

Huntleys' Your Money Weekly

ASX Listed Hybrids

11 June 2009

As a quasi debt, quasi equity security, there are many hybrid securities trading on the ASX offering interesting value. Companies raise money through issuing these securities for a variety of reasons. They are like debt as they pay regular distributions to investors, similar to an interest payment. Because hybrids rank after most other creditors in the wind up queue they are generally worth at best a few cents in the dollar if the company gets wound up – just like equity but a touch better. Some hybrids are very good income investments and they can also, if bought at a particularly large discount to face value, offer good capital gains.

Exciting times are afoot in the hybrids market. They were punished in the 2008 equities crash but have recovered much of their value since then. There were few bond issues outside of banks in early 2009 as companies looked elsewhere to raise funds. Hybrids are one place. Margins above bank bill swap rates which used to look lackluster are now healthy indeed. Westpac has a new hybrid yielding a 3.8% margin over bank bill swap rates. AMP offered a 4.75% margin over the bank bill swap rate for its subordinated debt. Tabcorp, while not a preferred investment, offered 4.25% over the bank bill swap rate for unsecured senior debt. With bank bill swap rates hovering around 3%, 6–7% yields in comparatively low risk instruments with an inbuilt inflation hedge represent good value if backed by solid companies. Many of these investments will only get better as the economy improves or interest rates rise. If inflation goes up, so do interest rates, and so does the rate on many hybrids at a fixed margin above the swap rate. Every instrument is a bit different with its own unique contract, thus requiring additional analysis.

Like many economists we expect the current recession to ease by mid 2010, at which stage

inflation probably will pick up. Yields of 6–7% aren't great by themselves, but the upside of an 8–9% yield in a comparatively secure instrument is attractive.

The face value of listed hybrids in mid 2009 from the big four banks is approximately \$8.5bn. In the current still tight credit conditions we expect more issues. Hybrid debt is an important component in a financial institution's capital structure, often comprising a quarter of the bank's Tier 1 capital as it ranks similar to equity. The hybrid investor's role from a bank depositor or regulator perspective is to be a loss buffer between the bank's deposits and loans. The hybrid – quasi equity, quasi debt – does this without diluting the ordinary shareholders. Imagine the unthinkable happens and a bank suddenly devalues its assets on average at 95c/dollar – it would be nearly insolvent, since banks typically hold very small amounts of equity with a bit less than a 20:1 gearing ratio. There's a queue of people each of whom will lose their money in turn as the assets get more and more devalued, first the equity, then the hybrid-holders, then subordinated debt, then unsecured debt, and finally secured debtors and depositors. In this sense the hybrid-holders give a little extra protection against asset devaluation, typically unexpected bad loans, to all the creditors. This hybrid quasi equity makes it easier for the bank to raise debt since the creditors are more protected. In exchange for this service the hybrid-holder expects a better yield than ordinary debt. If the bank moves close to default there's not much difference between the value of the equity and the hybrids – both hover close to zero.

On risk, it's important to remember that hybrids although generally safer than ordinary equity, still are not necessarily safe with a capital S. ABC Learning, Allco, Timbercorp and Great Southern all had hybrids, and investors in these troubled companies can expect at best a few cents in the dollar. ABC Learning hybrid investors were paid around 1.5% more interest than Commonwealth Bank hybrid investors, for a hybrid issued at about the same time. That 1.5% extra yield was meant to compensate for the

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additional risk of ABC Learning over CBA, but in hindsight 1.5% didn't compensate for investors losing all their money! The yields are a little bit better than a bank deposit because investors are shouldering more risk – and that risk can be very real. Don't mindlessly chase yield. We don't say that all hybrids are terribly risky, many are excellent value when backed by solid companies. However (just like ordinary shares) they're pretty much worthless when backed by worthless companies. There are additional risks in hybrids over equities. Liquidity is a big risk as the hybrids market is often illiquid, so if you need to realise your investment quickly you may not be able to at a reasonable price. Patience may be required.

A Typical Bank Hybrid – How does it all work?

