

EUREKA *report*



Ramsay's risky hybrid

By Jim Stening
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PORTFOLIO POINT: Its shares have performed strongly, but the risks associated with the hybrid mean investors could find better value elsewhere.

Ramsay Healthcare was recently covered by Eureka Report as quality defensive stock with global footprint (see *My desert island picks*).

With that in mind, we thought that Ramsay Healthcare's hybrid security deserved some analysis.

With an expected yield to call of about 30%, Ramsay Healthcare's CARES security looks like a compelling opportunity. However, the phrase in that last sentence you really need to pay attention to is "to call".

The security, known by the ASX code RHCPA, is a perpetual with a call date that is solely at the discretion of the issuer.

If we use the experiences of similar hybrids as a guide, there is a strong possibility that Ramsay Health will elect not to redeem the security at the first opportunity on October 20, 2010.

If the RHCPA were stepped-up rather than redeemed (which involves the payment of a larger coupon to security holders), then the coupon margin on the securities will increase from 2.85% over the 180 day bank bill swap rate (BBSW) to 4.85%.

RHCPA Ramsay Healthcare Limited



At current levels, that would equate to an annual coupon rate of close to 10%. That would produce a running yield of over 10% based on a current clean price of about \$94.25.

While that might seem like a good return when compared with other stepped-up hybrids, there are more attractive alternatives.

Seven hybrid comparison

The best example of what could happen to RHCPA is provided by the Seven Group Holdings hybrid (SVWPA). This security traded as high as \$95 just prior to its call date.

However, when it was announced that the security would be stepped-up to pay a margin of 4.75% over the 180 day BBSW (almost exactly the same as the RHCPA), the actual price of the security plummeted, despite promise of a higher coupon.

The SVWPA now trades at a clean price of about \$75 – a decline of more than 20% from its highs.

So while the yield to maturity of close to 30% might look attractive, it must be noted that this is an annualised, not overall return.

The actual capital upside of the RHCPA is only a few dollars and, based on the example of the SVWPA (other stepped-up hybrids are priced similarly), there is downside risk in the price of about \$20.

Likelihood of call

The important issue for RHCPA investors therefore is the likelihood that Ramsay Health will call the security at the first opportunity on October 20, 2010. If the hybrid is redeemed then investors will realise a small capital gain.

However, if the security is stepped-up then there is a strong probability the RHCPA will suffer a substantial price decline.

The good news for RHCPA investors is that Ramsay Health has the balance sheet capacity to call the issue.

The company has advised that it has headroom under its debt covenants of about \$500–600 million even after its recent 57% acquisition of Proclif. This is more than enough capacity to refinance the \$260 million worth of RHCPA outstanding, with senior debt.

From an economic perspective, the company may find it preferable to simply step-up the security.

In the current environment, a rate of 4.85% over BBSW isn't prohibitively expensive for a perpetual, subordinated instrument. Ramsay Health may value retaining the flexibility that the current headroom provides or simply view the RHCPA as a cheap form of funding.

This is exactly the view that Seven Group took when determining whether to redeem its hybrid. Seven effectively had no net debt and easily had the capacity to redeem its security but instead elected to incur the step-up.

Ordinary share conversion

The terms of the RHCPA prospectus allow for another option instead of redemption or a step-up: conversion of the securities into ordinary shares of Ramsay Health at a 2.5% discount to the market price.

Unlike most hybrid issuers, Ramsay Healthcare has been a stellar performer on the stockmarket over the past 12 months and its share price is high enough that a conversion wouldn't excessively dilute existing shareholders.

The following table outlines the impact of the RHCPA converting to ordinary shares as opposed to a step-up.

-Ramsay Healthcare

	Step-up	Conversion
Net profit (pre RHCPA distribution)	\$172.0m	\$172.0m
RHCPA distribution	(\$18.2m)	Nil
Net profit	\$153.8m	\$172.0m
Ordinary shares	202.1	221.5m
Earnings per share	76.1¢	77.7¢

We estimate Ramsay Health should earn about \$172 million in 2010 prior to RHCPA distributions. If the securities

step-up then Ramsay Health would incur approximately \$26 million in pre-tax costs (\$18.2 million after tax on the hybrids) resulting in net profit of \$153.8 million.

This would result in earnings per share of about 76.1¢ based on 202.1 million ordinary shares outstanding.

If the RHCPA were converted to ordinary shares then there would be no further hybrid distributions required and net profit would remain at \$172 million. It would, however, produce an increase in the number of ordinary shares on issue, to about 221.5 million based on the \$260 million of RHCPA being converted at a current price of around \$13.75 and applying the 2.5% discount.

Under this scenario, earnings per share would actually increase by 1.6¢ to 77.7¢. This means there is a reasonable chance the company will convert the RHCPA to ordinary shares rather than redeem for cash or step-up the securities.

Summary

The RHCPA are now only just over three months away from their call date and we would expect an announcement on what the company intends to do with the securities at their forthcoming profit result.

With a strong balance sheet and a share price that hasn't been decimated like other issuers, there is a good chance that Ramsay Healthcare will either redeem for cash or convert the securities to ordinary shares; either outcome should deliver a return to investors of \$100.

The downside risk is that the company elects to step-up the hybrids. While a stepped-up margin of 4.85% over BBSW might be relatively attractive on a long-term basis there is a strong probability the security price would fall back to about \$75–80, in line with other stepped-up hybrids.

In other words, while there is upside of a few dollars with the security on redemption or conversion, there is far greater downside if the company elects to step-up.

On this basis, with the RHCPA currently trading close to face value of \$100 we recommend investors avoid this potential risk and SELL.



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