

Yield chaser

Income investments can fund your lifestyle or supplement your returns



Read the fine print

Hybrid securities can be difficult to understand. Investors might be smitten by an offer but they need to consider how company intentions might affect yield, Philip Baker writes.

Investing in some hybrid securities can be tricky. At first glance investors might be smitten by the Ramsay Health Care hybrid. If the security is redeemed when it falls due in October then it is trading on a yield close to 30 per cent. But if the company elects not to buy it back later this year then the running yield drops to 10 per cent.

Ramsay issued the hybrid to help fund the \$1.4 billion takeover of Affinity Health in 2005. Back then if the security wasn't redeemed the step up of 2 per cent – taking the coupon to 4.85 per cent, from 2.85 per cent – it looked attractive. But not any more, and this was always the danger of investing in these sorts of deals.

In the early days of hybrids, investors were offered a product that paid a higher rate of interest than a regular debt instrument and gave them the option to convert into stocks, or get their original investment back in cash at a set date.

But then international accounting standards dictated that the old breed of hybrids would be classified as debt instruments, not equity, so investment banks had to create a new type of security that met the requirements of the updated accounting rules.

The new securities do not have a final maturity date and are very similar to income securities that flooded the market in 1999.

The trick with the Ramsay deal (code: RHCPA) is the likelihood it will be called. If it is then investors have got the yield and a small capital gain as it is trading around \$94. But if the step-up clause is enforced it's likely the RHCPA will suffer a substantial fall in its price.

If other corporate hybrids are a guide, there is a good chance Ramsay will elect not to redeem the security at the first opportunity – October 20, 2010.

It has the cash to buy the security back, but with jittery credit markets it might view the hybrid as cheap funding and leave it. This is what Seven Group did with its hybrid (SVWPA). Ramsay will probably announce a decision when it issues its 12-month profit report.

It's an interesting time for yield chasers as, with some term deposits paying up to 7 per cent under the government savings guarantee, it's starting to pay to leave money in the bank.

Investors can venture into high-yield territory, but of course that comes with the added risk.

Otherwise there's a new product from FIIG Securities called Direct Bonds service, which gives investors with \$50,000 to spend access to the high-yielding investment-grade corporate bond market.

Investors can buy into low-risk Telstra bonds, but can take on more risk by gaining exposure to bonds issued by the likes of Suncorp, Rural Bank and Sydney Airport. The yield on those bonds are about the 8 per cent to 8.8 per cent range, but if you throw in well-known global names, like Swiss Re and AXA, investors can get up to 11 per cent to 12 per cent.

Another hybrid that faces a similar dilemma to Ramsay is the step-up preference share issued by Fairfax Media, publisher of *AFR Smart Investor*. (code FXJPB).

The Fairfax step-up date is April 30, 2011. On that day Fairfax can redeem the securities at face value, convert them to ordinary shares, or step up the coupon on the hybrid from 1.55 per cent over the benchmark borrowing rate to 3.8 per cent over.

There is one difference, however. The Ramsay hybrid is changing hands at about \$94 but the Fairfax security is hovering around \$84, delivering investors a running yield of about 7.5 per cent.

As FIIG Securities points out, the key issue is whether Fairfax will redeem, convert, or step up the security. If it buys back the security investors get a windfall as the price will be \$100, if it doesn't then the price may fall.

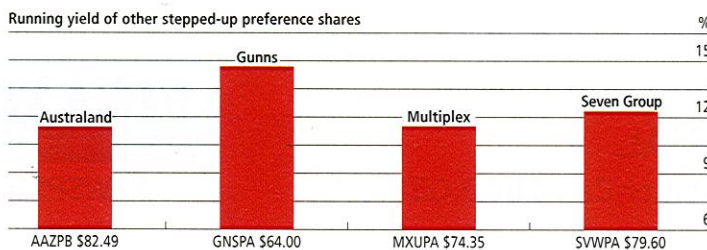
According to FIIG, the company is likely to take into account the reputational considerations involved and in the past has redeemed hybrids at the first opportunity.

Also, the broker reckons the increased coupon margin would be a reasonably expensive form of funding for the company and it could likely access senior debt at cheaper levels.

However, the hybrid is still cheap funding for Fairfax, which may find it tough to pay out the \$300 million issue.

According to FIIG, Fairfax has a net debt to earnings before interest, tax, depreciation and amortisation covenant of 4.0 times, which sits at 2.9 times. Refinancing the \$300 million of hybrids with debt will increase this ratio to about 3.4 times – still within the covenant but substantially reducing leeway. **Si**

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Source: FIIG Securities