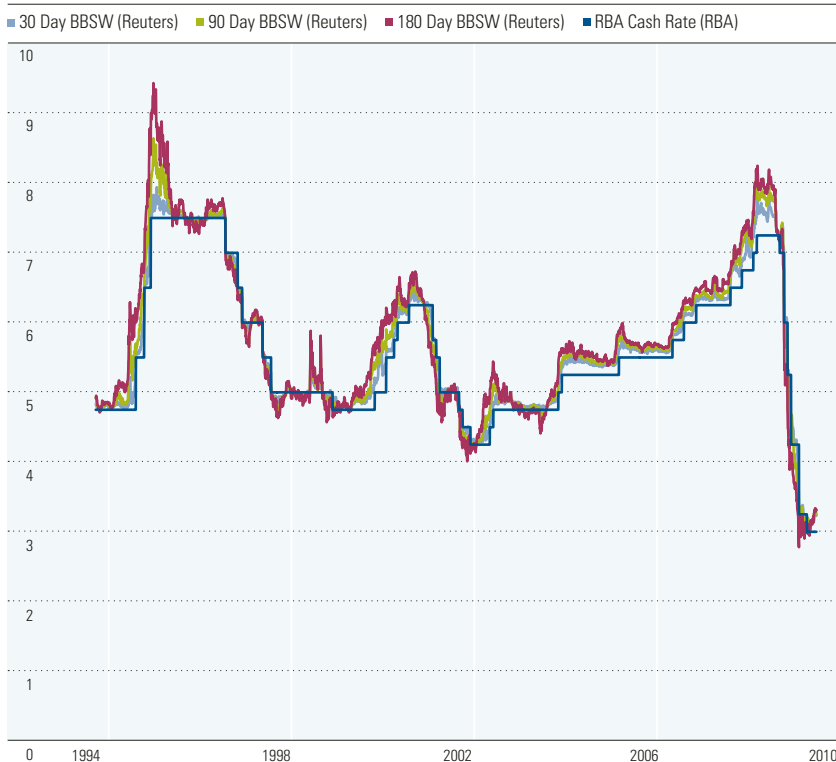
The big-four bank securities are mostly good value. Retail investors get interest rates better than bank-bill backed by some of the most secure institutions in the country outside government. The credit risks on these institutions are comparable. These are all good AA-rated institutions, the hybrids themselves are rated A or better by the major ratings agencies. Despite this slight preference, in general a portfolio of four hybrids from each of these banks is far safer than plumping all your money with just one.

These securities pay a regular distribution or dividend. The calculation for most instruments is similar. Start with the 90 or 180 Day Bank Bill Swap Rate (see graph below), which is the rate at which major financial institutions commonly lend money to each other. This rate often sits a little bit above the Reserve Bank cash rate, so now for instance the 90 day rate is sitting at 3.25%, above the cash rate at 3%. To this you add a margin, which differs from security to security. For instance the ANZ offering, with ASX Code ANZPB, has a margin of 2.5%, CBAPB has a margin of 1.05%, WBCPB has a margin of 3.8%. The codes are assigned by the ASX, the "P" indicates a preference share, the "B" means it is the second in the sequence. The hybrids trade at different prices depending on whether the margin is generous or slim, so slim margins make the hybrid trade at a discount. The distribution may be franked and the numbers we quote include the franking credit where applicable. When each distribution is paid, the rate for the next period is set. Companies calculate the interest on the face value of the note, generally \$100 with the exception of CBA who use a \$200 face value. For almost all hybrids, distribution payment is conditional. Typical conditions include the obvious such as the company/institution having sufficient funds, APRA not objecting to the payment, and the directors at their sole discretion permitting the payment. The flipside is a dividend stopper which applies to dividends or distributions on all its issued securities – this makes the bank pay a coupon on the hybrids if dividends are being paid on the ordinary shares. Distributions are often non-cumulative, so there's limited requirement for the institution to make up missed payments.

What's the consequence? When times are good, these securities look like debt. When times are bad just like equity, distributions can be suspended.

