

EUREKA *report*



Step-ups' big potential

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PORTFOLIO POINT: They're offering strong, double-digit returns, but there are risks associated with step-up hybrids.

Hybrids – securities that blend debt and equity – can be structured in various ways. Where banks have favoured a structure in which the security is eventually converted into equity, other corporates tended to issue step-up preference shares, which present different challenges and opportunities.

The step-up preference share is structured as a perpetual security, which means they have no maturity date although they will eventually reach what is known as a call date after a set period of time, normally five years. When this initial call date is reached the issuer of the hybrid has several options.

Call date options

The first option the issuer has is to redeem the security for face value (usually \$100). This is the preferred option for investors who regard the instrument as a fixed income security and expect their capital back at the first opportunity. But in this post-GFC world many issuers have explored other options.

The second is for the issuer to exchange the hybrid into ordinary shares of the issuer. The exchange is usually done at a discount to the prevailing price of the ordinary shares (normally 2.5%) so that the investor will receive a slight premium to the face value for their investment, so in the case of a hybrid priced at \$100 the investor receives \$102.5 worth of ordinary shares.

This small discount provides investors with an exit mechanism to sell the ordinary shares without incurring a capital loss. While it is possible the price of the ordinary shares may drop by more than 2.5% as hybrid investors cash out, a 2.5% buffer is more than sufficient in most cases to ensure no capital loss is incurred.

A third option is for the issuer to remarket the terms of the security, although this clause is rarely invoked. The main purpose of this is if the issuer is looking to set a new coupon margin for the securities below the stepped-up margin (which we will discuss below). However, since the global financial crisis, this has become a redundant clause due to the vast increases in the cost of funding.

If the issuer elects to not utilise any of these options then the default clause of a step-up occurs, which increases the yield of the hybrid. A typical step-up in margin can be anywhere between 1% and 2.5%, to provide issuers with an economic, not just a reputational, incentive to redeem the security at the first call date.

Essentially, this stepped-up rate is supposed to be a prohibitively expensive cost for the issuer but during the GFC, when the cost of debt skyrocketed, paying the stepped-up margin was in fact less of an impost on the issuer than sourcing funds elsewhere.

Issuers also have a range of other options available. With many step-up preference shares currently trading at significant discounts to face value some are re-purchasing-back these securities in on or off market buybacks. Other issuers are contemplating changing the terms of the hybrids, a process that is subject to the approval of shareholders at a general meeting.

An example of a step-up preference share is the Goodman Plus Trust hybrid (GMPPA) issued by the Goodman Group. The security was initially issued in March 2008 paying a margin of 1.9% over the bank bill swap rate (BBSW). If the security isn't redeemed at the first opportunity in March 2013 then the margin on the hybrid will increase to 2.9% over the BBSW.

Step-up or redeem?

The following table sets out a selection of step-up preference shares currently on issue. As mentioned above though, some issuers may not elect to redeem the security at the first opportunity so while the yields may look impressive (they are calculated on the basis they will be redeemed on the call date), they may prove to be misleading.

| Step-up preference shares currently on issue | | | | | | |
|--|----------|----------|-----------|--------------|---------|--------|
| Name | ASX Code | Price | Call Date | Rate | Step-up | YTM |
| Dexus Rents | DXRPA | \$93.44 | 01-Jul-12 | BBSW + 1.30% | 2.00% | 12.17% |
| Fairfax | FXJPB | \$102.50 | 30-Apr-11 | BBSW + 1.55% | 2.25% | 9.20% |
| Goodman | GMPPA | \$76.24 | 31-Mar-13 | BBSW + 1.90% | 1.00% | 22.55% |
| Orica | ORIPB | \$99.30 | 30-Nov-11 | BBSW + 1.53% | 2.25% | 11.02% |
| PaperlinX | PXUPA | \$66.75 | 30-Jun-12 | BBSW + 2.40% | 2.25% | 47.14% |
| Transpacific | TPAPA | \$70.00 | 01-Oct-11 | BBSW + 3.50% | 2.50% | 96.99% |
| Woolworths | WOWHB | \$99.50 | 15-Sep-11 | BBSW + 1.10% | 2.00% | 7.80% |

Source: FIIG Securities, ASX, as at March 28, 2011

By looking at the prices of these securities you can get an indication of the likelihood of the security being redeemed at the first opportunity. For hybrids trading close to face value, there is a good chance the issuer will redeem them at the first opportunity. For securities trading at substantial discounts to face value, there is a good chance the issuer will elect to step-up the coupon margin instead.

