

Hybrids offer investors attractive yields

Philip Baker

Looking for a good investment? The recent sell-off in equity markets has sent the prices of some hybrid securities to the bargain basement level, prompting some analysts to say it's buy time.

Credit spreads have widened over the past month as investors headed for safe haven assets amid concerns over Europe's debt woes and the mixed outlook for the global economy.

Hybrid securities provide an income stream via the steady payment of coupons, or distributions. They sometimes contain an equity component that offer the option to convert into stock or get the original investment back in cash at a set date.

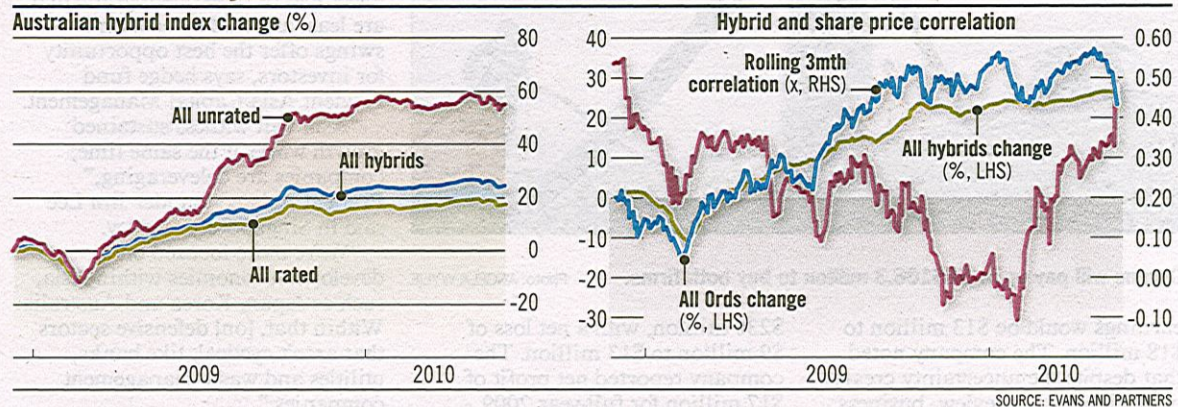
According to FIIG Securities director Brad Newcombe, the best value in the sector now are hybrids that haven't been redeemed but have a feature allowing investors to be paid a higher rate of interest as compensation.

He recommends the Bendigo and Adelaide Bank step-up preference share currently trading at \$86 and offering a running yield of around 7.5 per cent that includes the value of franking credits.

Some hybrids in this space have been sold off recently as investors are concerned the securities won't be redeemed when they fall due.

However, Mr Newcombe is confident the regional banks will continue to redeem these hybrids at

A bet each way



the first opportunity due to reputational issues.

Investors in hybrids prefer to get their original investment paid in full when the security matures, but changes to tax rules, banking regulations and international accounting rules led to the arrival of securities that technically have no maturity date.

To offer some comfort to investors, hybrids such as the Bendigo and Adelaide Bank issue have a "step-up" provision that means investors will be paid a higher rate of interest if the bank does not buy them back on a set date.

Investors in the Bendigo and Adelaide Bank hybrid will get an additional one per cent if the hybrid isn't called on October 10, 2014.

So far, all the banks have redeemed their hybrid issues at the

first opportunity to keep their debt investors on side.

One hybrid that doesn't have a step-up but is offering value, according to Mr Newcombe, is the Bank of Queensland preference share trading around \$86, with a running yield of more than 7 per cent.

"Conversion is up to the issuer and there is no step-up but we think it's likely investors will get their \$100 back in December, 2012," said Mr Newcombe.

Evans & Partners derivatives analyst Michael Saba recommends the Orica preference share that closed yesterday at \$91. It has a step-up clause but Mr Saba reckons Orica's balance sheet is in good shape and could be potentially improved with the mooted sale of Dulux.

The hybrid has a step-up clause that falls due in November, 2011 and has a running yield of 6.35 per cent now but if it is repaid at \$100, it will give investors a yield to maturity of more than 12 per cent.

If it is not redeemed, there is a step-up of 2.25 per cent.

The problem with some securities in the hybrid space, ranging from convertible notes, exchangeable notes, converting preference shares and reset securities through to the perpetual floating rate notes, is they have been marketed and generally bought as bond-like, when in fact there are also equity-like risks.

One issue, the Tabcorp retail bond, is as close to a pure fixed-income play as investors can get. The credit spread on this bond has widened recently and it is offering investors a running yield of 8.77 per cent

SOURCE: EVANS AND PARTNERS