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SGD perpetuals: Are these bonds or equity?

Be prepared to hold perpetuals perpetually

PERPETUALS, as the name suggests, are distribution-paying instruments with no maturity date. Following the 2007-08 Global Financial Crisis, which saw global interest rates pinned down to historical low levels, perpetuals had a good run with over S$40 billion issued in the SGD bond market since 2009. Issuers were varied, ranging from banks, Reits, and industrial and property companies which looked to raise capital at a reasonable funding rate.

Investing in perpetuals as a strategy had broadly outperformed investing in the vanilla bonds of the same issuer. This is because perpetuals paid a higher distribution rate and most issuers have redeemed the perpetuals when the call date came due (with the exception of Ezion Holdings Ltd). Calls are typically embedded in perpetuals, which give issuers the option to redeem perpetuals at a certain date.

Perpetuals have behaved like bonds during good times

Thus far, SGD perpetuals have mostly exhibited bond-like features. Like vanilla bonds, perpetuals have been paying regular and fixed distributions (even though distributions are typically deferrable, meaning that it is not an event of default for missing distributions). While there is no maturity date, to date most of the issuers have redeemed the perpetuals at the first call date. Most of the time, the motivation is due to economics as the cost of refinancing with new perpetuals is cheaper than keeping the existing one. This is largely due to spread compression, given the market rally prior to 2020.

In several other circumstances (for example, Genting Singapore Ltd), we believe that issuers called and redeemed the perpetuals because they have excess capital and also possible repercussions from reduced market access if they renegade on their call date (in effect to protect their reputation in the perpetual market as an issuer that will call at first call).

With higher distributions than vanilla bonds, investors have flocked into SGD perpetuals that satisfy the "impossible trinity" for yield-hungry investors, namely (1) high yield, (2) low risk and (3) limited tenor. Given the good track record of being called, we believe many sophisticated and retail investors similarly see perpetuals as a type of bond (as opposed to equity).

Perpetuals may behave like equity during bad times by not exercising the call

However, we think that the near-impeccable track record may be broken. Due to the Covid-19 outbreak, we think that many perpetuals may not be called and we will not exclude the possibility that distributions will be entirely deferred.

To explain, we will first debunk the "conventional wisdoms" that (1) lower interest rates are good for perpetuals and (2) when stocks go down, perpetuals (because it is seen as a bond) go up. The rationale is that in bad times, perpetuals behave like equity and lose their bond-like features (such as having a maturity date and providing a fixed-income stream). This is because issuers may exercise prudence by not calling their perpetuals.

in March 2020 Deutsche Bank opted not to exercise the call for its US$1.25 billion perpetual. PHOTO: AFP

Today, the outbreak of Covid-19 has dampened demand, especially in the travel, hospitality and retail sectors. The curb on movements has also impacted supply chains, which may invariably curtail production. The Ministry of Trade and Industry is forecasting that Singapore's GDP will shrink by 1-4 per cent in 2020. Amid the weak outlook, profitability and cash flows are expected to weaken. Meanwhile, liquidity has receded from the markets and we observe that good-quality companies in the US have to pay up significantly to issue bonds.

Cash is king in this environment. Companies have reportedly tapped on bank lines even though several may not have apparent immediate use of proceeds. We think companies may consider opting not to call their perpetuals in order to conserve cash and keep a larger equity cushion to ride through the downturn. Non-call risks may also be triggered by the regulator. For example, The Reserve Bank of New Zealand has forbidden AT1 capital (a type of perpetuals issued by banks) to be redeemed.

Watch out for perpetuals with insufficient step-ups

Bonds prices typically rise when interest rates are down. This is because the income stream from bonds is stable, which becomes more valuable when interest rates fall, assuming no default risk. However, distributions from perpetuals are not necessarily stable because of resets and option for the issuer to defer distributions.

Because of resets, the distribution rate of perpetuals periodically follows the prevailing interest rates that are referenced. When interest rates fall, distributions from perpetuals are expected to fall upon the reset date, which may coincide with the first-call date. For example, for MLTSP 3.65 per cent PERP (one of two perpetuals issued by Mapletree Logistics Trust) with a reset spread of 1.815 per cent, if the referenced five-year SGD swap rates fall to 0, the distribution rate upon reset will be a mere 1.815 per cent. We do not find that such a distribution rate is sufficiently punitive to the issuer in the event that the perpetual is not called. Already, in March 2020 Germany's Deutsche Bank opted not to exercise the call for its US$1.25 billion perpetual.

Step-ups will be useful to incentivise the issuer to call by increasing the distribution rate, usually in the event that the issuer chooses not to exercise the call to redeem the perpetual. However, many perpetuals in the SGD bond market do not feature step-ups at all, such as bank capital instruments (which are a type of perpetuals issued by banks) and Reit perpetuals. Step-ups are not allowed for such issuers in order to gain equity credit treatment by the regulators. For most other issuers, the step-up for their perpetuals is a mere 100bps, which is in our view insufficient to incentivise issuers to exercise the call to redeem the perpetuals. As borrowing costs have spiked (even though risk-free interest rates have fallen), we think perpetuals look like a cheap form of equity to issuers, which in turn may make sense for issuers to keep in their capital structure permanently.

Be wary of deferral of distributions

Another risk is the option for issuers to defer distributions on perpetuals. Usually, issuers which have declared equity dividends are obliged to also pay distributions to holders of perpetuals. However, increasingly, dividends are cut (sharply or entirely), which in turn exposes perpetuals to the risk of distributions deferral.

The European Central Bank and Bank of England have recommended that banks suspend dividends, and we note that banks including HSBC Holdings plc and Standard Chartered plc have cancelled dividends even though they were declared. The Reserve Bank of New Zealand has also mandated banks in the country to halt dividends.

For Reits, while in normal times we expect equity dividends to be paid, the same cannot be said for extraordinary times like today. For example, SPH Reit has cut its dividends by 79 per cent year-on-year to shore up its cash buffer. Versus corporates, Reits generally hold little cash on their balance sheet.

For both bank capital and Reit perpetuals, risks of deferral of distributions are accentuated. Unlike perpetuals from most corporate issuers, the deferred distributions for banks and Reits are non-cumulative due to regulatory requirements. In other words, any distributions missed do not have to be paid in the future, even when equity dividends are resumed.

Are perpetuals still good value?

We see heightened risks of non-call, distribution deferral while distribution rates may be reset lower. We also recognise that market liquidity has receded in today's environment and as such, investors looking to sell may not find a ready market at reasonable prices.

On a positive note, while investors should be prepared to hold the perpetuals indefinitely, we think that the majority of the companies that we cover which issued perpetuals are unlikely to default. In any case, perpetuals are also senior to equity, which confers better protection in a liquidation scenario. Hopefully, Covid-19 will blow over and restore normalcy in the markets and economy.

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