equity content due to a reduction in the remaining term. Such decisions by issuers may have a major impact on the overall equity.

In light of the characteristic of such hybrid securities, JCR reflects in its qualitative assessment of capital base when the amount of hybrid securities' equity equivalents exceeds 30% of the issuer's total equity after taking equity content of the hybrid securities into account. On the other hand, we do not see any impact on equity content of individual hybrid securities. This treatment is similar to the case where the issuer raises new hybrid securities, as well as where the impairment of the issuer's equity results in a higher percentage of the equity being represented by hybrid securities. In a situation where the issuer’s capital base is under stress, if hybrid securities, which account for a large percentage of capital structure, are prepaid without replacement, there would be a negative impact on the issuer's creditworthiness, clearly. These risks are qualitatively factored into the evaluation of capital bases as being relatively weak in stability. In contrast, if replacement, call skipping, and deferral of interest payments were properly implemented in the same circumstances, we consider that the financial flexibility expressed as equity content in the security would be demonstrated sufficiently.

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