

Hybrid Securities - a combination of Equity and Debt

Sithara C.

Research Scholar,

Department of Commerce and Management,
Sahyadri Commerce and Management College,
Shivamogga

Dr. Giridhar K. V.

Assistant Professor and Research Supervisor,

Department of Commerce and Management,
Sahyadri Commerce and Management College,
Kuvempu University.

Abstract

A hybrid security is a single financial instrument that combines both the features of debt and equity. The present study is carried out with the main objective of understanding the features of Hybrid securities and also to analyze the key factors of related to hybrid securities. It emphasizes on liquidity, complexity, unpopularity and volatility of Hybrid securities in incorporating in investment portfolio.

Key words: Hybrid securities, Debt, Equity, liquidity, complexity, unpopularity, volatility

1. Introduction

An investment decision will play a crucial role in deciding the financial position of an investor. There are so many options of investment in current era. The investment may be on physical assets or on financial assets. While focusing on financial instruments it is debt and equity play a major role in investment. Both Debt and equity have their advantages and limitations. To make over the limitations of both instruments and to combine advantages of both the instruments there is a financial instrument called “Hybrid Security”. Hybrid Security is a financial instrument with combination of both equity and debt nature.

Hybrid securities are fixed income instruments with both the characteristics of debt and equity. They are considered somewhere in between debt and equity. Hybrid instruments are structured with wide variety of features. Hybrid instruments may be perpetual or have a limited life, cumulative or non cumulative, redeemable or irredeemable and convertible or nonconvertible instruments. Hybrid securities resemble debt in that they pay a regular, fixed or floating interest rate, coupon or dividend. At the same time, like common equity, payments under hybrid instruments are usually contingent on an acceptable level of distributable profits. Hence they rank lower in payment of priority to other debt instruments. Hybrid instruments also provide higher return than traditional debt with some additional risk.

Preference shares, Convertible Debts and Capital Notes are Hybrid Securities that are majorly traded in Indian capital market. Preference Shares have the characteristics of both equity and debt. Like equity, dividend on preference shares is payable only when there are profits and on the direction of Board of Directors. Preference shares are similar to debt in the sense that the rate of dividend is fixed and preference shareholders do not generally enjoy voting rights. Therefore preference shares are considered as Hybrid securities.

Convertible debts are another type of Hybrid security. Convertible debts are fixed income instruments that can be converted into fixed number of issuer at the option of the investor. Convertible debts have the benefits of both debt and equity. They have maturity date, fixed interest payment, protection of principal amount like debt. Similarly the holders of convertible debts are allowed to convert each debt into equity, when its value rises. Then the debt's features are fully converted to equity features.

Capital Note is a short-term unsecured debt generally issued by a company to pay short term liabilities. Capital Notes are debt securities that have equity like features attached. Perpetual debt securities, Subordinated debt securities and Knock out debt securities are considered as capital notes with equity like features. Hence these are considered as Hybrid securities.

2. Features of Hybrid securities

The following are the important features of Hybrid Securities, which are presented as below:

- i. Steady and defined income for the investors.
- ii. Higher return than simple bonds as it has higher interest.
- iii. Diversify the risk of overall portfolio by including hybrid securities in portfolio.
- iv. Profit from anticipated movements in interest rates or equity prices.
- v. The hybrid securities help to reduce risk and protect returns over the longer term.
- vi. Hybrid securities provide more stable returns.

3. Review of literature

Review of literature has been undertaken with two important objectives. The first objective is to obtain a comprehensive idea about the topic of the present study, including theoretical frame work, different dimensions of the problem, etc. The second objective is to identify the research gap that exists at present, based on the review of literature of earlier studies and to show that the present study is not a topic on which someone has already worked. Besides, it also aims at showing how this study is an attempt to fill the research gap that exists at present.

Randall S. Billingsley, Robert E. Lamy, G. Rodney Thompson (1988) in their article “ **The choice among debt, equity and convertible bonds**” said that the hybrid nature of convertible bonds continues to interest of corporate financial managers, investors and economists. While much theoretical and empirical research examines an issuer's choice between using straight debt and equity, little research evaluates how an issuer chooses among debt, equity and convertible bonds. It also illustrates how various distinguishing features influence the possibility that each security will be issued.

