



Hybrids set to rebound after the downturn

These securities can provide a good return

SARA RICH



BARGAIN hunters may find good value in the hybrid securities sector after the recent sharemarket sell-off put pressure on prices.

Experts say good quality hybrids are trading significantly below their issue prices and are likely to rebound.

Called hybrids because they are a mix of debt and equity, the securities are traded on the sharemarket and provide investors with a fixed income-like return via the steady payment of distributions.

They pay a higher rate of return than bonds — usually the bank bill swap rate plus a margin — but less than equities. Some also offer investors the option to convert the security into the underlying share at a set date.

They sit higher up on the capital structure compared with shares, so if the company defaulted on its debt or collapsed, hybrid holders would get their money back before shareholders, but after ordinary creditors.

FIIG Securities director Brad Newcombe says they are also generally less volatile than equities. He believes most investors in hybrids would have been slightly better off than investors holding equities during the downturn.

“What we have seen recently in the global financial crisis was a lot of companies have had to cut their dividends, whereas with hybrids you keep getting your set, fixed return each period, each quarter or half year,” he says.

A good example of this was the Goodman Group, which had to cut its dividends to zero at the end of last year whereas investors in its hybrids still got the bank bill swap rate plus 1.9 per cent.

The sector was not immune to the crisis, however.

While hybrids are a lot like bonds, they can still trade above or below their issue price because they are listed on the stock exchange.

Hybrids are generally issued at a \$100 face value. “What we saw was a lot of them were hit pretty hard in the financial crisis; some of the bank ones got down to as low as 60c in the dollar and some of the corporate issues got down into the teens and \$20 and \$30 mark,” Newcombe says.

The good thing for investors is that while prices have started to recover, there is still value in the sector, especially after the recent sharemarket sell-off.

UBS head of hybrid capital Tricia Ho says she likes Fairfax’s hybrid, the Fairfax SPS, which last week was trading at \$88. She says Fairfax has a good track record of redeeming its securities in full, meaning investors get their money back at maturity.

“Fairfax is a very experienced hybrid issuer so I would say if you look at Fairfax’s past form they have always managed to do what the market expects, which is to redeem its securities,” Ho says.

She says agricultural company Nufarm is another experienced hybrid issuer.

From a sector perspective, FIIG Securities likes property trust hybrids.

“The reason being they really got hit in price and a lot of that was concerns about whether they had too much debt, but what we have seen post crisis is a lot of these property trusts have substantially de-leveraged,” Newcombe says.

He says capital raisings have helped many property companies eliminate a lot of credit risk.

“So you have these greatly reduced risks on these hybrids and they are still trading well below their face values, offering double-digit running yields, which is your income return,” he adds.

“Then there is the prospect for a capital gain if these securities get redeemed at some point in the future for

their \$100 face value.”

Newcombe’s individual picks for the property trust sector include the Goodman Group’s Plus Trust, which he says has rebounded somewhat but remains good value, and Multiplex’s Sites Trust, which has an attractive running yield with the potential for capital gain on redemption.

He also rates Australand’s Assets Trust for its high yield and potential for redemption at face value.

Hybrids offered by the banks are also high on his list, particularly some of the regional banks. Newcombe says the extra yield provided by some regional bank hybrids more than compensates for what he thinks is only a little bit of extra risk when compared with the big banks.

“One of the standouts there is one issued by Bendigo and Adelaide bank,” he says.

All the big banks and most of the regional banks offer at least one hybrid and they are generally lower risk than corporate hybrids. They haven’t fallen as much, however.

Risks associated with hybrids include the potential for the distribution to be suspended — this happened recently with PaperlinX — with no obligation on the issuer to back-pay the distribution.

PaperlinX announced recently it was starting distributions again but won’t be making up the missed payment for June last year.

Ho likes this hybrid, however, and points out the company worked hard to sell down its assets to repay its borrowings.

“I think it is an opportunity because it is \$67.99 and you would expect that price to improve as they continue to pay distribution,” she says.

Newcombe advises investors to look for good quality companies and to do

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plenty of research.

“If you are pretty risk-averse you might want to stick with the bank securities,” he says.

“If you can handle a bit more risk as an individual then some of the high-

risk corporate ones, which pay much higher returns, might be suitable.”

FIG'S TOP FIVE HYBRIDS

Multiplex Sites (MXUPA)

Australand Assets (AAZPB)

Seven Telys 4 (SVWPA)

Goodman Plus Trust (GMPPA)

Suncorp Metway (SUNPB)