

# EUREKA *report*



## Regional bank hybrids look oversold

By Jim Stening  
June 7, 2010

**PORTFOLIO POINT:** Hybrids are becoming more attractive against the volatility of the market, and some step-up preference shares are the most attractive of all.

Volatile markets cause a lot of heartburn but they also present opportunities for investors prepared to look beyond the noise.

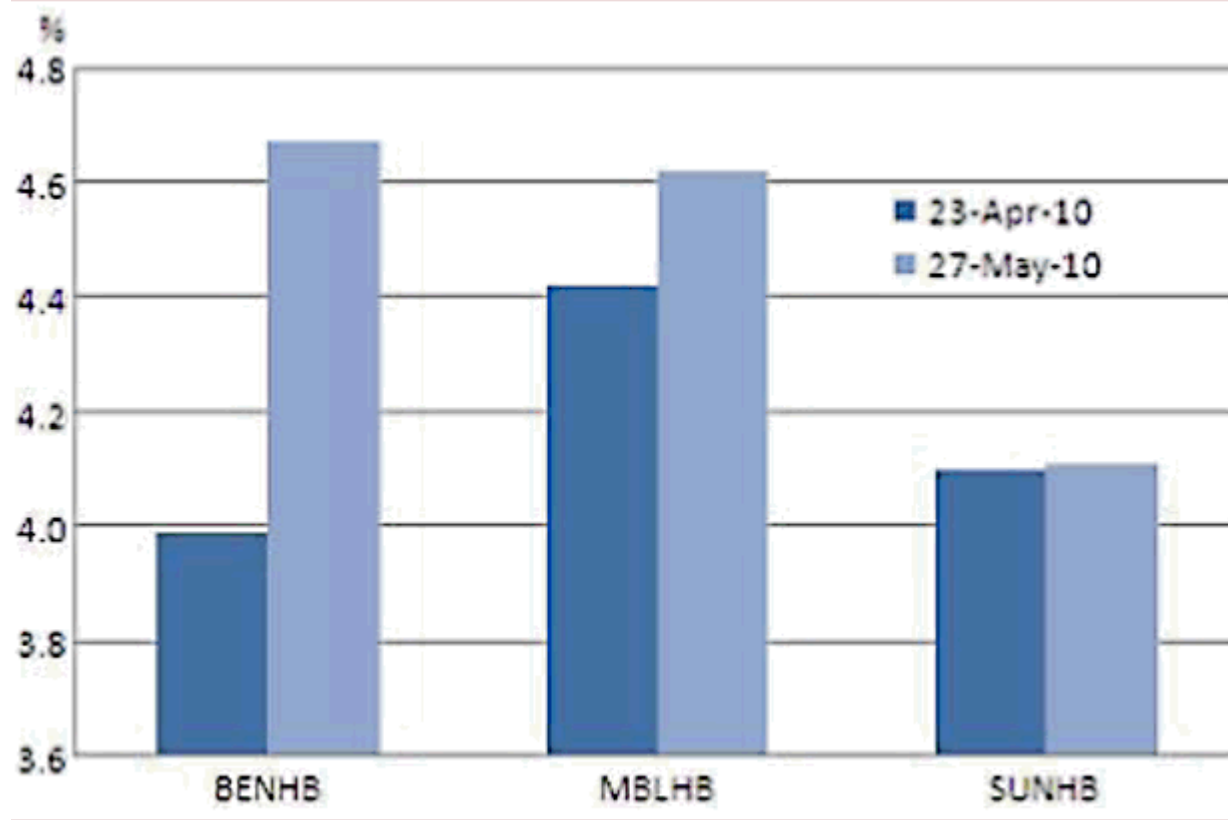
Against a challenging macro outlook both here and abroad, we note that Australian regional bank hybrids appear to be oversold. Prices of the securities have dropped in recent weeks, making spreads more attractive than they have been for six months or more.

### Income securities

Income securities are what are known as “true perpetuals”, meaning they were never intended to be redeemed. This group includes hybrids from Bendigo & Adelaide Bank (BENHB), Macquarie Group (MBLHB) and Suncorp (SUNHB).

Any change in price can have a significant impact on credit spreads. All three securities are currently trading at significant discounts to face value of \$63–71.

### Spreads on income notes



Source: FIIG

While spreads on these securities have increased significantly recently (and hence prices decreased) they aren't among our favourite picks at the moment. We prefer securities that at some point in time are likely to be redeemed and we believe all the other types of bank hybrids will at some point be called.

So while there is reasonable value in these securities (the Macquarie Group hybrid, MBLHB, is currently a buy), our preferred picks lie elsewhere.

### Reset preference shares

Spreads on reset preference shares have also blown out substantially. Reset preference shares pay a fixed rate over a fixed term (usually five years) after which they are either redeemed or a new rate is set.