Randall Billingsley and David M Smith (1996) in their article “**Why do firms issue convertible Debt?**” updated several widely cited studies on the motivation for convertible debt issuance. It also says that firms use convertibles primarily as an alternative to straight debt, employing a conversion feature to buy down the coupon rate and thus preserve cash flow. The results confirm a decreasing reliance on convertibles as delayed equity financing. This study shows that abnormal returns are significantly and negatively associated with the degree of equity dilution implied by a convertible issue.

Guy Ford, Tysons M Carlin and Nigel Finch (2006) in their article “**Do Hybrid Instruments lower the cost of capital?**” opined that the issue of hybrid instruments by firms is often justified on the grounds that these instruments allow issuers to achieve a lower cost of capital than would be the case under issues of straight debt and equity. In order to assess the validity of such claims it is necessary to examine the economic impact of hybrid instruments on the issuing company. If a firm can genuinely achieve a lower cost of capital than would otherwise be the case with the issue of either straight debt or equity, this paper argue that this is directly linked to regulatory arbitrage, rather than the outcome of financial synergy that arises when debt, equity and option instruments are combined to form a hybrid security. This paper mainly focuses on analysis of two main structures such as convertible debt and preference shares.

Balaram Bora (2015) in his article “**Preference shares role in Indian companies**” opined that ordinary shares, preference shares and debentures are three important securities used by the firms to raise funds to finance their activities. This study is an attempt to analyze the issues in the areas of preference share capital to find out its contribution in mobilizing share capital in India. This paper mainly focused on how the preference share capital is used by the corporate firms.

Jeet Singh and Preeti Yadav (2016) in their study “**a study on the factors influencing investors decision in investing in equity shares in Jaipur and Moradabad with special reference to gender**” tries to find out the factors that have major influence on the share investment decisions of investors in Moradabad. Revolution in the finance industry is brought about through the advent and evolution of behavioral finance. Investors hardly act rationally in taking decisions while investing. Investors simply react on the available information possessed by them and react accordingly. The paper tries to know the attitude of male and female investors towards variety of investment alternatives.

Payal Ghose and N Aparna Raja (2016) in their article “**The changing Dynamics of Debt financing in India**” focuses on debt financing. Debt financing basically refers to a business raising capital by borrowing. The global financial crisis that originated in the credit markets of advanced economics and the massive liquidity measures

are taken. A liquid corporate debt market can play a crucial role by supplementing the banking system to meet the requirements of the corporate sector for long term capital investment and asset creation.

Prasanta kumar Dey (2018) in his article “**Capital market instruments in India- profile**” explained that to have an idea on capital market, it is very much essential to know important instruments used in primary and secondary segments of capital market. Capital market instruments are those instruments which are used by the corporate entities for raising medium and long term funds from the capital market. This article contains a profile on various concepts and terminologies relating to instruments used in the capital market of India. At first, various conventional instruments of capital market have been discussed. Then some important concepts and terminologies relating to non conventional instruments for trading on Indian capital markets have been discussed.

4. Research Gap

Few more studies both by the individuals and the groups have been undertaken, both at the national and international levels. An extensive review of literature reveals that, few researchers have worked on Indian capital market structure, growth, financial instruments, investment portfolio and so on. Some researchers are also worked on Hybrid securities. However a comprehensive review of these studies shows that much work is carried out focusing on the issues of tax, legal frame work, rules and regulations. But the present study focuses on establishing the meaningful relationship between the conventional financial instruments and hybrid securities and also the study has been undertaken on the perception of the investors. However, it is an attempt to fill the literature gap which is existing at present.

5. Objective of the Study

The objectives of the present study are as below:

1. To study the features of Hybrid Securities with the combined nature of Debt and Equity.
2. To study the role of Liquidity, Volatility, Complexity, Unpopularity in incorporating Hybrid securities in investment portfolio.

6. Scope of the study

The present study covers marketability, volatility, complexity and investor’s behavior with regard to Hybrid Securities. This study tries to assess investors perception regarding investing in hybrid securities.

7. Research Hypothesis

| Hypothesis Number | Research Hypothesis |
|-------------------|--|
| H ₀₁ | Steady and defined income of a security has a positive impact on incorporating Hybrid Securities in Investment portfolio. |
| H ₀₂ | There is no association between rate of return and incorporation of Hybrid securities in investment portfolio. |
| H ₀₃ | There is insignificant relationship between convertibility and incorporation of Hybrid securities in Investment Portfolio. |

8. Research Methodology

Research methodology is a practice of studying how research is to be carried out scientifically. Various tools and techniques employed to accomplish the objectives of the study.