The Woolworths hybrid (WOWHB) is a good example of a security that is likely to be redeemed. Woolworths recently issued debt on terms that are more favourable than those listed here and this fact is reflected in the above price of \$99.50, which is a fraction away from the issue price of \$100.

Conversely, the PaperlinX hybrid (PXUPA) is unlikely to be redeemed and instead stepped-up after its first call date of June 30, 2012.

The company has been struggling operationally for some time and although it has relatively low debt levels, it would likely struggle to redeem the full \$285 million of hybrids securities on issue. The company has, however, flagged that it is reviewing its options for the hybrid so a partial buy-back of the securities (likely at a discount to the \$100 face value) remains a possibility.

Risks and protection

Also, bear in mind that the discounted price of some of these securities is a reflection of credit risk. If the issuer goes broke then hybrid investors are unlikely to see a return in a liquidation of the company, which is one of the key risks in sitting just above ordinary equity in the capital structure.

The other main risk apart from insolvency is that the issuer may suspend distributions on the security at their discretion. This is so the securities meet the equity requirements on a balance sheet as defined by the accounting standards.

Hybrid investors are protected from the issuer just simply not paying distributions by a number of mechanisms. By far the strongest is the clause that the issuer won't be able to pay dividends to ordinary shareholders if distributions on the hybrid aren't being made. This is known as a distribution stopper.

While unusual, it is not unheard of for issuers to suspend distributions on their hybrids, usually at the behest of the company's banks who are looking to safeguard their position. In the past, PaperlinX suspended distributions for a year but has since reinstated them. Currently, the hybrid issued by Elders (ELDPA) remains suspended although is forecast to be re-instated in the last quarter of 2011.

Stepped-up preference shares

As previously mentioned, a number of issuers have elected not to redeem their hybrids at the first call date and instead allowed them to step up. Detailed below are the "stepped-up" hybrids currently listed on the market.

| Stepped-up hybrids currently listed on the market | | | | | |
|---|----------|----------|--------------|---------------|----------------|
| Name | ASX Code | Price | Rate | Running Yield | Capital Upside |
| Australand | AAZPB | \$93.00 | BBSW + 4.80% | 10.23% | 7.50% |
| Gunns | GNSPA | \$71.10 | BBSW + 5.00% | 13.74% | 40.60% |
| Multiplex | MXUPA | \$79.70 | BBSW + 3.90% | 11.11% | 25.50% |
| Seven | SVWPA | \$92.95 | BBSW + 4.75% | 11.04% | 7.60% |
| Ramsay Health | RHCPA | \$103.95 | BBSW + 4.85% | 9.77% | -3.80% |

Source: FIIG Securities, ASX as at March 28, 2011

A number of these securities are attractive investments. They typically offer investors a double-digit running yield, with the prospects for capital gains (due to the discount they are trading at to face value) for securities that are lower risk than equities (higher placed in the capital structure).

While these securities are perpetual in nature they may still be redeemed by the issuer on any coupon payment date. As credit markets continue to normalise after the GFC, issuers may look at redeeming these securities, resulting in a one-off capital gain for stepped-up preference share investors.

A good example is the Australand Assets (AAZPB). At a current price of about \$93, it is offering a running yield of about 10.50% based on a current annualised coupon rate of around 9.7%. The margin of 4.80% over BBSW is an expensive form of funding in the current environment and if the company redeems the securities then investors are set for a one-off capital gain of 7.5%.

Step-up preference shares potentially offer exceptional returns for investors, although it is dependent on whether the issuer redeems the security at the first call date. Potentially there are better returns available in stepped-up preference shares that offer high running yield plus the prospects of capital gains if the securities are redeemed by the issuer.



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