Over the past five weeks there have been good opportunities to trade those issued by Bendigo & Adelaide Bank (BENPA), Bank of Queensland (BOQPA) and Suncorp (SUNPA).

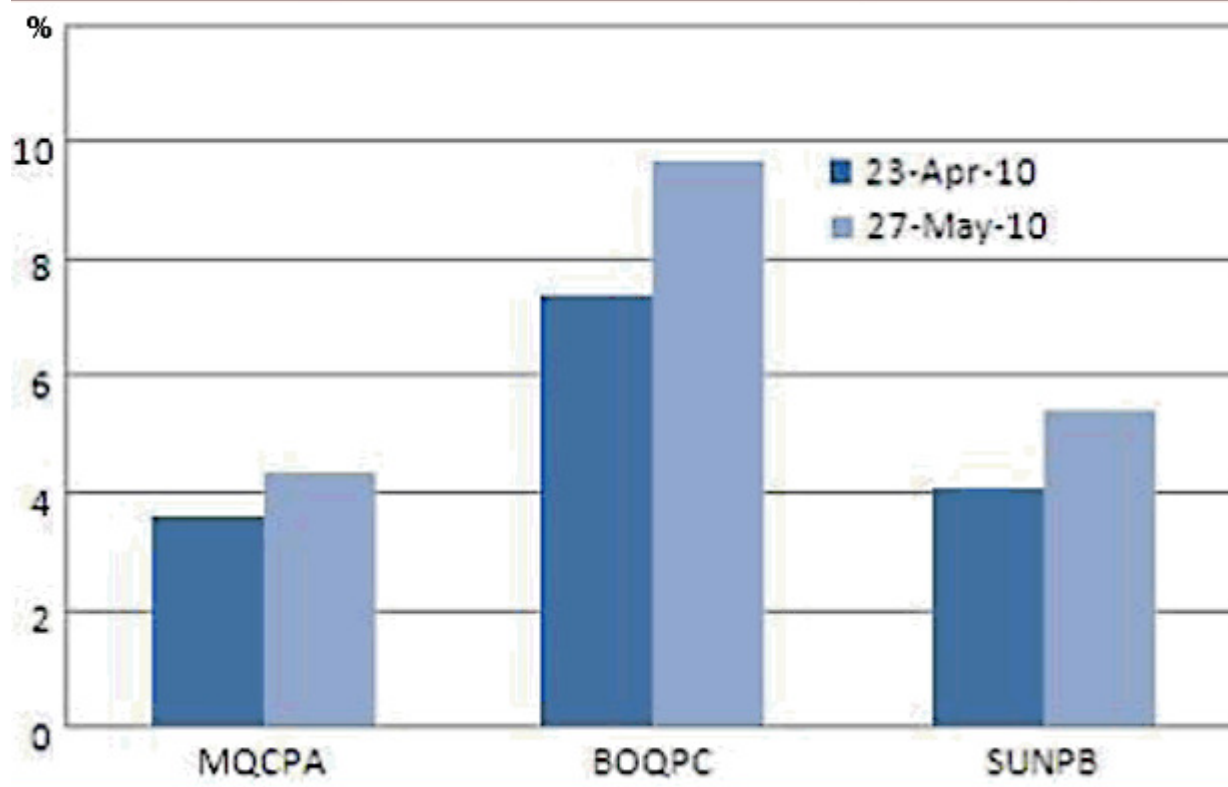
However, most of these securities are due to reset/redeem in the next few years, so we don't see fantastic value in them right now. As a general rule, we believe that when these securities are trading above a \$100 clean price then this is an opportunity to exit.

### Converting preference shares

Converting preference shares (CPS) are securities that convert into ordinary shares of the issuer after a set period of time, usually five years. Of particular interest to us are those issued by Macquarie (MQCPA), Bank of Queensland (BOQPC) and Suncorp (SUNPA).

For MQCPA and SUNPB, the conversion is mandatory so long as certain conversion conditions are met. Usually the most important ones relate to the price of the ordinary shares.

#### Spreads on converting preference shares



Source: FIG

However, conversion on the BOQPC is at the option of the issuer and there is no step-up (or increased coupon) on the security if it isn't, providing some uncertainty as to whether this hybrid will be converted at the first opportunity. This structural flaw is the reason this security is trading at substantially higher spreads than the other two hybrids.

While in the past we have shied away from recommending the BOQPC based on this flaw, the wide spread and accompanying discount to face value (about \$86) means we are close to an upgrade. With the other two securities our preferred pick is the SUNPB.

### Step-up preference shares

The best value in the sector lies in step-up preference shares such as those offered by Bendigo & Adelaide Bank (BENPB and BENPC). The reason these securities are trading on the highest spreads is due to the uncertainty as to whether they will be redeemed on their first call date.