9. Data Analysis and Interpretation

The data analysis for present study was done quantitatively with the help of statistics. These data will provide more details about respondent's perception regarding investing in Hybrid securities. Due to lack of investors in hybrid securities in the selected area, number of respondents in hybrid securities is limited to 250.

Table: 1: Garrett Ranking of respondent's perception regarding Volatility of Hybrid Securities

| Particulars | Overall | | |
|--|-------------|------------|------|
| | Total Score | Mean Score | Rank |
| Due to deference in interest paid by company on listed Hybrid Securities | 13225 | 52.90 | 1 |
| Decline in the performance of company, which issued Hybrid Securities | 12385 | 49.54 | 3 |
| Change in the company share price and other interest rates | 12535 | 50.14 | 2 |

Source:Primary Data

Analysis and Interpretation:

The above table shows the respondent's perception regarding volatility of Hybrid securities. According to respondents the major reason for volatility of Hybrid security is deference in interest paid by company on listed Hybrid securities as it shows the mean score of 52.90. Change in the company share price and other interest rate stands next with mean score of 50.14. From the above table it is clear that like company shares the market price of listed hybrid securities may fall below the price that the investor originally paid, especially if the company suspends or make any difference in interest or dividend payment. Changes in the company's share price and in other interest rates may also be reflected in the price of the listed security.

Table: 2: Garrett Ranking of respondent's perception regarding Complexity of Hybrid Securities

| Particulars | Overall | | |
|---|-------------|------------|------|
| | Total Score | Mean Score | Rank |
| It is not easy to understand the terms and conditions | 12500 | 50.00 | 2 |
| Less number of persons involved in trading | 11855 | 47.42 | 3 |
| Few Hybrid Securities have some rules and few have some other rules | 12885 | 51.54 | 1 |

Source:Primary Data

Analysis and Interpretation:

The above table shows respondent's perception regarding complexity of hybrid securities. According to respondents few hybrid securities have some rules and few have some other rules are considered as first important reason for complexity of hybrid securities with mean score of 51.54 and difficulty to understand the terms and conditions relating to hybrid securities stand next in deciding the complexity of Hybrid securities. It is not easy to select the right type of hybrid security at the right time. Because some type of hybrid securities have some rules and some other types of hybrid have some other rules. Hence the respondents consider it as the major reason for complexity of Hybrid securities. It is not easy for the investors to understand the terms and conditions of Hybrid securities. Hybrid securities may contain terms and conditions that are complex and impact significantly on the future value of the security. Hence this is another important reason behind complexity of Hybrid securities.

Table: 3: Garrett Ranking of respondent's perception regarding Liquidity of Hybrid Securities

| Particulars | Overall | | |
|---|-------------|------------|------|
| | Total Score | Mean Score | Rank |
| Due to fewer buyers and sellers in the market | 13105 | 52.42 | 1 |
| Retail investors are rarely involved in Hybrid Securities trading | 12600 | 50.40 | 3 |
| Complexity of Hybrid Securities lead to less trading | 12690 | 50.76 | 2 |

Source:Primary Data

Analysis and Interpretation

The above table is about respondent's perception regarding Liquidity of Hybrid securities. Hybrid security has less liquidity. According to respondent's perception Lesser number of buyers and sellers in the share market is the main reason for less liquidity of Hybrid securities with mean score of 52.42. Complexities of Hybrid securities lead to less trading stand next with mean score of 50.76. Most of the Hybrid securities

traded in the market are often have less liquidity than shares issued the company. There are fewer buyers and sellers in the market for this type of investment option and if the investor wants to sell the investment in hurry, the investor has to accept a lower price. The complex nature of Hybrid security make the investor not to invest in hybrid securities, this is also one of the main reason for less liquidity of hybrid securities.

