The Crown hybrid conundrum and hybrid misconceptions

Owners of Crown hybrids (CWNHB) have one heck of a bet on their hands. Given the current price, holders have taken a strong view that they will be redeemed on or soon after the first call date in July 2021. However, offers by Blackstone and Oaktree could turn this situation on its head with the potential for Crown's debt levels to significantly increase and the interest payments to cease for an indefinite period. Here's a quick summary of the potential outcomes under each of the three scenarios and some wider applications for hybrid holders.

Status quo

By far the best outcome for hybrid holders is for the Board to reject the two offers and continue the rectification strategy. Equity analysts have noted that Crown could be debt free by 2023, assuming the Sydney casino begins operations and Covid restrictions ease. Should this come to pass, the hybrids would be comparatively expensive with any senior debt the company might need much cheaper.

This raises the question of when the company would redeem the hybrids. In the current cheap funding environment, it is highly likely the company could redeem holders and reduce its interest bill. However, as the hybrids don't mature until 2075 and there's considerable uncertainty for the company's near term cashflows and capital requirements, it would be reasonable for the Board to leave the hybrids outstanding for another 6-12 months. This would be seen as a prudent step for the company, but it also creates potential value for those looking to purchase part or all of Crown.

Blackstone buyout

The Blackstone offer to buy all the shares in Crown would constitute a change of control if consummated. However, unlike standard debt instruments, Crown's hybrid does not contain a right for holders to be redeemed if a change of control occurs. Instead, there is a step up in the margin from bank bills + 4% to bank bills + 9% if the Board chooses not to redeem holders after a change of control.

The woeful protections for Crown's hybrid holders also include the ability for the Board to defer the interest payments indefinitely. This makes the hybrids similar to but worse than mezzanine debt with a PIK (payment in kind) toggle mechanism. It's similar as the company has the discretion to pay the interest along the way or to accrue it on top of the face value owed. It's worse as mezzanine debt is likely to have a maturity date five to ten years after issuance, rather than the 54 years to maturity for Crown.

There's two key questions in this scenario; (i) would Blackstone want to keep the hybrids outstanding and (ii) would the Board fight to redeem hybrid holders if Blackstone wanted them left in place? In the US, private equity firms have a history of buying casinos and loading them up with debt, though Crown has regulatory limitations on how much debt it can incur. If Blackstone decided to keep Crown at an investment grade credit rating, keeping the hybrids outstanding would be expensive and redemption is probable.

However, given the very cheap rates on sub-investment grade debt currently, it is more likely that Blackstone would opt for greater leverage, reducing its equity cheque. Leaving the hybrids outstanding could then be an optimal capital decision. In that scenario, the hybrids could trade down to 70-80% of their face value. They could fall further if Blackstone opted to defer the interest payments.

A precedent for non-call is the Multiplex hybrids, which were left outstanding after Brookfield bought Multiplex in 2007. After the acquisition, holders were given limited information on the performance of the company and the

likelihood of being redeemed. The Multiplex hybrids were eventually redeemed in 2019 but traded below their face value for the 12 years after Multiplex was acquired.

Oaktree offer

The Oaktree offer is vague but appears to involve a mix of debt and equity, but could be fully debt funded with equity optionality for Oaktree. This makes it a lot harder to predict what could happen to the hybrids in the medium term. What seems likely is that Oaktree's offer will bring fresh debt to the company which would rank ahead of the hybrids.

Oaktree's offer should keep Crown as a listed company, which would decrease the incentive to gear up the company to levels typically preferred by private equity. However, it increases the likelihood that the current investment grade rating would be lost. It also means there wouldn't an increase in the interest rate as a change of control wouldn't occur. This would make the hybrids a useful instrument to keep outstanding. They would then be a cheap (bank bills + 4% interest rate) and flexible form of deeply subordinated capital, increasing the upside for Oaktree and for Crown's existing shareholders.

Hybrid misconceptions

Hybrid holders often misunderstand the optionality they give away to the corporate or financial institution that issued the securities. In Crown's case the Board can opt to defer interest payments indefinitely, substantially gear up the company or sell to a buyer who will substantially gear up the company, all with holders having little recourse. Hybrids from Nufarm (NFNG) and Ramsay (RHCPA) are still outstanding around a decade after their expected call dates.

Bank and insurance hybrids also have similar features built in. Dividends are typically discretionary and subject to regulatory approval. If the financial institution takes losses and its capital levels fall, dividends can be reduced or switched off. If dividends are not paid, they are non-cumulative and may never be made up. If the financial institution gets into serious trouble, the hybrids can be converted to equity at a substantial loss or written off altogether. The much higher capital ratios since the Financial Crisis substantially reduce the probability of this occurring, but there's building risk in housing debt today which could be triggered if interest rates normalise.

Whilst the more dire scenarios for bank hybrids have played out overseas, Australian bank hybrid holders haven't seen major losses. What has occurred is hybrids being left outstanding long after their expected call dates, notably BENHB and SBKHB. Holders of these would take some hope after the redemption of higher yielding MBLHB (2020) and NABHA (2021) hybrids that these sagas might be coming to an end. Extension risk for newer securities remains, as recent overseas examples have demonstrated that regulators can disallow redemptions under varying circumstances.

Given the low margins on hybrids today, their main appeal is the liquidity available for small investors. For those looking for better risk/return prospects and willing to own less liquid securities, securitisation and marketplace lending opportunities are far superior.

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