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Perpetuals:
Underweight

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Perpetuals Tetralogy: Step-ups Matter

With rates down and spreads up, is this positive or negative for perpetuals?

- Rates have declined significantly over the past week, accelerated by the 50bps Fed rate cut and exacerbated by the collapse in crude price. As of writing, most parts of the curve, including SGD 3-year swaps, 5-year swaps, 7-year swaps and 10-year swaps have crashed to multi-year lows.
- The conventional thinking is that bonds, especially higher grade ones, will outperform when rates are down. This logic should apply to perpetuals if issuers treat perpetuals as bond-like (i.e. with an obligation to be repaid at the call date).
- However, assuming spreads do not compress, we believe that more issuers will likely treat perpetuals as more equity-like in today's environment and will likely **not exercise the call**. This is because we think it looks uneconomical to call and refinance with another perpetual, especially for perpetuals without sufficient step-ups at the call and/or reset date.
- We believe that issuers may also prefer to exercise prudence by not calling, in order to keep a larger liquidity and equity cushion to ride through a downturn (if any). We think cash is king as liquidity has largely withdrawn from the market.
- Resets look undesirable now for investors as coupons will be reset lower if rates stay low and hence perpetuals do not enjoy the full upside as a "fixed-income" instrument. Meanwhile, we think issuers are unlikely to call as a replacement perpetual today with potentially wider reset spreads may look unappealing.

Recommendation: Underweight

- We are Underweight perpetuals as an asset class, with many facing elevated non-call risks. If rates were to move lower (e.g. to 0%), we think more perpetuals will look vulnerable.
- We think perpetuals (e.g. REITs, bank capital) without step-ups may face heightened non-call risks though this may be mitigated if the initial spreads were priced wide in the first place.
- While better positioned, corporate perpetuals with a step-up are not significantly more protected. In most instances, the step-up is a mere 100bps – which may look insufficient given today's environment.
- Considerations for bank capital instruments are more nuanced in our view given that Financial Institutions must balance economics, reputational impacts but also regulatory requirements.
- We prefer vanilla bonds over perpetuals especially from high grade issuers. Amidst heightened market volatility, vanilla bonds generally sport two features which are highly attractive in the current environment: (1) Fixed maturity date and (2) Fixed coupon. These give investors assurance on the repayment period and expected total returns (if held to maturity).

A quick recap of the perpetual trilogy (before we renamed it as the tetralogy)

1st piece: An introduction to SGD Corporate Perpetual Bonds

We discussed that **structures are important**, which include resets and step-ups.

- Reset dates and step-up dates should coincide to increase the economic incentive to call.
- Economic incentive is to call is higher for step-ups with 300bps or more.
- REITs perpetuals do not include step-ups.

2nd piece: Still worthwhile?

We discussed that the **chance of missing a call is not zero** especially during a market correction.

- Cost savings is the most common reason to call.
- Older issuances with wider spreads are likely to be called.
- Optimism in perpetuals is driven by compression in spreads and swap rates.

3rd piece: Paying issuers when it is at their option to call?

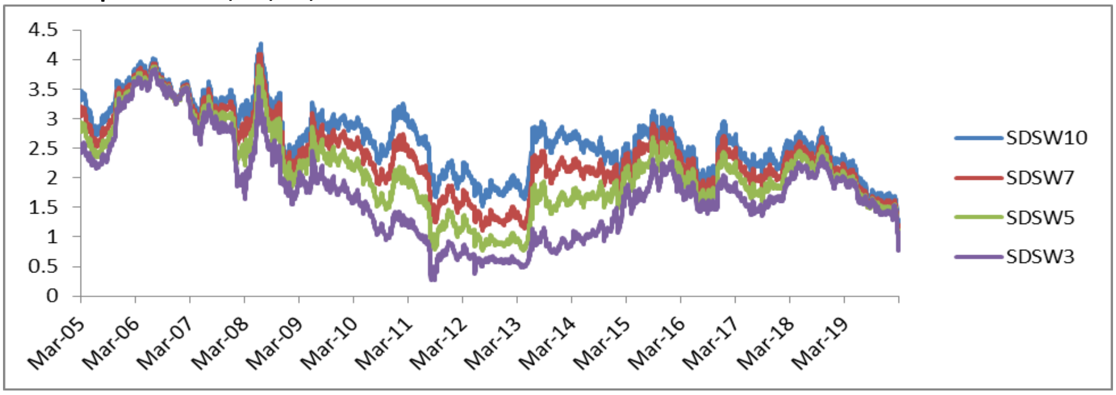
We discussed that investors **should not price perpetuals to call unless they are very likely to**.

- Many perpetuals issued since 2017 have call and reset dates that do not coincide.
- Widening of spreads may put newer perpetuals with compressed spreads at risk.
- Rotate away from perpetuals that look uneconomical to be called on first call.

