Asia Credit Research

SGD Corporate Perpetual Bonds: Paying issuers when it is at their option to call?

Friday, March 09, 2018

Summary

- **Increasingly, perpetuals are structured with different call and reset date:** 8 out of 16 perpetuals issued since 2017 have call and reset dates that do not coincide. Another 3 feature a step-up date that is different from the reset date. This appears to be the new norm only in the SGD space. Typically in the USD space, the dates for call, reset and step-up coincide.

- **Such a structure fulfils the needs for both issuers and investors?:** Historically, SGD issuers have generally called on first call, regardless of structure. Seeing that the 'impossible trinity' (High yield, limited tenor, low default risk) can be fulfilled, investors have responded by pricing to call (instead of reset and/or step-up dates). This creates an incentive for issuers to issue perpetuals with earlier call dates, as they get both the flexibility to call earlier and cheaper financing rates (since investors see this as a shorter tenured perpetual). We believe this is the rationale for issuers to structure perpetuals this way, though the intention to call on first call is difficult to be known with certainty at the outset.

- **Investors are in effect selling options below zero:** Calls are at the option of the issuer, not investors. As such, investors should demand compensation when such an option is given to issuers. However, by pricing perpetuals with earlier calls dates (but not reset dates) at lower distribution rates, the contrary has happened – investors are paying issuers to take an option. We acknowledge market structure reasons (e.g. hunt for yield) that drove certain investors to "give-away" this compensation, although that is not the focus of this paper.

- **A number of perpetuals are uneconomical to be called:** With the increase in interest rates and rising rates expectations, call risks have significantly increased, in our view. Based on expectations of swap rates increasing further in the future, a number of perpetuals with differing call and reset dates will look uneconomical by the issuer to be called – it will be cheaper to simply not call than to call a perpetual and replace with another. The perpetuals, which are vulnerable in our view, include MAPLSP 3.95% PERP, SCISP 3.7% PERP, STHSP 3.95% PERP, WINGTA 4.35% PERP, FPLSP 4.38% PERP and GUOLSP 4.6% PERP.

- **Don't price the perpetuals to call unless they are very likely to:** The perpetuals which are likely to call, as discussed in our earlier paper, are those which have seen significant compression in yield spreads after issuance. As a recap, this includes FHREIT 4.45% PERP, LMRTSP 7% PERP, LMRTSP 6.6% PERP, SCISP 5% PERP, MLTSP 4.18% PERP, ARTSP 5% PERP, FPLSP 4.88% PERP, FPLSP 5% PERP, AREIT 4.75% PERP and KREITS 4.98% PERP. However, with credit spreads at already compressed levels, it is not prudent to assume further compression - we may even see widening of spreads, which may put newer perpetuals with compressed spreads at risk.

- **Pullback from exuberance creates opportunity though investors should stay selective:** With a broad selloff in February, we begin to see pockets of opportunities. We favour FHREIT 4.45% PERP, FPLSP 4.88% PERP, FPLSP 5% PERP, KREITS 4.98% PERP, LMRTSP 7% PERP and LMRTSP 6.6% PERP – we note these have high likelihood to be called. We prefer avoiding duration risk and prefer to rotate away from perpetuals that look uneconomical to be called on first call, such as GUOLSP 4.6% PERP and SCISP 3.7% PERP.

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

GT Institutional Sales
Tel: 6349-1810

Wong Hong Wei
+65 6722 2533
wonghongwei@ocbc.com

I) Exceptions are now the norm

Differing call, reset and step-up dates: With the issuance of FPLSP 4.38% PERP and GUOLSP 4.6% PERP, the new norm is to structure perpetuals with call dates that do not coincide with their reset or step-up dates. 9 out of 18 perpetuals issued since 2017 (Figure 1, in yellow) sport a reset date that is different from call date. Excluding 4 perpetuals issued by REITs (which cannot have step-ups to receive equity treatment under MAS's aggregate leverage cap), 3 out of the remaining 5 perpetuals sport a step-up date that is different from reset date. In total, 17 out of 35 outstanding perpetuals have a first call date that differs from the reset and/or step-up date.

