

ANZ's euro tempter



By Elizabeth Moran

PORTFOLIO POINT: If you can afford ANZ's latest hybrid offering, expect a yield of just over 12%.

The current uncertainty in Europe has meant some securities have been oversold and the prices have fallen to unbelievable lows. For instance, there is an ANZ tier-one hybrid (called the ANZ Euro Capital Trust) available to wholesale investors with a first call date of December 15, 2014, that is trading at just €74 per €100 face value.

Now there is some risk around the call date, and I'll explain that in more detail later, but essentially I expect ANZ to call the security on that first call date and repay face value of €100. That equates to an expected yield to maturity of just over 12% (or three-month Euribor + 1050 basis points), being a €26 capital gain over 3.2 years plus coupons of three-month Euribor + 0.66% currently 2.2% pa.

A 12% return for ANZ risk is outstanding value. I don't think anyone believes ANZ will default or have any reason not to call this security at the first opportunity, but as with any investment there are risks, which I'll explain.

Tier-one securities sit low in the capital structure

First, it's a tier-one security, which means it sits low in the bank's capital structure and is meant to absorb losses if the bank gets into financial difficulty. Tier-one securities are technically perpetual in nature and in limited circumstances can have coupons deferred or cancelled. In addition, lower-ranking securities are higher-risk in a liquidation scenario and, as such, should pay higher returns to compensate for the higher risk of loss.

Tier-one securities are used to satisfy regulatory requirements that banks set aside funds to absorb losses (on an ongoing basis) in case of financial difficulty. However, investors want to know when they can expect to be repaid. Historically banks have had an implied agreement with investors to repay these tier-one securities at the first call date, in that way satisfying regulators that the capital is perpetual but also satisfying investors' needs.

With this security, one risk is that ANZ fails to repay investors at that first call date of December 15, 2014, and then the investment becomes perpetual.

There are several reasons why I think ANZ will repay the security at the first call date:

- Throughout the global financial crisis, ANZ continued to call all tier-one securities at the first available opportunity, as did the other major Australian banks. They maintained their reputation with investors.
- Non-call may be interpreted as financial difficulty, a poor signal to the market at this time.
- If ANZ chose to not repay, any new issues would have to pay higher coupons. During the GFC, Deutsche Bank failed to call one of its tier-one securities for economic reasons, as the coupon was very low and the bank was not able to refinance the debt at the same low rate. Deutsche Bank then suffered as the market expected to be compensated for that uncertainty in final repayment with a higher margin on its new issues. So debt became more expensive.
- As a step-up security, this ANZ tier-one will no longer qualify as

capital towards tier-one/total capital ratio calculations under new regulations proposed by Basel 3/APRA, if it is extended past its call date.

In fact, in a consultation paper last month titled *Implementing Basel 3 capital reforms in Australia*, APRA wrote that "outstanding non-complying instruments [such as this ANZ step-up tier-one] will be **required to be phased-out no later than their first available call date**, where one exists" (emphasis and [information] added).

The bank isn't legally obliged to repay the debt at first call but I think it very likely.

Currency risk

Buying a foreign currency bond means buying that currency without knowing what the exchange rate will be when the security is repaid. So there is a risk the Australian dollar will vary and thus uncertainty in regards to what eventual return you will receive. There are hedging options available.

For investors who have existing Euro accounts and assets, or are indifferent to the currency risk, I believe this is simply an outstanding opportunity. Most Australian bank hybrids (listed and unlisted) are trading at margins of 3–5% over respective base rates meaning the 10.5% spread on the Euro Capital Trusts is exceptional.

Why is the hybrid price so low?

Investors get nervous in volatile markets and securities that aren't as well understood are often sold off. International investors are generally very comfortable with Australian banks, but consider two main risks: that the country is reliant on commodities for a large proportion of its income; and that the banks have a high exposure to what is considered an overpriced property sector.

Another reason the price may be low is that European institutional funds could be faced with redemptions, so would be forced to sell some of their assets.

With this security trading at such a wide margin over other ANZ issues, I simply think there is an anomaly in the market, presenting investors with a great opportunity.

Similar to ANZ CPS3

The ANZ Euro tier-one ranks equally with the ANZ hybrid CPS3 issued recently in the Australian market, and available to retail investors, meaning should ANZ go into liquidation, both securities have an equal right to repayment. The Australian market was very excited about the CPS3 given a margin of 3.1% over the bank bill swap rate (BBSW), but when compared to this Euro issue, the pricing looks cheap for the bank. (For more on the CPS3, click [here](#).) Still ANZ managed to upscale the size of the issue due to demand, from the initial \$750 million to \$1.34 billion (see the table below for a comparison between the two securities).

	Euro Capital Trusts	ANZ CPS 3
Structure	Step-Up Preference Share	Converting Preference Share
First Call/Conversion Date	15/12/2014	1/09/2017
Coupon	EURIBOR + 0.66%	BBSW + 3.10%
Step-Up	1.00%	Nil
Denomination	Euros	Australian Dollars
Capital Structure	Preference Share	Preference Share
Call Risk	Yes	No
Conversion Price Risk	No	Yes
Core Tier 1 Loss Absorption Risk	No	Yes
Trading Margin	Circa 10.0% over	Circa 3.1% over

Source: FIIG Securities

Elizabeth Moran is director of education and fixed income research at [FIIG Securities](#).