EUREKA report

Hybrid triple play

By Jim Stening
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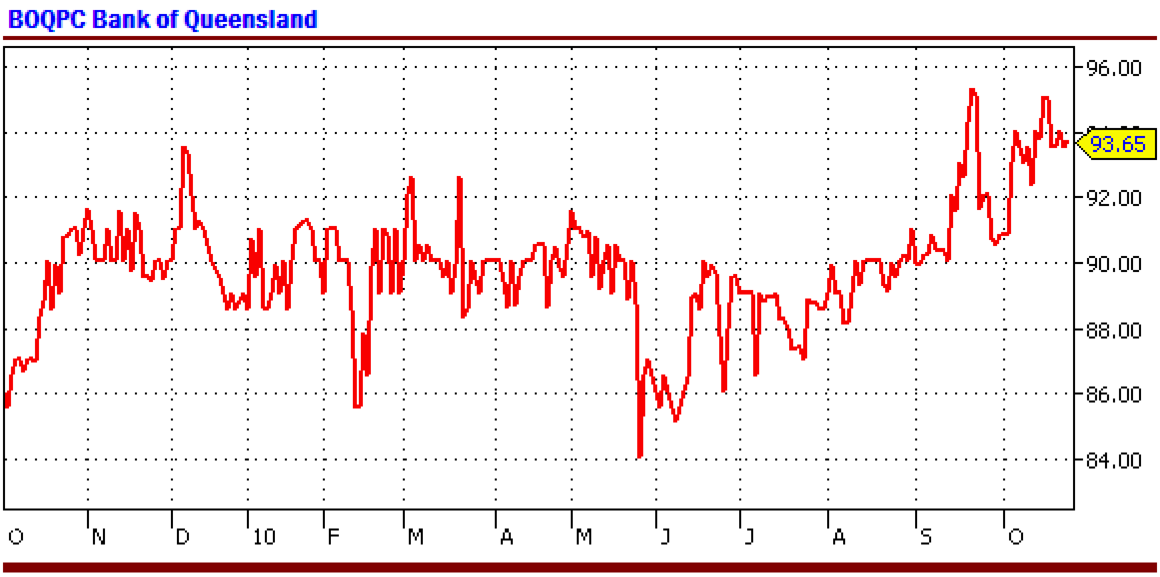
PORTFOLIO POINT: Hybrids from Bank of Queensland, Tabcorp and Gunns have their attraction improved by corporate or regulatory activity.

BOQ hybrid rallies. A number of preference shares continue to rally in price following the release of the Basel III proposals. Essentially, these changes to the bank capital rules increase the (already high) likelihood that Australian banks will convert/redeem their hybrids at the first opportunity.

Prior to this announcement, one of the securities trading at the biggest discount to face value based on the uncertainty was the Bank of Queensland's hybrid (BOQPC). However, with this risk now largely abated, the security price has shot up, as indicated in the following chart.



The BOQPC are a converting preference share but unlike the subsequent issues of these types of securities by other banks, the conversion terms aren't mandatory. This led to the risk that the bank would simply leave the security continue as a perpetual after the first call date on December 17, 2012, with the hybrid paying the relatively paltry coupon margin of just 2% over the bank bill swap rate.

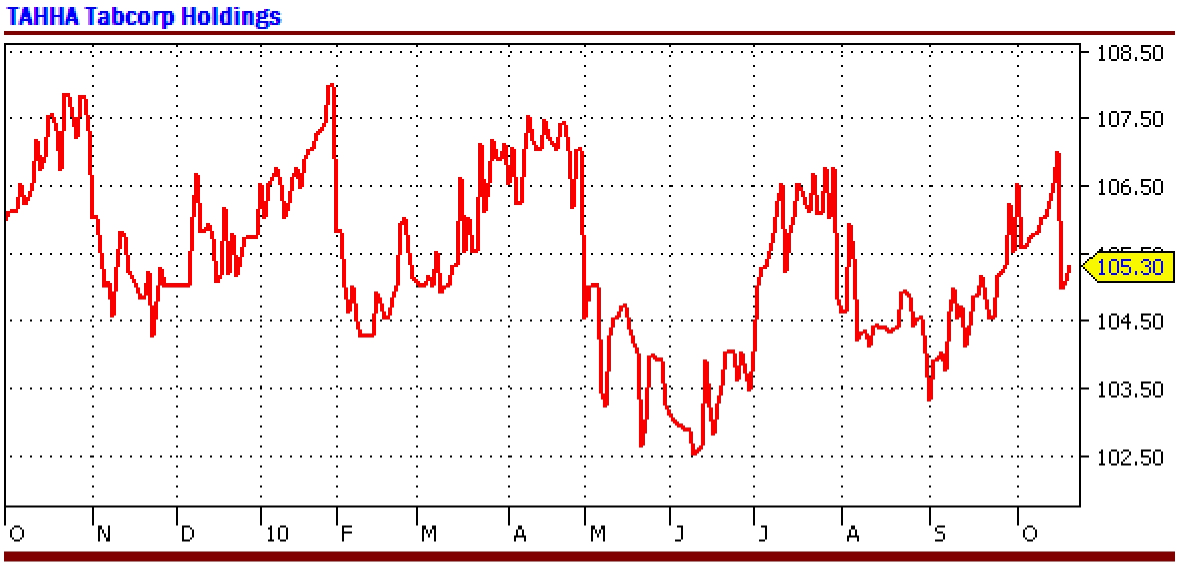
The Basel III proposals are still preliminary and full details of how they will apply are yet to be announced by the Australian Prudential Regulation Authority. However, the general theme of the accord is that banks will be expected to redeem/convert most existing hybrids at the first opportunity if they are to continue to qualify for capital adequacy purposes.