Figure 1: Comparison between call date, reset date and step-up date

Issue date	Security	First call date	Reset date	Step-up date
02-Mar-12	SPOST 4.25 PERP	02-Mar-22	02-Mar-22	02-Mar-22
21-Aug-13	SCISP 5 PERP	21-Aug-18	21-Aug-23	21-Aug-23
19-Feb-14	TRAFIG 7.5 PERP	19-Feb-19	19-Feb-19	19-Feb-24
24-Sep-14	FPLSP 4.88 PERP	24-Sep-19	24-Sep-19	24-Sep-24
27-Oct-14	ARTSP 5 PERP	27-Oct-19	27-Oct-19	-
06-Nov-14	TATSON 6.65 PERP	06-Nov-19	-	06-Nov-19
19-Nov-14	EZISP 7 PERP	19-Nov-18	19-Nov-18	19-Nov-18
09-Mar-15	FPLSP 5 PERP	09-Mar-20	09-Mar-20	09-Mar-25
20-May-15	SCISP 4.75 PERP	20-May-20	20-May-25	20-May-25
30-Jun-15	ARTSP 4.68 PERP	30-Jun-20	30-Jun-20	-
14-Oct-15	AREIT 4.75 PERP	14-Oct-20	14-Oct-20	-
02-Nov-15	KREITS 4.98 PERP	02-Nov-20	02-Nov-20	-
12-May-16	FHREIT 4.45 PERP	12-May-21	12-May-21	-
25-May-16	MLTSP 4.18 PERP	25-Nov-21	25-Nov-21	-
27-May-16	HYFSP 6 PERP	27-May-20	27-May-20	27-May-20
08-Jul-16	FIRTSP 5.68 PERP	08-Jul-21	08-Jul-21	-
27-Sep-16	LMRTSP 7 PERP	27-Sep-21	27-Sep-21	-
19-Jan-17	MAPLSP 4.5 PERP	19-Jan-22	19-Jan-27	19-Jan-27
05-May-17	HPLSP 4.65 PERP	05-May-22	05-May-22	05-May-27
12-May-17	MAPLSP 3.95 PERP	12-Nov-22	12-Nov-27	12-Nov-27
16-Jun-17	STHSP 3.95 PERP	16-Jun-22	16-Jun-27	16-Jun-27
19-Jun-17	LMRTSP 6.6 PERP	19-Dec-22	19-Dec-22	-
22-Jun-17	SCISP 3.7 PERP	22-Jun-20	22-Jun-22	22-Jun-22
28-Jun-17	WINGTA 4.08 PERP	28-Jun-22	28-Jun-22	28-Jun-27
11-Jul-17	OLAMSP 5.5 PERP	11-Jul-22	11-Jul-22	11-Jul-22
19-Jul-17	ARASP 5.2 PERP	19-Jul-22	19-Jul-24	19-Jul-24
24-Aug-17	WINGTA 4.35 PERP	24-Aug-20	24-Aug-27	24-Aug-27
21-Sep-17	FPLSP 3.95 PERP	05-Oct-22	05-Oct-22	05-Oct-27
28-Sep-17	MLTSP 3.65 PERP	28-Mar-23	28-Mar-23	-
19-Oct-17	CELSP 3.9 PERP	19-Oct-20	19-Oct-20	19-Oct-20
03-Nov-17	EREIT 4.6 PERP	03-Nov-22	03-Nov-22	-
17-Jan-18	FPLSP 4.38 PERP	17-Jan-23	17-Jan-28	17-Jan-28
23-Jan-18	GUOLSP 4.6 PERP	23-Jan-23	23-Jan-25	23-Jan-25
01-Feb-18	CACHE 5.5 PERP	01-Feb-23	01-Feb-23	-
14-Mar-18	ARASP 5.65 PERP	14-Mar-23	14-Mar-28	14-Mar-28

