Market Commentary - Corporate hybrids to benefit from Lufthansa's allowance to pay coupons

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- **Earlier this year, the European Commission has amended its state aid framework, to allow temporarily banks to receive support to cover Covid-related losses without a burden-sharing scheme (coupon suspension on sub-debt or even bail-in).**
- **In this temporary framework, non-financials remain subject to non-mandatory coupon suspension in case of state aid. In that respect, weakest names of the corporate hybrid space were under great scrutiny (Lufthansa with a state aid already in place).**
- **Discussing with Lufthansa, their state aid contract with the Economic Stabilization Fund (ESF) stipulates that they are not to pay any coupons which they are not obligated to pay. They did, however, clarify with the ESF that this wording is not intended to cover coupon payments on their hybrid bond. Hence despite the state aid received from the German government, they will be able to pay the coupon on their hybrid if they want to.**
- **Making corporate hybrids coupons safer than expected in cases of state-aid, we then view it as a further positive for the entire corporate hybrid space, especially the weakest name of the universe, reinforcing our strong preference for the asset class for 2021.**

Bail-ins schemes followed very unpopular bail-outs during GFC

Through the great financial crisis (GFC), taxpayers had to bail-out companies, mostly in the financial sector, without creditors ending up absorbing all losses. Indeed, even subordinated creditors of banks who requested public support weren't touched, while they were supposed to receive a higher yield in exchange of higher risk.

Hence, in an attempt to build a fairer system, bail-in mechanisms have been put into place both by financial regulators and the European Commission (EC) via the competition framework both for financial and non-financial companies. Also under the rules of competition governed by the DG Comp of the European Commission (EC), both financial and non-financial companies have gradually become subject to the burden-sharing principle, meaning that shareholders, subordinated creditors and possibly senior creditors must absorb losses before governments can decide to grant state-aids to a company in difficulty.

But the EU partially suspended the Bail-ins during Covid

But the EU Commission took action to preserve the continuity of economic activity during and after the COVID-19 outbreak, allowing member states to use the fiscal leeway to help their respective business sectors. Indeed, the main fiscal response to the Coronavirus is coming from Member States' national budgets, and the EU State aid rules have been amended to enable the Member States to take swift and effective action to support citizens and companies. On 19 March 2020, the Commission adopted the Communication on the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak (TF COVID-19).1, which has been amended three times afterwards (on 3 April 2020 and on 8 May 2020). The Temporary Framework was initially set to expire on 31 December 2020, except for recapitalisation measures that could be granted until 30 June 2021, but it was extended for an additional six months until 30 June 2021, except the recapitalisation measures which are prolonged for three months until 30 September 2021.

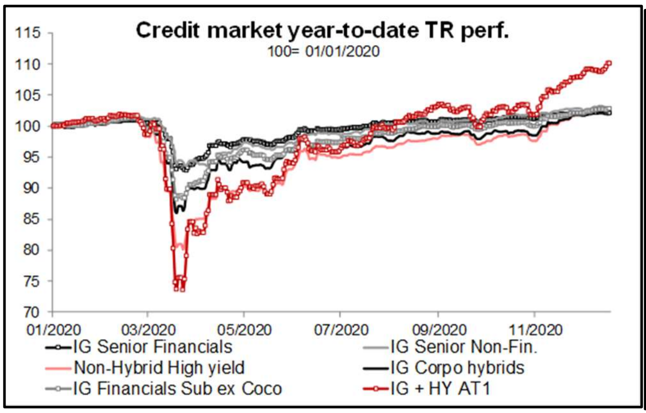
Banks are well protected by the Covid framework non-financials less so

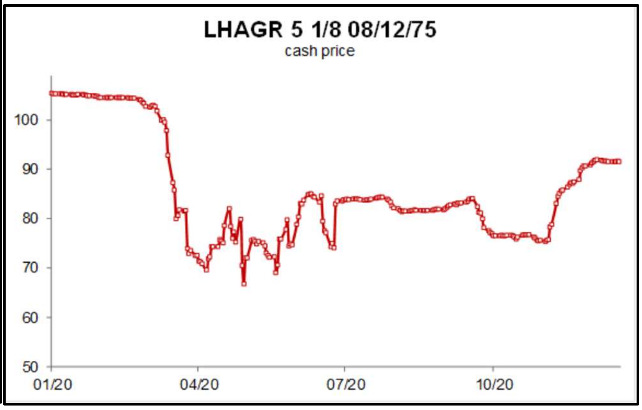
To preserve the credit channel via bank lending the EC via the DG Comp has eased rules for governments desiring to support their banking sector in difficulty. The first version of the temporary framework has been very strong support for banks as it clearly states that the burden-sharing principle is suspended provided the losses are related to Covid-19.

However, the second amendment to the temporary framework is making clear that, unlike in the financial sector, may-pay coupons and dividends will have to be suspended until the state-aid has been fully repaid.

But Lufthansa confirmed this week that corporate hybrids are not considered as may-pay coupon hence making their payment safer

Our initial understanding was that corporate hybrid coupon payment would be suspended in case of state aid as they are fully discretionary. But this week the company confirmed its state aid contract with the Economic Stabilization Fund (ESF) stipulates that they indeed are not to pay any discretionary coupons. The company did, however, clarify with the ESF that this wording is not intended to cover coupon payments on their hybrid bond.





Positive read-across for Corporate hybrids, especially the weakest ones

Other potential candidates for state aids will benefit from this clarification. Corporate hybrids coupons appear now very safe. Hence we view it as a positive for the entire corporate hybrid space, especially the weakest names of the universe. We reiterate our strong buy recommendation preference for the asset class for 2021.

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