How is the principal returned to the investor? The contracts on bank securities are all different. Many bank hybrids have Mandatory Converting Conditions. There are offerings of this variety from Westpac, ANZ and CBA, as well as Macquarie and Suncorp. At the end of the term, around the Mandatory Conversion Date there are tests against the share price of the underlying security. For instance ANZPB is tested against the share price of ANZ. If the volume weighted average share price (VWAP) of the institution is above some threshold just prior to the Mandatory Conversion Date then the issuer must convert the hybrid securities into a variable number of ordinary shares – the value of

Historical Rates (%)



Source: Morningstar Analysts

the shares will be the face value of the hybrid plus a small conversion discount, typically 1%–2.5%. Often there's a test that the price on the 25th business day before the mandatory conversion date is at least above 55–60% of the issue date VWAP, and then that the VWAP for the 20 business days prior to the conversion date is above 50–52% of the issue date VWAP.

For instance for ANZPB, the ANZ volume weighted average price must be above \$9.72 25 days before conversion for the first condition to hold; that's OK as ANZ currently trades at around \$16.80. Sometimes there's a condition the stock remain trading – not suspended – during this period too. The precise thresholds and conditions vary, but they follow this general format. There's a number of other ways the bank (at their option) can return cash to investors, generally by selling the shares on to a third party or redeeming them with APRA permission. But the sale or redemption must be at the face value – \$100 for ANZPB. If these threshold tests fail, and there's no return of cash or shares to investors, then the same test is made every distribution date (in this case every three months) until the hybrids are converted or sold.

So an investor who puts in \$100 in a new issue today has effectively bought a \$100 bond, whose redemption is conditional on the underlying bank price. If the bank does ok, these hybrids will redeem or convert for something very close to their face value. If the bank stock falls and never recovers, then they effectively become a perpetual instrument, still paying reasonable distributions. If the bank gets into real strife but remains solvent, investors might see distributions suspended for a period of time. The market price will adjust according to these different expectations. Investors will demand higher yields to compensate for higher perceived risks. This will drive the price down. If the bank fails the hybrids will almost certainly be worthless – the history of bank failures is replete with 0c/dollar payouts to preference share holders.

The take-home message is the same, when the institution looks good the hybrid looks like debt, when the institution looks bad the hybrid looks like equity.

These securities are not equivalent to debt or cash. As general advice think of them as defensive income investments. They do not have the lovely property of senior debt, which might be worth

30–50c/dollar in defaults, or government guaranteed cash deposits, worth 100c/dollar plus interest. They don't replace a bond fund or a money market fund in a portfolio. Also keep in mind that "high yield debt funds" often have hybrid investments, so if you own both units in a high yield debt fund and a few hybrids directly, you might not be diversifying – you effectively own the same thing by two different mechanisms. A single collapse in value can punish your portfolio in two places, on the direct ownership side as well as the on the fund side.

Hybrid returns are measured by a yield – an estimate of the additional return an investor will get. Unfortunately there are many methods of measuring yield. It all depends on your assumptions.

- ▶ **Nominal Yield** is the distribution rate.
- ▶ **Running Yield** is the annual coupon divided by the face value. Suppose a hybrid pays 8% interest on \$100 face value, but is on market at \$80. Then the running yield is $8/80 = 10\%$.
- ▶ **Yield to Reset** is the yield of the distributions plus the differential between the market price and the face value, assuming the principal is returned on the reset date – so if a security trading at \$95 will pay two \$7 distributions and then be redeemed for \$100, the yield to reset accounts for the discounted \$5 gain on the face value of the security. More formally it is the discount rate such that the sum of the discounted future cash flows including the return of the principal to investors is equal to the current market price. Sometimes this is called **Yield to Maturity**.

Perpetual securities are valued using a running yield. Hybrids where the return of the investment looks certain should be valued on the yield to reset. Where the reset is uncertain or optional, the yield will sit somewhere in between. We don't include the conversion premium in the calculations.

