

EUREKA *report*



Fairfax hybrid: read all about it

By Jim Stening
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PORTFOLIO POINT: Fairfax's hybrid is approaching its first call date. The downside is limited and the upside quite attractive.

Fairfax Media is one of Australia's oldest companies, with a history dating back to 1841 when John Fairfax purchased the *Sydney Morning Herald*.

The company owns a stable of well-known and highly regarded newspaper mastheads, including the *SMH*, the *Australian Financial Review* and the *Age*.

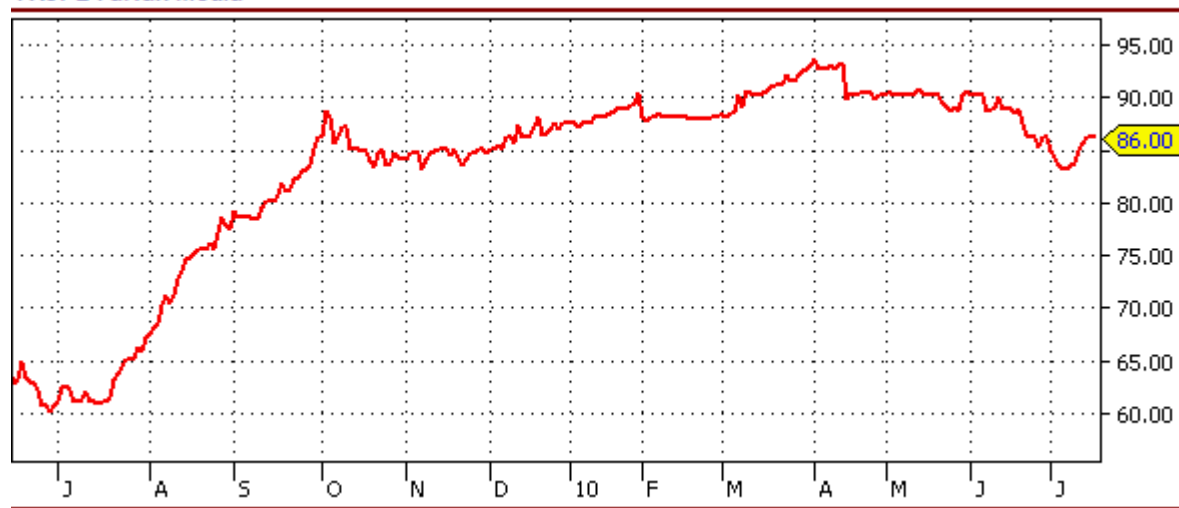
More recently, to maintain its hold on advertising revenues, the company has expanded operations to the internet with numerous websites including Domain, Drive, My Career and the dating site RSVP.

Fairfax is also a hybrid issuer and its step-up preference shares (FXJPB) have caught our eye as a security worthy of closer inspection after recent price falls.

Similar to Ramsay Healthcare's CARES hybrid (RHCPA), which we reviewed recently (click [here](#)), the Fairfax hybrid has a first call date that is fast approaching. In this case, the date is April 30, 2011 – less than a year away.

At that time, Fairfax can redeem the securities at face value, convert them to ordinary shares, or step-up the coupon on the hybrid from current levels of 1.55% over the 180-day bank bill swap rate (BBSW) to 3.80% over.