Source: Bloomberg, OCBC

Have your cake and eat it too: Such a structure (with differing dates) is rare for USD perpetuals we saw in 2017. Its prevalence in the SGD market though is likely due to the lower distribution rate required for shorter call dates. As discussed in our prior publication on perpetuals, most issuers called on first call. Called issues include issues with differing dates between call, reset and step-up, such as MAPLSP 5.125% PERP (5Y call, 10Y reset & step-up) and OLAMSP 7% PERP (5Y call, 10Y reset & step-up). Investors have responded by pricing to call (instead of reset/step-up). This creates an incentive for issuers to issue perpetuals with earlier call dates (versus reset dates), benefiting from both the flexibility to call earlier and cheaper financing rates.

II) Selling options cost you money upfront?

Call options are not liabilities to the holder: A call option gives the right (but not obligation) to the buyer to buy an asset. Similarly, a bond with a call gives the right (but not obligation) to the issuer to redeem the bond. Hence, an embedded call option is a benefit to the bond issuer. As an asset, it should confer value to the issuer; zero value in worst case scenario, but never a liability.

Calls embedded in perpetuals limit upside, hence investors ought to be compensated: Conversely, a call option creates a contingent obligation for the seller to sell the asset to the buyer at a pre-determined price. Typically, sellers get paid to assume the contingent obligations. Similarly, a bond with a call (at the option of the issuer) exposes the investor to reinvestment risks (if interest rate falls) when the bond is called prematurely. As such, investors of bonds with a call should be paid for taking on reinvestment risks and the effect should be that bonds with calls should trade at higher yields than similar bonds without the call.

Investors appear to be paying issuers for the option to call: Instead of pricing perpetuals wider when call dates are shorter than reset/step-up dates (which provide economic incentive to call), investors appear to indiscriminately price perpetuals to call regardless of the reset date. We deduce so as we observe similar levels of spread pickup for perpetuals with coinciding dates (105bps) and the ones that do not (110bps), by comparing the YTC spread of perpetuals with the YTM spread of the straight bonds from the same issuer. We think it is unlikely that investors are pricing the perpetuals to reset given only 72bps in spread pickup (YTR of perpetuals over YTM of straight bonds). While calls can create value to perpetuals investors, as demonstrated by EZRASP 8.75% PERP, SWIBSP 9.75% PERP and EZISP 7.8% PERP, which the issuer prioritised payment of perpetuals because the call date came earlier before other repayments, we are doubtful if this will continue to be the norm for companies under stress / distress.

Figure 2: Selected perpetuals with non-coinciding call and reset dates

Security	YTC spread	Comparable	YTM spread	Spread pickup
MAPLSP 4.5 PERP	184	MAPLSP 2.85 08/29/2025	64	120
MAPLSP 3.95 PERP	187	MAPLSP 2.85 08/29/2025	64	123
SCISP 5 PERP	118	SCISP 3.7325 04/09/2020	80	38
SCISP 4.75 PERP	214	SCISP 3.7325 04/09/2020	80	134
SCISP 3.7 PERP	202	SCISP 3.7325 04/09/2020	80	122
STHSP 3.95 PERP	185	STHSP 3.08 09/12/22	55	130
WINGTA 4.35 PERP	275	WINGTA 4.25 11/29/22	133	142
FPLSP 4.38 PERP	225	FPLSP 3.95 10/07/21	116	108
GUOLSP 4.6 PERP	250	GUOLSP 3.85 02/15/23	175	75
Average	**204**		**94**	**110**