Also note that some people quote hybrids including reinvestment of the distributions, and some exclude it. This can have a big effect on long-dated securities. We quote excluding reinvestment, but annualize the yields. Annualizing allows us to compare quarterly and semi-annual hybrids directly.

Hybrids from the Major Banks

Specific hybrids, from the big banks in the mandatory converting category are CBA PERLS IV (ASX Code: CBAPB), Westpac SPS and SPSII (ASX Codes:

WBCPA and WBCPB), and ANZ CPS (ASX Code: ANZPB). The yields are all comparable, between 6% and 7%, this calculation assumes the investor receives the face value of the hybrid on the mandatory conversion date and bank bill swap rates stay at their current level, with mandatory conversion dates from 2012 to 2015. These yields are reasonably good and will be attractive to some investors. The hybrid yield on market tends to rise as the underlying security gets closer to the mandatory conversion thresholds, and the holder bears some capital loss. Note that the market recently penalised CBAPB when the CBA share price moved below the \$33.05 threshold for one of the hybrid's mandatory conversion conditions, so there's a potential to buy these cheaply when this happens, at the cost of a slightly greater risk that conversion will be postponed. We base this view on CBA being a strong bank and the recent fluctuations representing market irrationality. The yields on these securities will be attractive to many investors. Today we estimate a fair yield margin of 2.1% for these securities, but this will come down as the recession recedes.

The table below describes the major bank hybrids – we're starting coverage on these securities soon.

In the yield table, we assume that future bank-bill rates will be the same as today. It's a big assumption. These are floating rate instruments, so if interest rates rise you can expect yields better than those above, if they fall you can expect worse yields. We also quote the highest Mandatory Conversion Condition threshold for the ordinary share price, which we consider the most material; if the ordinary share price is below this price the security may fail one of its Mandatory Conversion Conditions, but the price isn't set in stone, it may need to be adjusted in the future for bank capital structure changes like equity raisings

or buy-backs. These securities are now mostly liquid with tight bid-ask spreads, but occasionally investors may need patience to realise their investment on market. They became very illiquid in the recent financial crisis.

Some bank hybrids don't look like this at all, and they can only be redeemed at the option of the institution – and some need APRA approval even for this! These instruments have no mandatory conversion like those above, there's no event which forces conversion or redemption. These are called perpetuals. Perpetual in this context means just that, investors should have no expectation that the instrument will ever be redeemed – the investment can only be realised by selling them on market. In Britain the government of George II issued perpetual securities called "consols" over 250 years ago; these instruments are still on issue today, paying 2.5% interest.

NAB is the major bank with a big perpetual hybrid issue, called "National Income Securities", with ASX Code NABHA. This security has a 1.25% margin over 90 Day bank bill swap rates, and distributions are unfranked. The market running yield at writing is 6%. There are other banking step-up hybrids, Westpac TPS (ASX Code: WCTPA) and CBA PERLS III (ASX Code: PCAPA). The step-up date is in 2016 for both securities; on this date the margin increases, but the institutions have the option of converting the hybrids into a variable number of ordinary shares at a 1% over the face value, or organising a \$100 cash return to investors. Just on the basis of their running yields from solid institutions, these are reasonable if unexciting securities. Given that Westpac recently needed to offer a 3.8% margin elsewhere to attract investors, redemption is less likely than the margin stepping up to 2–2.05%. But if this credit easing continues,

Major Bank Listed Hybrids (as at 11/06/09)

Hybrid	Issuer	Margin (%)	Step-up-Margin (%)	MC/ Step-up Date	Franking (%)	MCC threshold (\$)	Market Price	Yield to Maturity (%)*	Running Yield (%)*
ANZPB	ANZ	2.5	na	16/06/14	100	9.72	97.50	6.4	5.7
CBAPB	CBA	1.05	na	31/10/12	100	33.05	183.50	6.5	4.4
PCAPA	CBA	1.05	2.05	06/04/16	100	na	169.90	7.1	4.9
NABHA	NAB	1.25	na	na	0	na	71.03	na	6.0
WBCPA	WBC	2.4	na	26/09/13	100	11.27	98.10	6.2	5.6
WBCPB	WBC	3.8	na	30/09/14	100	9.83	105.95	5.9	6.5
WCTPA	WBC	1	2	30/06/16	100	na	81.48	7.6	5.0

* Running yield is the expected annual distribution divided by the market price. Yield to maturity is the yield assuming the investor receives all distributions up to the maturity date and the face value of the note is returned to the investor at maturity. It includes the current distribution. Yields are annualized. Yields include franking credits where available.