FXJPB Fairfax Media

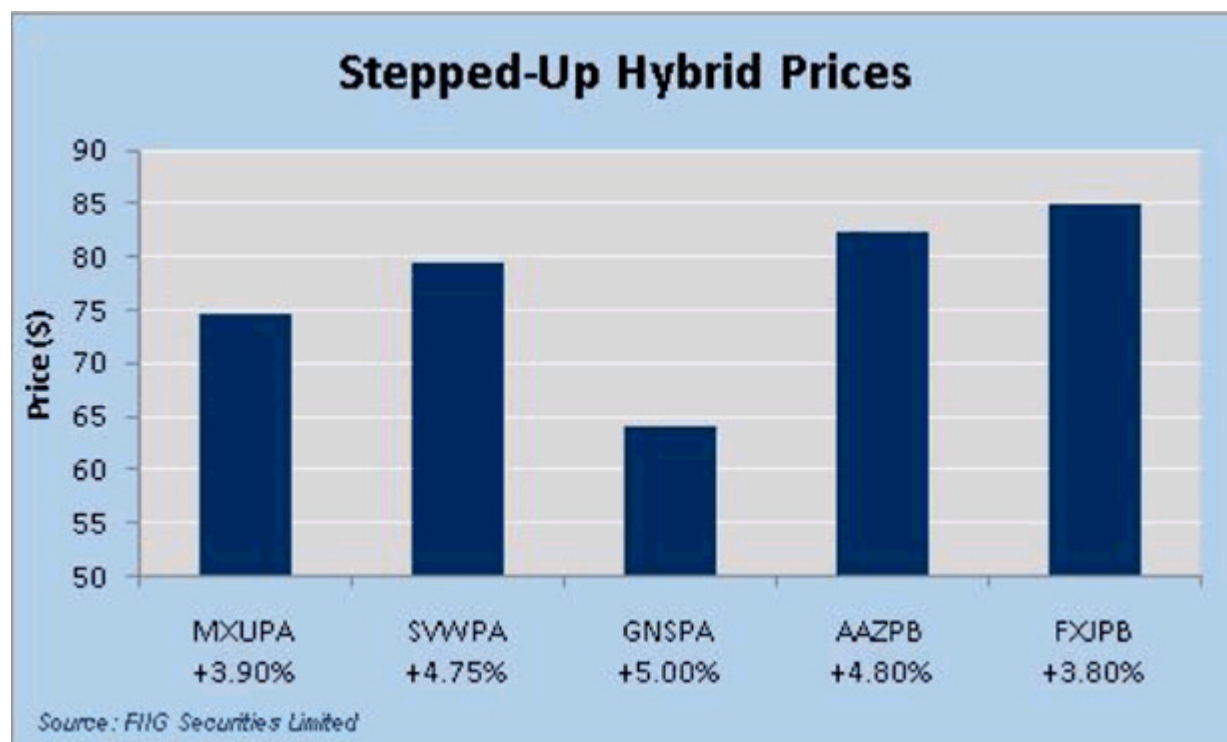


The big difference between the two securities, however, is that although the Ramsay hybrids are priced at levels close to face value (around \$95), the Fairfax hybrids are trading at a more substantial discount (\$85).

Redeem, convert or step-up?

In determining whether the Fairfax hybrid represents good value, the key issue is whether Fairfax will redeem, convert, or step-up the security next April. The first two options would deliver investors \$100 of value and would be an excellent result. If the securities are stepped-up, their ultimate value is far more subjective but would certainly see

the price of the hybrids initially settle below \$100.



The final option, stepping-up (technically there is also a re-marketing process but that is extremely unlikely to yield a result), would give investors an additional 2.25% a year in income but, perversely, would likely see the price of the security fall.

The following table outlines the prices of the four securities that have already stepped-up, along with the Fairfax hybrid. The coupon margins they pay above BBSW are also quoted.

Fairfax 2011 Pro Forma Earnings		
	Step-up	Conversion
Net Profit (Pre FXTPB distribution)	\$338.5m	\$338.5m
FXJPB Distribution	(\$18.5m)	Nil
Net Profit	\$320m	\$338.5m
Ordinary Shares	2352m	2564.2m
Earnings Per Share	13.6c	13.2c

Source: FIIG Securities

At current levels, the Fairfax FXJPB is trading at the highest price and there is a likelihood there would be some fall-back if the securities were stepped-up. Regardless of any price decrease, we would think that for risk-tolerant investors they would still represent good long-term value at stepped-up running yields in excess of 10%, with the potential for capital gains if they were redeemed on a future payment date.

Valuation

As previously mentioned, the Ramsay and Fairfax hybrids are similar in many respects. Both have call/step-up dates approaching, and there is at least a reasonable chance the issuers will redeem or convert the securities at the first opportunity, resulting in investors getting \$100 of value. The big difference is where the securities are currently priced.

At around \$95, there is very little upside in Ramsay's RHCPA if they are redeemed or converted, yet there is significant downside security price risk if they are stepped-up. For Fairfax's FXJPB, the equation is different. We think the immediate downside is limited. Based on the relatively low credit risk of Fairfax, we would expect the price would settle around \$80 (which again would represent good long-term value). This is a decrease of only around \$5 from current levels. Meanwhile, if the securities are redeemed or converted, there is approximately \$15 of upside.

Overall, the Fairfax hybrid is a solid credit risk. Based on the limited downside risk of the security (assuming non-default) if the hybrid is stepped-up, and substantial upside if it is redeemed or converted, we are upgrading our recommendation to buy. However, now that we have a positive recommendation on the security, and to reflect the risk the security will likely fall in price if they are stepped-up rather than redeemed or converted at the first opportunity, we are increasing the risk to high.



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