The opportunity to profit from this event still remains. A few months ago, the BOQPC was trading on a spread over the bank bill swap rate (BBSW) of more than 8%. Despite the recent price rally, it is still trading at more than 6% over BBSW. We rate BOQPC a buy.

Tabcorp punts on demerger. Tabcorp bond (TAHHA) investors have had a pretty good ride since the securities listed on the market in May 2009 with the security price consistently trading well above the issue price of $100.

Investors received more good news recently with the announcement that Tabcorp plans to demerge its casinos business from the rest of the company while simultaneously raising $430 million in capital.

The demerger has important implications for Tabcorp bond investors. The securities will remain within the Tabcorp entity, which will be a smaller entity without the casinos operation. The capital raising will bolster the balance sheet though to provide flexibility for the demerger to occur.



The deal is still subject to shareholder and regulatory approvals; however, we anticipate these will not be a major impediment to the demerger. If the deal is successfully completed, we expect Tabcorp to retain its investment-grade credit rating although there is the possibility it will be downgraded by a notch.

The Tabcorp bonds remain a reasonably attractive investment despite the uncertainty that this deal may bring. The securities are currently trading on a margin of close to 4% over BBSW, which is a competitive rate for a senior debt offering with low credit risk. We rate TAHHA a buy.

Gunns upgrades softwood sawmill. A few months ago there were rumours in the market that forestry business Gunns was about to go broke. That story always seemed a bit far-fetched and the recent announcement that it is poised to purchase the softwood sawmill from failed competitor Forest Enterprises Australia shows that the company is a long way from being consigned to the corporate graveyard.

The proposed deal coincides with Gunns plan to close down its nearby softwood sawmill plant at Scottsdale. This operation is old and inefficient. Gunns views it as unviable in both the short and long term and intends to replace it with the modern and low-cost production facility at Bell Bay.

The acquisition of the almost-new sawmill has received ACCC approval and Gunns is expected to close Scottsdale over the next four months. Overall, the proposed acquisition is mixed news for investors in the Gunns Forests hybrid (GNSPA).

While no acquisition price was mentioned we suspect Gunns has picked up the asset for a good price. Receivers generally aren’t in a position to demand a top price for assets and its unlikely the sawmill was in great demand from other parties. Gunns also has the advantage that it can derive synergies from this asset based on nearby wood supply.

The downside for GNSPA investors is that, in the absence of information to the contrary, we expect Gunns will be funding the acquisition with cash. This news in itself isn't necessarily bad though. While I would prefer that Gunns conserves cash and continues to pay down debt, the fact it can make the acquisition reinforces the view that the company isn't about to go broke anytime soon.

The risks involved in the acquisition are more than compensated for in the price of the hybrid. The GNSPA has already stepped-up and currently pays a quarterly fully franked distribution based on a grossed up margin of 5% over BBSW. On a current clean price of about $80, that translates to a perpetual running yield of more than 12%. There is also the prospect for further upside if interest rates increase as expected.

As with all stepped-up hybrids, there is also the potential for the security to be redeemed at face value ($100) on any future coupon date. We still expect Gunns to take up this option over coming years, considering the relatively high funding cost of this security to the company. The running yield alone makes this hybrid a worthwhile investment regardless of the potential for future redemption. We rate GNSPA a buy.

*Jim Stening is managing director of **FIIG Securities**.*