Table: 4: Garrett Ranking of respondent's perception regarding Unpopularity of Hybrid Securities

| Particulars | Overall | | |
|---|-------------|------------|------|
| | Total Score | Mean Score | Rank |
| Due to less liquidity than shares | 12165 | 48.66 | 4 |
| Due to complex structures of the Hybrid Securities | 13715 | 54.86 | 1 |
| Due to risk factors involved in Hybrid Securities | 12830 | 51.32 | 2 |
| Due to market price volatility of the Hybrid Securities | 12745 | 50.98 | 3 |
| Hybrid Securities are often considered as unsecured | 11675 | 46.70 | 5 |

Source:Primary Data

Analysis and Interpretation:

The above table shows the respondent's perception regarding unpopularity of Hybrid securities. Complex structure of the Hybrid security stands first with mean score of 54.86 regarding the unpopularity of hybrid securities. Risk factors involved in hybrid securities is the in the second position according to respondent's perception regarding unpopularity of hybrid securities. The difficulty to understand the terms and conditions and distinct features of hybrid securities make the security more complex as compare to other type of securities and this is considered as one of the main reason for unpopularity of Hybrid securities. The risk factors like Yield interest rate risk, credit rate risk, marketability risk, complexity risk and share price risk of Hybrid securities are considered as another important reason for unpopularity of hybrid securities.

10. Result of Hypothesis

Hypothesis one:

H₀1: Steady and defined income of a security has a positive impact on incorporating Hybrid Securities in Investment portfolio.

H_a1: Steady and defined income of a security has a negative impact on incorporating Hybrid Securities in Investment portfolio.

The relationship of steady and defined income of a security was studied with incorporation of hybrid securities in investment portfolio and it was observed that among various factors influencing investment of hybrid securities, factors related to getting of tax advantage ($r = 0.252$), low interest rate when compared to standard bonds ($r = 0.242$), priority of payment of dividend than ordinary shareholders ($r = 0.136$), fixed maturity period ($r = 0.177$) and hybrid securities suitable for moderate return expecting investors ($r = 0.031$) had positive relationship while factors related to high rate of returns of hybrid securities when compared to

simple bonds ($r = -0.190$), chance of converting hybrid securities into ordinary shares ($r = -0.089$) and risk level of hybrid securities ($r = -0.144$) had negative relationship.

Hypothesis Two:

H₀₂: There is no association between rate of return and incorporation of Hybrid securities in investment portfolio.

H_{a2}: There is association between rate of return and incorporation of Hybrid securities in investment portfolio.

The relationship of high rate of returns with factors influencing investment in hybrid securities was studied and noted that factors influencing investment in hybrid securities in terms of the chance of converting hybrid securities into ordinary shares ($r = 0.204$), priority of payment of dividend than ordinary shareholders ($r = 0.105$), hybrid securities having less risk ($r = 0.371$) and hybrid securities suitable for moderate return expecting investors with moderate risk ($r = 0.160$) have positive but weak association with high rate of returns, while other factors in terms of steady and defined income to investors of hybrid securities ($r = -0.190$), getting tax advantage ($r = -0.071$), low interest rate compared to standard bonds ($r = -0.186$) and fixed maturity period ($r = -0.161$) had weak negative association.

Hypothesis Three:

H₀₃: There is insignificant relationship between convertibility and incorporation of Hybrid securities in Investment Portfolio.

H_{a3}: There is significant relationship between convertibility and incorporation of Hybrid securities in Investment Portfolio.

Further, the study of relationship between convertibility and incorporation of hybrid securities in investment portfolio showed that except the factor steady and defined income to the investor of hybrid securities ($r = -0.89$) having negative relationship rest all the factors like high rate of return from hybrid securities when compared to simple bonds ($r = 0.204$), tax advantage ($r = 0.134$), low interest rate compared to standard bonds ($r = 0.025$), priority of payment of dividend than ordinary shareholders ($r = 0.018$), fixed maturity period ($r = 0.039$), hybrid securities with less risk ($r = 0.250$) and hybrid securities suitable for moderate return expecting investors with moderate risk ($r = 0.062$) all had weak positive relationship with the factor convertibility.

