

EUREKA *report*



What the hell are hybrids, anyway?

By Elizabeth Moran

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PORTFOLIO POINT: Here's a primer on the how, what and why of hybrids.

As Eureka Report subscribers will have gathered from today's lead story by Robert Gottlieb (click [here](#)) and other recent stories including my review today of two key issues from Origin Energy and AFIC (click [here](#)), hybrids really are becoming a key part of the Australian investment landscape. But I find many investors still need to understand the basics of hybrids. Moreover, they need some guidance in how to spot value. So let me explain.

What is a hybrid?

The term hybrid is a broad classification for a group of securities, used by a variety of companies to raise money that combine debt and equity characteristics. Hybrid securities pay a predetermined (fixed or floating) rate of return or distribution until a certain date. At that date the issuer may have a number of options including converting the securities into the underlying ordinary shares of the issuer (in most cases the options are determined by the issuer of the security but occasionally the investor does have some options).

This may allow the company to classify the security as equity but also claim tax benefits of issuing debt, and hence offer a higher return for the risk involved.

It is important to note that every hybrid security is structured differently, which allows more flexibility, but also additional complexity making them difficult to assess in terms of the risk/ reward continuum. Some securities behave more like fixed income, while others behave more like the underlying shares into which they convert.

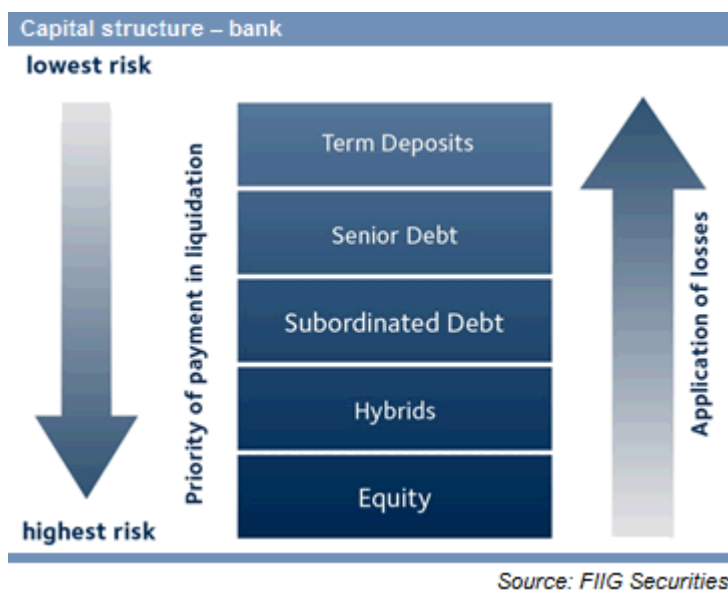
To be regarded as equity, hybrids must be perpetual in nature: that is, they have no maturity date. So although many of these securities have clauses whereby they can be redeemed at the issuers', not the investors', option, they technically have no set maturity date.

In a stressed market perpetual hybrid prices can behave similarly to the equities of the same company that issued them and there can be periods of

illiquidity, so if you are a forced seller, you may have to accept a larger bid-offer spread. But they have specific characteristics that set them apart from being valued purely as an equity security, including:

- Hybrids typically rank higher in liquidation and also have priority in the payment of distributions when compared to ordinary shares (see the capital structure diagram below).
- The distributions/coupons (if paid) are pre-determined as either a fixed rate or a margin over the benchmark bank bill swap rate (BBSW), unlike ordinary share dividends where payments can vary significantly.

These features are typical of debt securities and mean that while perpetual hybrids and equity are alike in many ways, they are lower risk than traditional equity.



Issuers: Bank versus corporate hybrids

Financial institutions and corporations both issue hybrids and in both cases the securities are meant to be loss-absorbing and protect bondholders and other creditors more senior in the capital structure (see the above chart). There are a couple of important distinctions, though. Financial institutions are regular issuers of hybrids and need hybrid funds to contribute to regulatory capital. So they have a vested interest in ensuring the market readily accepts their issues.

Bank hybrids (often called Tier-1 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-1 securities at the first call date, in that way satisfying regulators that the capital is perpetual but also satisfying investors'

needs.

So, in international markets the majority of banks call (or repay) their hybrids at the first opportunity which is usually after five or 10 years (for more detail, see ***ANZ's Euro tempter***).

An extra incentive is that the new Basel III regulations will penalise banks that don't repay most existing hybrid securities at first call, and new financial institution hybrids are likely to be issued with a trigger where securities are converted to equity or accept a capital write-down to meet Basel III requirements.

Hybrids issued by Australian financial institutions also have the added benefit of being overseen by the Australian Prudential Regulation Authority.

Corporations, on the other hand, are less frequent issuers and are more likely to not call at the first opportunity, particularly if replacement funding would be more expensive than extending the existing hybrid. This is because corporations aren't necessarily regular issuers and don't have the same reputational risk as financial institutions so have less incentive to repay the hybrid at the opportunity.

Distributions can also be suspended, although there is usually a dividend stopper clause meaning dividends on shares must be halted as well, something most companies are very reluctant to invoke.

Australia's market is relatively under-developed so the number and range of issuers is much lower than in other countries.

The hybrid market

Most Australian investors would know hybrids from the ASX-listed hybrids reported in the press. The list of about 30, of which about half are bank securities, are only a very small part of the domestic and international markets. The ASX-listed hybrids are available to all investors and once listed there is no minimum tradeable parcel. On first issue these retail hybrids are usually sold in \$5000 parcels.

Consequently when high-quality corporations have new issues, such as the recent Woolworths, Origin and AFIC issues, they are well bid, providing diversification to portfolios and a high rate of return.

However, the hybrid market is so much more than those listed on the ASX. Many hybrids are never listed on an exchange and are traded in the over-the-counter (OTC) market, the same way as bonds so you need a fixed income broker to be able to buy and sell. Again, this market is under-developed in Australia and most investors need \$500,000 face value to invest, although

some brokers have split bonds into smaller parcels and can make hybrid or Tier -1 securities available in parcels from \$50,000 face value.

How to transact

- The vast majority of hybrids are traded over-the-counter (OTC) that is there is no exchange used for the majority of these securities, which means you'll need to find a fixed income broker who matches buyers and sellers in the market. Otherwise, you can use your stockbroker to buy ASX-listed hybrids.
- Settlement for OTC traded hybrids is the same as for bonds and usually takes place three business days (T+3) after the day the contract is issued for the transaction.
- Investors are issued with a contract note when the trade is agreed, which includes the full details of the security involved.
- No fees are paid on the trade. Brokers take a small margin between the seller offering the security for sale and the buyer purchasing the security. No transaction would occur unless both were happy with the transaction, which means the margin is typically small. The actual transaction is the only way the broker makes any money. Unlike managed funds, there are no ongoing fees.
- In OTC cases, investors do not receive a certificate for their holdings. The holdings are held in an electronic register called Exigo (formerly Austraclear). If investors don't have an Exigo account, the securities are held in a custodian account, much like shares are held with a HIN.
- If you want to sell OTC hybrids, you would need to contact your broker who would then find a buyer through their networks.



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