Source: Morningstar Analysts

which it should, the market will soon come to expect redemption, and these securities could quickly become very attractive. The yields to reset where we assume redemption on the step up date sit at 7%–7.2%.

A last point – these securities are very complex and we have only an overview of the contracts here. With hybrids it's very important to carefully examine the prospectus, where the terms and conditions are spelled out in often mind-numbing detail.

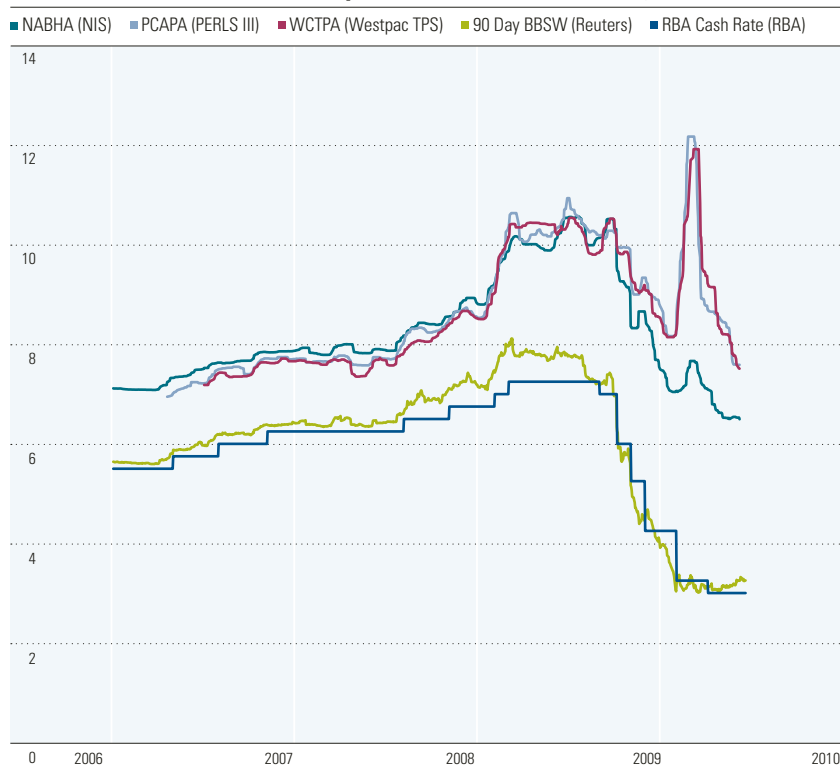
Look at the graph below of historical yields on long-dated bank hybrids, running yield for NABHA and yield to reset for the others. You can see that before the recent financial crisis, yields sat around 1–1.5% above the RBA Cash Rate. Now, post financial crisis the spread (i.e. the gap) between the cash rate and the yield has become much wider. If the banks don't get into strife, we expect that this spread will narrow as the recession recedes, and furthermore the cash rate should rise as inflation picks back up. So the absolute yield will still be attractive, but the price of the instrument on market should improve substantially as the spread drops. All this depends on the institution not getting into

substantial trouble. Mild trouble will still be ok for hybrid investors – remember that the bank equity raisings which come from the current mild difficulties don't dilute the hybrid holders.

We'll start detailed coverage on a range of hybrids soon. ■■

Analyst: Patrick Caldon

Major Bank Hybrids with Redemption after 2015 – Rate/Rolling Median Yield (%)



Source: Morningstar Analysts