Resets increase the vulnerability of non-call when rates head lower

While resets are useful to protect investors against increases in interest rates (as opposed to a fixed-for-life perpetual), the reverse is true when rates fall as the perp will reset to a lower distribution rate. In today's environment, where SGD swap rates are significantly below (60bps-150bps) the past 10Y average, distribution rates will decline in the absence of step-ups. For example, MLTSP 3.65% PERP with 181.5bps reset spread will reset to ~2.6% distribution rate given the swap rates of 0.79% as of writing.

SGD swap rates – 3Y, 5Y, 7Y, 10Y



Source: Bloomberg

Perpetuals without step-ups are more vulnerable. Perpetuals without step-ups include REITs perpetuals and bank capital. For REITs, step-ups are disallowed in order to gain equity credit treatment by MAS. This is similar for bank perpetuals in order to be treated as bank capital.

For REITs, we have highlighted in yellow those with heightened first non-call risks, which include FHREIT 4.45% PERP, MLTSP 4.18% PERP, LMRTSP 7% PERP, MLTSP 3.65% PERP, EREIT 4.6% PERP, and SBREIT 6% PERP. **We are Underweight on these issues.**

If rates were to move lower (to e.g. 0%), we think more perpetuals will turn vulnerable, including AREIT 4.75% PERP, ARTSP 4.68% PERP, ARTSP 3.88% PERP, FIRTSP 5.68% PERP, CACHE 5.5% PERP and SCISP 3.7% PERP. **We are Neutral on these issues.** We are also **Neutral** on KREITS 4.98% PERP as prices have not come off significantly. We do not rate SPHR 4.1% PERP. In general, we think it is likely for investors to shun REIT perpetuals with tight initial margins.

REIT perpetuals

Perpetuals	1st call date	Reset date	Reset spread	Distribution rate on reset*
ARTSP 4.68% PERP	30-Jun-20	30-Jun-20	2.50%	3.39%
AREIT 4.75% PERP	14-Oct-20	14-Oct-20	2.43%	3.32%
KREITS 4.98% PERP	02-Nov-20	02-Nov-20	2.705%	3.60%
FHREIT 4.45% PERP	12-May-21	12-May-21	2.45%	3.34%
FIRTSP 5.68% PERP	08-Jul-21	08-Jul-21	3.925%	4.82%
SBREIT 6% PERP	27-Sep-21	27-Sep-21	3.79%	4.64%
MLTSP 4.18% PERP	25-Nov-21	25-Nov-21	2.30%	2.71%
LMRTSP 7% PERP	27-Sep-21	27-Sep-21	5.245%	6.14%
LMRTSP 6.6% PERP	19-Dec-22	19-Dec-22	4.76%	5.65%
MLTSP 3.65% PERP	28-Mar-23	28-Mar-23	1.815%	2.71%
EREIT 4.6% PERP	03-Nov-22	03-Nov-22	2.60%	3.49%
CACHE 5.5% PERP	01-Feb-23	01-Feb-23	3.58%	4.47%
SPHR 4.1% PERP	30-Aug-24	30-Aug-24	3.37%	3.41%
ARTSP 3.88% PERP	04-Sep-24	04-Sep-24	2.352%	3.24%

Similarly for bank capital instruments, we find that practically all face heightened first non-call risks assuming current spreads remain where they are. The picture is of course the same if rates were to move lower (to e.g. 0%).

Bank capital

Perpetuals	1st call date	Reset date	Reset Spread	Distribution rate on reset*
BAERVX 5.9% PERP	18-Nov-20	18-Nov-20	3.32%	4.21%
UOBSP 4.0% PERP	18-May-21	18-May-21	2.035%	2.73%
BAERVX 5.75% PERP	20-Apr-22	20-Apr-22	3.915%	4.81%
HSBC 4.7% PERP	08-Jun-22	08-Jun-22	2.870%	3.76%
HSBC 5% PERP	24-Sep-23	24-Sep-23	2.665%	3.56%
UBS 5.875% PERP	28-Nov-23	28-Nov-23	3.605%	4.50%
SOCGEN 6.125% PERP	16-Apr-24	16-Apr-24	4.207%	5.10%
CS 5.625% PERP	06-Jun-24	06-Jun-24	3.767%	4.66%
UBS 4.85% PERP	04-Sep-24	04-Sep-24	3.372%	4.26%
STANLN 5.375% PERP	03-Oct-24	03-Oct-24	3.683%	4.57%
DBSSP 3.98% PERP	12-Sep-25	12-Sep-25	1.650%	2.58%
UOBSP 3.58% PERP	17-Jul-26	17-Jul-26	1.795%	2.73%

Source: Bloomberg
*Based on today's swap rates

The considerations for bank capital instruments however are more nuanced in our view. While there have been examples where bank capital instruments in Europe have not called for economic reasons, reputational and regulatory considerations also need to be considered. These differ from jurisdiction to jurisdiction. In particular, regulators and banks will be seeking to balance the requirement for higher minimum capital requirements with maintaining a manageable cost of capital to ensure banks continue to support the economy. While we have turned cautious on bank capital and prefer names in strong operating environments with pro-active regulatory oversight and ongoing government support, we have not underweighted the class just yet.

