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DCM Quick Guide
A new path to 100% equity credit corporate hybrids

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In February 2024, Moody's updated their rating methodology for hybrid equity credit. While much of the market discussion has focussed on the updated methodology as it applies to investment grade issuers, the methodology for non-investment grade issuers was also significantly updated.

Working within these new rating methodology requirements, the Dentons DCM team have recently worked on a corporate hybrid transaction for a non-investment grade European corporate that has achieved 100% equity credit from Moody's under the new methodology. This type of instrument could represent a new path to 100% equity credit corporate hybrids for some non-investment grade issuers (at least from the Moody's perspective).

From S&P's perspective, corporate hybrids from non-investment grade corporates can (at best), achieve intermediate (50%) equity content credit, unless the instrument mandatorily converts into equity within two years of issuance.

How Moody's approach non-IG corporate hybrids

The Moody's approach to non-investment grade corporate hybrids can be summarised as follows:

100% equity credit ascribed if:	0% equity credit ascribed if:
• terms do not allow for holders to trigger bankruptcy; and	• terms allow holders to trigger bankruptcy; and/or
• terms do not allow holders to have creditor rights in bankruptcy.	• terms allow holders to have creditor rights in bankruptcy.

Moody's also provide that deeply subordinated instruments that are effectively functionally equivalent to equity (with no ability to influence the probability of default of an issuer, and no ability to influence the loss given default on more senior debt of the issuer), will be treated as similar to equity from a credit perspective. In short, for an instrument to be treated like equity, the credit risk of more senior debt issued by the issuer needs to be the same regardless of whether the hybrid instrument is actually equity or a deeply subordinated instrument equivalent to equity.

Mapping the new path

While an individual issuer's circumstances will require tailored advice on each transaction, the Dentons DCM team worked with the issuer and transaction participants on a recent European corporate hybrid to achieve 100% equity credit from Moody's by adopting the following features within the instrument:

Features of the new corporate hybrid instrument	
No maturity	Undated corporate hybrid instrument.
Ranking	*Pari passu* with the issuer's existing subordinated bonds for so long as the issuer remains investment grade. Otherwise, *pari passu* with the most senior class of preferred shares of the issuer.
Automatic conversion on "trigger event"	A "trigger event" occurs if, at any time that the issuer is not investment grade rated, there is: • a downgrade by Moody's of the long-term corporate family rating to Caa1 or below; • the issuer is determined to be insolvent, the issuer stops or suspends payments of its debts or makes an arrangement or enters into a moratorium in respect of all or any part of its debts; or • a winding up of the issuer (other than a solvent winding-up pursuant to a reorganisation approved by the Trustee or an extraordinary resolution of noteholders). Immediately prior to the occurrence of the "trigger event", each noteholder's right to repayment of principal, interest, and any arrears of interest, are mandatorily and automatically converted into, and exchanged for, a right to be issued fully-paid Conversion Beneficiary Units. The issuer's liabilities in respect of repayment of the undated corporate hybrid are accordingly wholly, unconditionally and irrevocably released upon such automatic conversion.
Conversion Beneficiary Units	Unlisted beneficiary units (*parts bénéficiares*) in the issuer, which do not represent share capital of the issuer, the rights of which are specified in or pursuant to the articles of association of the issuer in accordance with Article 430-1(1) of the Luxembourg Companies Act 1915. The beneficiary units rank equally with the most senior preference shares of the issuer, and carry rights to fixed distribution, deferral rights and arrears rights equivalent to those on the undated corporate hybrid instrument. *Note that this structure should be capable of being adapted to jurisdictions other than Luxembourg, including those that do not have a "beneficiary units" concept, with consideration of what is the appropriate instrument for the undated corporate hybrid to convert into being driven by what instrument carries a rank equivalent to the senior preference shares of the issuer. In some jurisdictions, this may be preference shares themselves.*
No events of default	There are no events of default or other acceleration rights under or in relation to the undated corporate hybrid.

The combination of these features, in particular the automatic conversion of the undated corporate hybrid into a claim akin to preference shares, based on a trigger arising ahead of a bankruptcy, enabled Moody's to conclude that not only did the instrument not have the ability to trigger bankruptcy (similar to standard corporate hybrid bonds), but it also did not offer its holders creditor rights in bankruptcy. Accordingly, Moody's ascribed 100% equity credit to the instrument under their hybrid equity credit methodology.

To discuss further...

Please reach out to any of the contacts below if you would like to discuss the issues raised in this Quick Guide further.

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This Quick Guide is a high-level overview of a complex topic and is limited to certain equity credit considerations for a corporate hybrid bond issued by a non-investment grade corporate in the European international debt capital markets, offered to professional investors and under an exemption to the registration requirements of the US Securities Act of 1933 (as amended), on either a Regulation S or a Rule 144A/ Regulation S basis. Additional points not set out above may also be relevant depending on the individual circumstances of the issuer and the individual characteristics of the bond transaction.

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