

EUREKA *report*



NAB's lively hybrid

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PORTFOLIO POINT: This perpetual's deep discount means it is offering a high running yield.

It has been 15 months since any of the major banks offered a new hybrid security. The pause in issuance is attributable to banks finding a suitable structure that meets APRA's approval in the wake of new global standards for banks – known as Basel III – following the GFC.

With the new structure for bank hybrids nearly in place we would expect that the major banks will come to market again this year. The key question is: what impact will this have on existing bank hybrids with an emphasis on the most recent type of security, the converting preference shares?

The purpose of hybrids (at least as far as regulators are concerned) is to absorb losses when banks experience difficulties. However, the global financial crisis exposed some flaws between theory and practice.

Essentially, because hybrids sit higher up the capital structure than ordinary equity, it was shareholders who felt the brunt of any pain experienced when the banks were floundering. They were forced to recapitalise the banks via equity raisings while hybrid investors (at least in Australia, anyway) continued to receive all distributions on their investments and ultimately being repaid capital on call/maturity dates.

Regulators, though, plan to change this. They intend for hybrids to become loss-absorbing instruments so in the event that a bank experiences severe financial difficulties, it won't just be shareholders feeling the pain but hybrid investors as well.

The way this will work is that all new hybrids will need to include either a write-off clause or a conversion to equity clause in their terms and conditions. Without going into the fine detail of these clauses, hybrid owners will be forced to accept less than 100¢ in the dollar for their investment in the event the bank needs to recapitalise.

These loss-absorption clauses make the new proposed class of hybrids far riskier investments than the existing crop of securities, in particular the most recent instrument, converting preference shares.

To entice investors to purchase this new class of hybrid, issuers will be forced to pay a significantly higher margin on them. While no bank is yet to test the market with a new hybrid, we expect they will be forced to pay a premium of at least 1% above current spreads to compensate for the additional risks involved.

Major bank hybrid spreads



The above chart illustrates the current spreads on major bank converting preference shares, step-up preference shares and the stand-alone National Income Securities (NABHA). Currently, the highest spreads are available on the step-up preference shares and these remain among our favoured major bank hybrids.

I would expect any new issuance of hybrids to be at spreads in excess of all current issues on offer.

While there is a good reason these securities will offer higher returns, we suspect there will be some investors who will be indifferent to the risk and purely regard the hybrids as a major bank exposure.

This may result in a sell-down of existing securities to help finance switches into the new hybrids, which will be offering superior yields. The converting preference shares that are trading at substantial premiums to face value, such as the CBAPA and WBCPB, would be most at risk.

Our pick of the bank hybrids

One existing major bank hybrid that we think offers good value is the NABHA. This security is a true perpetual, meaning when it was first issued it was never meant to be redeemed, paying a coupon margin of 1.25% over the 90-day bank bill swap rate.

The main attraction of this security is that due to the deep discount in its current price (about \$81 on a clean price basis), it offers a high running yield for a highly rated Australian major bank of about 7.6%.

Currently, the security classifies as tier-1 capital for the bank but under Basel III our interpretation is that it would lose this status (pending a decision from APRA).

There is an argument that this means little for the NABHA because even as perpetual senior debt (I think it will still at least initially qualify as tier-2 capital) it represents a cheap form of funding for the bank.

However, this ignores the point that the security will no longer serve its original purpose of counting as a tier-1 instrument. We believe this will provide the bank's management with an incentive to buy back the securities at a premium to the current price.

Another option would be to restructure the securities. However, to gain security holder approval, the bank would need to improve the current terms of the hybrid, which would then likely also lead to an increase in the price.

While there is no guarantee that the bank will undertake either of these initiatives, we believe that the upside from such options aren't being priced into the security. When this option value is combined with the attractive running yield of the hybrid, the NABHA appears to be good value.

Summary

We would expect that the banks will come to the market later this year offering a new class of hybrid security. Due to the additional risks that will be involved with these hybrids they will command higher yields, which may result in a sell-down of existing hybrids as some investors will be indifferent to this added risk and simply chase yield.

For investors adopting a long-term strategy, we are comfortable with the existing CPS and SPS securities the banks have on offer. While they might suffer a near-term price decline, we are confident investors will continue to receive income from these securities and have their capital returned at maturity while holding a low-risk hybrid.

Traders may wish to be a bit more proactive in their approach, however. There is the potential for existing hybrids to be sold down so that the yields on these instruments will be more commensurate with the new class of hybrids likely to be issued later this year.

Our overall favourite pick of the major bank hybrids is the NABHA. Despite its perpetual status, its discounted price means it is offering an attractive long-term running yield. Further, there is potential upside to the security price if the hybrid is restructured in the future to allow it to maintain tier-1 status in a Basel III environment.



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