Step-ups less effective if it falls after the reset date. We see heightened non-call risks for perpetuals with step-up dates falling after the reset dates. We Underweight HPLSP 4.65% PERP, WINGTA 4.08% PERP, WINGTA 4.48% PERP, CAPLSP 3.65% PERP and HPLSP 4.4% PERP.

Non-REIT corporate perpetuals with non-coinciding step-up and reset date

Perpetuals	1st call and Reset date	Step-up date	Reset Spread	Distribution rate on reset*
HPLSP 4.65% PERP	05-May-22	05-May-27	2.685%	3.58%
WINGTA 4.08% PERP	28-Jun-22	28-Jun-27	2.37%	3.26%
WINGTA 4.48% PERP	24-May-24	24-May-29	2.562%	3.45%
CAPLSP 3.65% PERP	17-Oct-24	17-Oct-29	2.20%	3.09%
HPLSP 4.4% PERP	22-Oct-24	22-Oct-29	2.915%	3.81%

Source: Bloomberg
*Based on today's swap rates

Resets not coinciding with call dates now looking favourable. While resets are useful to incentivise the issuer to call in times of rising interest rates, the converse is true as resets decrease the economic incentive for issuers to call. For perpetuals with non-coinciding 1st call and reset dates, ironically, the risk of missing the 1st call is lower as there may be room for the issuer to call the perpetual and replace it with a lower coupon one if the rates environment continues to stay low. We are Neutral on STHSP 3.95% PERP, SCISP 3.7% PERP, WINGTA 4.3% PERP, GUOLSP 4.6% PERP and SCISP 4.75% PERP. If interest rates head lower, SCISP 3.7% PERP though may look more vulnerable given that it was issued with low initial spreads.

Non-REIT corporate perpetuals with non-coinciding 1st call and reset date

Perpetuals	1st call date	Reset date and step-up date	Reset Spread	Distribution rate on reset*
MAPLSP 4.5% PERP	19-Jan-22	19-Jan-27	2.865%	3.84%
MAPLSP 3.95% PERP	12-Nov-22	12-Nov-27	2.52%	3.49%
STHSP 3.95% PERP	16-Jun-22	16-Jun-27	2.715%	3.69%
SCISP 3.7% PERP	22-Jun-20	22-Jun-22	2.92%	3.81%
ARASP 5.2% PERP	19-Jul-22	19-Jul-24	6.12%	7.05%
SCISP 4.75% PERP	20-May-20	20-May-25	3.11%	4.08%
WINGTA 4.35% PERP	24-Aug-20	24-Aug-27	3.087%	4.06%
GUOLSP 4.6% PERP	23-Jan-23	23-Jan-25	3.609%	4.54%
ARASP 5.65% PERP	14-Mar-23	14-Mar-28	6.128%	7.10%
SINTEC 5% PERP	17-Jan-24	17-Jan-29	3.705%	4.68%

Source: Bloomberg
*Based on today's swap rates

Step-ups help and a bigger step-up will be more effective. We think the perps with the largest step-ups should find the lowest risk of non-call at first call, unless the issuer faces liquidity issues or funding conditions turn very negative. These issues include OLAMSP 5.5% PERP, CELSP 3.9% PERP and ARASP 5.6% PERP. We think SPOST 4.25% PERP and KITSP 4.75% PERP will likely be called as they were issued with a wide initial spread. SCISP 4.75% PERP, may turn vulnerable should rates head significantly lower. We are Neutral on the names that we cover in this group, which includes OLAMSP 5.5% PERP, CELSP 3.9% PERP, and KITSP 4.75% PERP.

Non-REIT corporate perpetuals with coinciding step-up, reset and step-up dates

Perpetuals	1st call, reset, step-up date	Reset Spread	Distribution rate on reset*
SPOST 4.25% PERP	02-Mar-22	3.69%	4.66%
OLAMSP 5.5% PERP	11-Jul-22	5.69%	6.58%
CELSP 3.9% PERP	19-Oct-20	7.38%	8.23%
SPHSP 4.5% PERP	07-Jun-24	3.61%	4.50%
KITSP 4.75% PERP	12-Jun-29	3.74%	4.71%
ARASP 5.6% PERP	04-Sep-26	7.06%	7.99%
SPHSP 4% PERP	12-May-25	3.55%	4.44%

Source: Bloomberg
*Based on today's swap rates

How the perpetuals market may evolve?

It is worth noting that SGD corporate perpetuals only started taking off in 2011. When these perpetuals were priced, forward rates then were not pointing towards a large rate rally such as the one we are currently experiencing. The main perceived concern then by both issuers and investors was one of a stable-to-rising rate environment. As such, we are of the view that there was little ill-intention at time of pricing to account for a swift collapse in rates.

Nonetheless, given that the market has now faced such an event, we expect a shake-up in corporate perpetual structuring, with investors demanding larger built-in step ups and/or other structures which allow protection against collapse in rates.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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