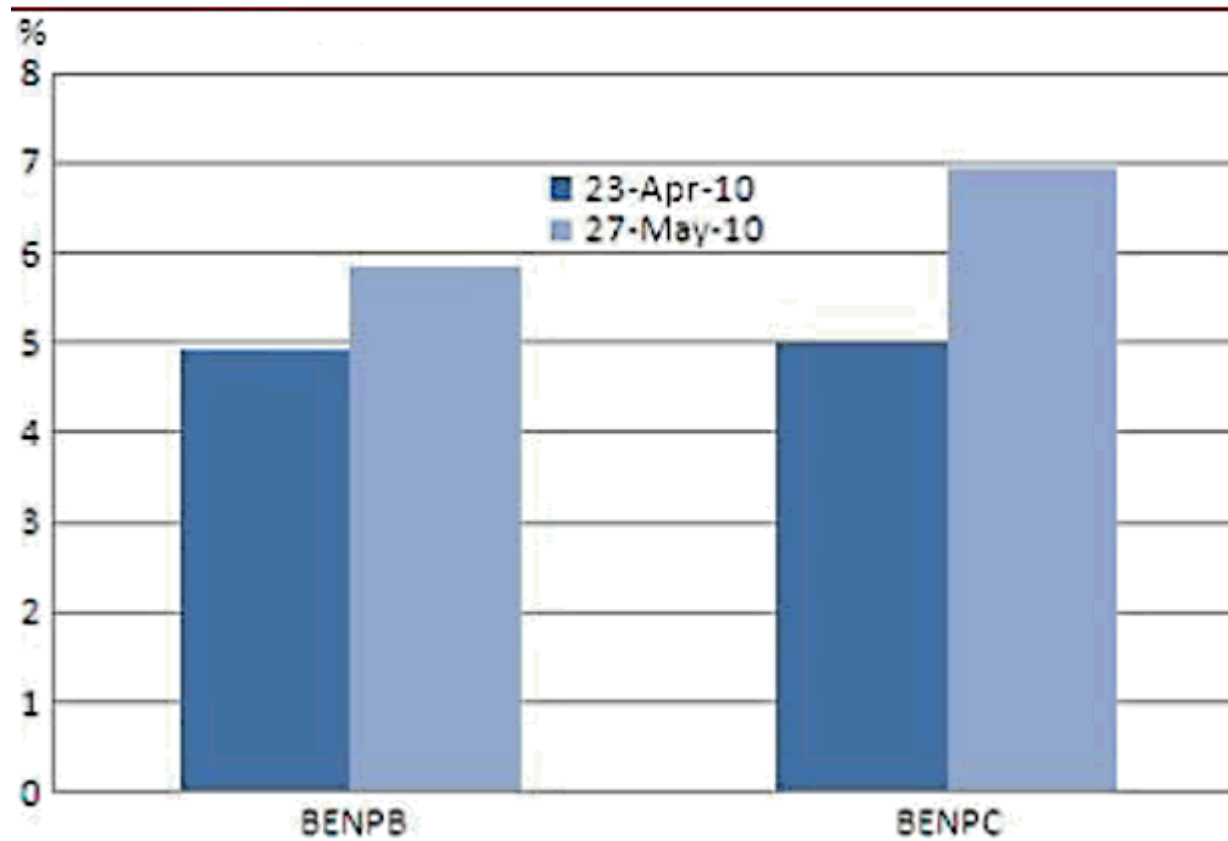
If the securities aren't redeemed, then the coupon margin will step up to a higher rate. In the current environment, it would be cheaper for the regional banks to incur the step-up rather than redeem them and issue a fresh hybrid.

As we have mentioned in previous research, however, we are confident that because of reputational issues the regional banks will continue to redeem these hybrids at the first opportunity regardless of economic cost.

All Australian banks have continued to call their subordinated debt and hybrid securities at the first opportunity due to the importance of appeasing their debt investors thus far. While there is a possibility the Australian Prudential Regulation Authority (APRA) will prevent a bank from redeeming a hybrid, this risk is slim.

As noted in the graph below, step-up preference shares currently offer the highest spreads of the regional bank hybrids. The BENPC currently is our favoured security with a spread of close to 7% over the BBSW (bank will swap rate), which equates to a low double-digit yield to maturity, a good return for the risk involved.

### Spreads on step-up preference shares



Source: FIG

Investors who are concerned about equity markets should keep an open mind about other securities. Rather than diminish the appeal of hybrids, the recent volatility has enhanced their appeal.

The fundamentals of these securities are little changed: their credit risk and likelihood of call remains the same, yet spreads have increased substantially.

While the attractiveness of the different types of hybrids varies, there is good value in the step-up preference shares, and the BENPC is our preferred pick.



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