Source: Bloomberg, OCBC

Figure 3: Selected perpetuals with coinciding call and reset dates

Security	YTC spread	Comparable	YTM spread	Spread pickup
AREIT 4.75 PERP	96	AREIT 2.95 08/03/20	51	45
ARTSP 4.68 PERP	208	ARTSP 4.205 11/23/22	80	129
ARTSP 5 PERP	151	ARTSP 4.205 11/23/22	80	71
FHREIT 4.45 PERP	212	FHREIT 2.63 07/06/2022	73	139
KREITS 4.98 PERP	183	KREITS 3.15 02/11/2022	74	109
LMRTSP 7 PERP	363	LMRTSP 4.1 06/22/2020	200	163
LMRTSP 6.6 PERP	384	LMRTSP 4.1 06/22/2020	200	184
MLTSP 3.65 PERP	156	MCTSP 3.25 02/03/2023	71	85
OLAMSP 5.5 PERP	348	OLAMSP 6 10/25/22	290	57
SPOST 4.25 PERP	114	SPOST 3.5 03/30/2020	41	73
CELSP 3.9 PERP	238	CELSP 4.7 04/29/2018	140	98
Average	**223**		**118**	**105**

Source: Bloomberg, OCBC

Figure 4: Selected perpetuals with non-coinciding call and reset dates

Security	YTR spread	Comparable	YTM spread	Spread pickup
MAPLSP 4.5 PERP	175	MAPLSP 2.85 08/29/2025	64	111
MAPLSP 3.95 PERP	147	MAPLSP 2.85 08/29/2025	64	83
SCISP 5 PERP	258	SCISP 3.64 05/27/2024	125	133
SCISP 4.75 PERP	213	SCISP 3.593 11/26/2026	167	45
SCISP 3.7 PERP	169	SCISP 2.94 11/26/2021	115	54
STHSP 3.95 PERP	147	STHSP 3.08 09/12/22	55	91
WINGTA 4.35 PERP	194	WINGTA 4.25 11/29/22	133	61
FPLSP 4.38 PERP	187	FPLSP 4.15 02/23/2027	171	16
GUOLSP 4.6 PERP	230	GUOLSP 3.85 02/15/23	175	55
Average	**191**		**119**	**72**

Source: Bloomberg, OCBC

III) Is it fair to assume issuers will always call?

Historical precedence may not guide the future: As discussed in our previous publication (SGD Corporate Perpetual Bonds: Still worthwhile?), most issuers have called on the first call date. Most often, (1) it was economical to do so with the historically benign environment when interest rates and credit spreads were declining. (2) Certain issuers called as more than sufficient capital was held, while other issuers called (3) to maintain confidence as going concerns and maintain access to external financing or (4) due to special circumstances (e.g. privatisation with a change of control clause). However, we may not extrapolate this to mean most issuers will continue to call on first call going forward.

Issuers may find it uneconomical to call amidst other reasons: With rising interest rates and credit spreads already heavily compressed, it may be uneconomical to call as refinancing with a similarly subordinated paper may be more expensive. It is also difficult to project if companies will hold more than sufficient capital at the first call. We should expect companies holding ample capital (e.g. Genting Singapore) to be the minority – in any case, if the issuer has excess capital, its credit profile would likely have improved and investors may not want the issuer to call. Breaking trend from prioritising the repayment of perpetuals, Ezion Holdings Ltd (which issued EZISP 7% PERP) is under restructuring and Hyflux Ltd recently signalled that its preference shares (but structured similarly to a perpetuals) will not be called until Tuaspring is divested. Thus, it remains to be seen if companies will continue to prioritise the redemption of their perpetuals during times of stress. However, we acknowledge that other reasons (e.g. reputational risks, ongoing access to cheaper and diversified capital) may also be contributing factors for issuers to call, though this would be difficult to ascertain. Economically speaking, issuers will only call upon resets and/or step-up, when higher rates (versus then prevailing refinancing conditions) incentivises the issuer to call, as we mentioned in An introduction to SGD Corporate Perpetual Bonds.

Rationale for issuers to structure calls earlier than reset?: While issuers have not disclosed the rationale for using such structures, this has resulted in cost savings to issuers while gaining from the option (but not obligation) to call before the reset/step-up date. With upsides (and no consequent downside) to the issuer, we think issuers will continue to favour such structures if the market persists to price perpetuals only to call.