11. Findings based on Objectives

The following findings are based on objectives of the study

i) To study the role of liquidity, volatility, complexity, unpopularity in incorporating Hybrid Securities in investment portfolio.

a) Unpopularity of Hybrid Securities

- With mean score of 54.86 respondents agreed that complex structures of the hybrid securities are the major reason for unpopularity of Hybrid securities and risk factors involved in hybrid securities have mean score of 51.32 are another major cause for unpopularity of hybrid securities.
- At the same time, less liquidity than shares and hybrid securities often considered as unsecured are the least factors causing unpopularity of hybrid securities.

b) Volatility of Hybrid Securities

- With mean score of 52.90 the major cause for volatility of hybrid securities is due to deference in interest paid by company on listed hybrid securities and change in the company share price and other interest rates is considered as another important factor for volatility of hybrid securities with mean score of 50.14. However, decline in the performance of the company which issued hybrid securities is causing least volatility of hybrid securities.

c) Complexity of Hybrid Securities

- With mean score of 51.54 few hybrid securities having some rules and few having some other rules is the major reason for complexity of hybrid securities. Less number of persons involved in trading are the major complexities of hybrid securities. But still, hybrid securities easily not understandable with regard to terms and conditions is also another complexity of hybrid securities

d) Liquidity of Hybrid Securities

- With mean score of 52.42 few buyers and sellers in the market and with mean score of 50.76 complexity of hybrid securities leading to less trading accompanied with retail investors rarely involved in hybrid securities trading highly influence the liquidity of hybrid securities.

12. Major Suggestions to Investors:

The major suggestions to investors are as below

- Hybrid securities are complex products even experienced investors may struggle to understand the risks involved in trading them. Don't invest in hybrid security products if you don't fully understand how they work.

- Market price of a listed Hybrid security may fall below the price you paid for it. This may be more likely if the company suspends or defers interest payments, or its performance decline. Changes to the company's share price or general interest rates may affect the price of a listed Hybrid Security.
- Hybrid Securities have less liquidity than shares. This means there are fewer buyers and sellers in the market for this type of investment and if you need to exit your investment in a hurry you may have to accept a lower price.
- The repayment is not secured over an asset. If the company is issuing the security becomes insolvent, you will usually rank behind senior bondholders and other creditors. Money will be paid after other creditors are paid.
- A Hybrid Security is a single financial security that combines two or more different financial instruments. The most common type of Hybrid security is a convertible bond that has features of an ordinary bond but is heavily influenced by the price movements of the stock into which it is convertible.

13. Conclusion

Hybrid security is a single financial instrument with both nature of Debt and Equity. Hybrid Security is an instrument with fixed or floating rate of return up to certain date as the debt securities do. However they also have equity like features competitive yield than traditional bonds, Long maturity period, participating in surplus profit and so on. Hybrid Securities are a good way to introduce as an investment avenue as it includes higher return than debt, offer a regular source of income in the form of interest or dividends and accumulated dividends are distributed before any dividend paid to the equity shareholders.

In the analysis it has been found that steady and defined income is the major key factor which influences the investor to invest in Hybrid securities. Also a separate study has been made to know the relationship between Hybrid securities and different variables such as liquidity, volatility, complex structure, familiarity and risk. And this study brings how these variables playing a key role in incorporating Hybrid Securities in investment portfolio. It is finally conclude that Hybrid securities are generally securities with steady income and diversified risk in investor's investment portfolio. Hybrid securities investors should have the knowledge and experience in financial matters to evaluate the merits and risks in light of their particular circumstances.

14. References

01. Randall Billingsley, Robert E Lamy and G. Rodney Thompson (1988), “ The Choice among debt, equity and convertible bonds”, the journal of Financial Research.
02. Randall Billingsley and David M Smith (1996), “Why do firms issue convertible debt?”, Financial management, Vol. 25(3), pp. 95-99.
03. Guy Ford, Tysone M Carlin and Nigel Finch (2006), “ Do hybrid instruments lower the cost of capital?”.
04. Balaram Bora (2015), “Preference shares role in Indian companies”, International Journal of conceptions on Management and social science”, Vol-3, Issue-2, ISSN;2357-2787.
05. Jeet Singh and Preeti Yadav (2016), “A study on the factors influencing investors decision in investing in equity shares in Jaipur and Moradabad with special reference to gender”, Amity Journal of Finance, Vol.1(1), pp. 120-137.
06. Payal Ghose and N Aparna Raja (2016), “The changing dynamics of debt financing”, CCIL- monthly News Letter.
07. Prasanta Kumar Dey (2018), “ Capital Market Instruments in India- Profile”, International journal of Trend in scientific Research and development”, Vol-2, Issue-6, ISSN: 2456-6470.

