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Volkswagen's Proposed Hybrid Securities Rated 'BBB-' And Assigned Intermediate Equity Content

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FRANKFURT Aug. 29, 2023--S&P Global Ratings today said that it has assigned its 'BBB-' long-term issue rating to the proposed two tranches of five-year non-call and nine-year non-call, perpetual, optionally deferrable, and subordinated hybrid notes to be issued by Volkswagen International Finance N.V. The proposed notes will be guaranteed by the parent company, Germany-based automaker Volkswagen AG (VW; BBB+/Stable/A-2) on a subordinated basis.

The completion and size of the transaction will be subject to market conditions, but we anticipate total issuance of up to €2 billion. VW plans to use the proceeds to replace its outstanding €1.25 billion hybrid instrument, which has a first call date in June 2024; and we will regard the €1.25 billion hybrid as having no equity content upon completion of the new transaction, compared with intermediate previously. We currently expect that VW intends to use issuance proceeds in excess of €1.25 billion to replenish its stock of hybrid debt. Excluding a €750 million hybrid to be repaid on its first call date of Sept. 4, 2023, VW's hybrid portfolio currently totals €13.15 billion. The company has stated in the past that it intends to maintain hybrids totaling about €14 billion.

Including the proposed hybrid notes, and assuming the outstanding €1.25 billion hybrid with a first call date in June 2024 will be called, we estimate the ratio of outstanding hybrids to adjusted capitalization at about 10%, below the 15% limit that caps the amount of hybrids that may receive equity content under our criteria.

We classify the proposed hybrid notes as having intermediate equity content until their first call dates in 2028 and 2032, respectively. This is because they meet our criteria in terms of subordination, permanence, and optional deferability during this period (see "General Criteria: Hybrid Capital: Methodology And Assumptions," published March 2, 2022). Consequently, in our calculation of VW's credit ratios, we will treat 50% of the principal outstanding under the proposed hybrids as equity rather than debt. We will also treat 50% of the related payments on the hybrids as equivalent to a common dividend.

The two-notch difference between our 'BBB-' issue rating on the proposed hybrid notes and our 'BBB+' issuer credit rating (ICR) on VW reflects the following downward adjustments from the ICR:

- One notch for the subordination of the proposed notes, because the long-term ICR on VW is investment grade (higher than 'BB+'); and
- An additional notch for payment flexibility, due to the optional deferability of interest.

The deduction for payment flexibility is only one notch because we consider that there is a relatively low likelihood that VW will defer interest payments. Should our view on this likelihood change, we may increase the number of notches we deduct to determine the issue rating on the proposed hybrids. We may lower the issue rating before we lower the issuer credit rating (ICR).

The documentation of the proposed notes (and of outstanding hybrids with identical language) provides for mandatory settlement of interest arrears upon payment of a dividend by VW, but not by VW's 75% subsidiary Porsche AG, as long as VW does not guarantee any of Porsche's securities. We do not currently expect a further reduction of VW's shareholding in Porsche. If this was to change, we may need to reassess whether this specific feature could affect the likelihood of deferral on VW's hybrid instruments and, possibly, the amount of notches we deduct from the ICR to derive the rating.

Key factors in our assessment of the securities' permanence: Although the proposed notes are perpetual, the issuer may redeem them on the first call dates in 2028 (for the five-year non-call tranche), and 2032 (for the nine-year non-call tranche), respectively, and on each interest payment date thereafter. In addition, the notes may be purchased at any time in the open market. The notes may also be called at any time for tax, rating, and accounting events, or if 80% or more of the notes have already been redeemed.

With certain exceptions, the issuer intends to redeem or repurchase the notes only to the extent that they are replaced with instruments with equivalent equity content, but it is not obliged to do so. In our view, this statement of intent and VW's multi-year track record of managing hybrids mitigate the likelihood that it will redeem or repurchase the securities without replacing them, beyond situations provided for in our criteria.

The coupon to be paid on the proposed securities will be fixed during the non-call period and, from the reset date, will equal the sum of the applicable swap rate plus a margin. The margin for the five-year non-call securities will increase by 25 basis points (bps) in 2033 and by a further 75 bps in 2048. For the nine-year non-call securities, the margin is set to increase by 25 bps in 2033 and by a further 75 bps in 2052. We consider the cumulative 100 bps step-up for each set of securities, which is unmitigated by any definitive commitment to replace the respective instruments, as an incentive for VW to redeem the instruments. This leads us to view the dates of the second step-up in 2048 and 2052, respectively, as the instruments' effective maturity dates. Consequently, we will no longer recognize the instruments as having intermediate equity content after the first call dates, because the remaining period until their effective maturity would be, by then, less than 20 years.

Key factors in our assessment of the securities' subordination: The proposed securities will constitute unsecured and subordinated obligations of the issuer, ranking pari passu with the issuer's existing portfolio of hybrids, and will benefit from an unconditional and irrevocable subordinated guarantee from VW. As such, the securities will be subordinated to senior instruments, and rank senior only to the issuer's ordinary and other classes of shares, or instruments that have a ranking equal to that of common shares.

Key factors in our assessment of the securities' deferability: In our view, VW's option to defer payment of interest on the proposed notes is discretionary. This means that the issuer may elect not to pay accrued interest on an interest payment date. However, any outstanding deferred interest would have to be settled in cash if, for example, the issuer paid interest on the next interest payment date, the issuer or the group paid interest on or repurchased equally ranked securities, or VW declared a dividend on or initiated repurchases of lower-ranking instruments such as common shares. This condition remains acceptable under our methodology since the issuer can still choose to defer on the next interest payment date after settling a previously deferred amount.

VW retains the option to defer interest throughout the life of the securities. The deferred interest is cumulative and non-compounding.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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