IV) Conclusion

In our view, investors should expect a number of these issuers not to call at first call, based on the issuer's economic incentive to call. In our analysis, we assume that the issuers will require capital till the reset date. At the first call date, issuers have the option to call (and refinance with another perpetuals or other securities), or exercising their contractual option to not call.

As an illustration below:

- At the call date of FPLSP 4.38% PERP (Jan 2023), FPL can choose not to call and continue paying distribution at the rate of 4.38% till the reset date (Jan 2028). FPL can also choose to refinance, assuming into a straight bond. Assuming that credit spreads (106bps) remain unchanged from today, bond yield for a hypothetical 5-year FPL straight bond issued on Jan 2023 should be priced at 4.01%, given that market expects 5Y swap rates to trade at 2.95% then (see Figure 6). In our view, it is very attractive for FPL not to call as the distribution pickup of FPLSP 4.38% PERP over the hypothetical seniors is only 37bps. If FPL were to refinance into another 5Y perpetuals, the distribution rate required may be closer to 5%, assuming investors demand ~100bps spread over the seniors.

Figure 5: Spread pickup over hypothetical bonds

Security	Coupon (%)	Call date	Reset date	Hypothetical straight bond issued at call date		Spread pickup (bps)
				Tenor	Yield (%)*	
MAPLSP 4.5 PERP	4.50	Jan-22	Jan-27	5	3.45	105
MAPLSP 3.95 PERP	3.95	Nov-22	Nov-27	5	3.53	42
SCISP 5 PERP	5.00	Aug-18	Aug-23	5	3.51	149
SCISP 4.75 PERP	4.75	May-20	May-25	5	3.84	91
SCISP 3.7 PERP	3.70	Jun-20	Jun-22	2	3.19	51
STHSP 3.95 PERP	3.95	Jun-22	Jun-27	5	3.39	56
WINGTA 4.35 PERP	4.35	Aug-20	Aug-27	7	4.08	27
FPLSP 4.38 PERP	4.38	Jan-23	Jan-28	5	4.01	37
GUOLSP 4.6 PERP	4.60	Jan-23	Jan-25	2	4.32	29

Source: Bloomberg, OCBC
**Yield is derived by adding the forward swap rates and the credit spreads of a comparable straight bond today (See Figure 6)*

Figure 6: Yields of hypothetical bonds

Hypothetical bond	Issue date	Tenor (yrs)	Swap reference	Forward swap rate, at issue date (%)	Straight bond spread (%)	Bond Yield (%)
MAPLSP 'Jan 27s	Jan-22	5	SDSW5	2.85	0.60%	3.45
MAPLSP 'Nov 27s	Nov-22	5	SDSW5	2.93	0.60%	3.53
SCISP '23s	Aug-18	5	SDSW5	2.31	1.20%	3.51
SCISP '25s	May-20	5	SDSW5	2.64	1.20%	3.84
SCISP '22s	Jun-20	2	SDSW2	2.44	0.75%	3.19
STHSP '27s	Jun-22	5	SDSW5	2.89	0.50%	3.39
WINGTA '27s	Aug-20	7	SDSW7	2.77	1.29%	4.08
FPLSP '28s	Jan-23	5	SDSW5	2.95	1.06%	4.01
GUOLSP '25s	Jan-23	2	SDSW2	2.85	1.47%	4.32

Source: Bloomberg, OCBC

A number of perpetuals to watch out for that may not be called: Aside from EZISP 7% PERP and the HYFSP 6% PERP, with increased interest rate expectations, we believe that call risks have increased, especially for perpetuals with non-coinciding call and reset dates. Majority of such perpetuals, based on the forward swaps market, appear vulnerable in our view as rates are expected to increase. These include MAPLSP 3.95% PERP, SCISP 3.7% PERP, STHSP 3.95% PERP, WINGTA 4.35% PERP, FPLSP 4.38% PERP and GUOLSP 4.6% PERP as they offer inadequate spread pickup. In addition, we think SCISP 4.75% PERP also look susceptible if rates move up more than what market expects now.

Co.Reg.no.:193200032W