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## HYBRID HORRORS

*The shine goes off debt-equity securities*





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## *The shine goes off debt-equity securities*

*Talked about as a win-win-win for investors, advisers and corporates alike, hybrid securities are not regarded as the sure thing they once were. FIONA HARRIS reports.*

**F**ailures such as Babcock and Brown and Orica have made investors and advisers more aware of hybrids' shortcomings as well as the discretionary option for issuers to stop dividend payments at any time.

Yet despite this, there is much anticipation over the prospect for there to be more corporate hybrid issues on offer in the coming year.

A good indicator has been the reaction to the Woolworths Notes II issue in early November.

Four times oversubscribed, this hybrid capital domestic raising of \$700 million was swamped, leaving many disappointed investors and advisers.

According to Shadforth Financial Group principal and senior financial adviser Matthew Torenus, following this experience, more hybrid activity is definitely on the cards.

"Companies will be keen to tap into investor interest. It [Woolworths Notes II] has shown when they are priced well it is well supported, particularly when investors have a greater reluctance to invest in equities," Torenus says.

The first raising to take place under the new rating agency rules, the Woolworths Notes II issue has both debt and equity characteristics, hence the name hybrid.

Analysts say this structure meant it appealed to retail investors who currently have a strong appetite for familiar blue-chip companies. Meanwhile, from Woolworths' point of view, the funds raised will reportedly help to finance the \$1.7 billion in bank debt Woolworths needs to refinance before May 2012.

Hidden behind the hysteria are legitimate concerns over the reliability of hybrids in volatile market conditions as well as the impact of redeeming the investment prior to maturity.

### HYBRIDS ARE

A hybrid issue is a capital management strategy

used by corporates. In volatile market conditions it is regarded as a particularly useful tool as it means companies can raise equity-like capital at attractive rates.

Historically in Australia, hybrids have been used primarily by the major banks. However, it is now expected that with continued volatility in global share markets, we could see more corporates raising capital through domestic hybrid securities issues.

The term hybrid securities is fairly broad and therefore extends to products such as convertible notes, which have been around for about 20 years

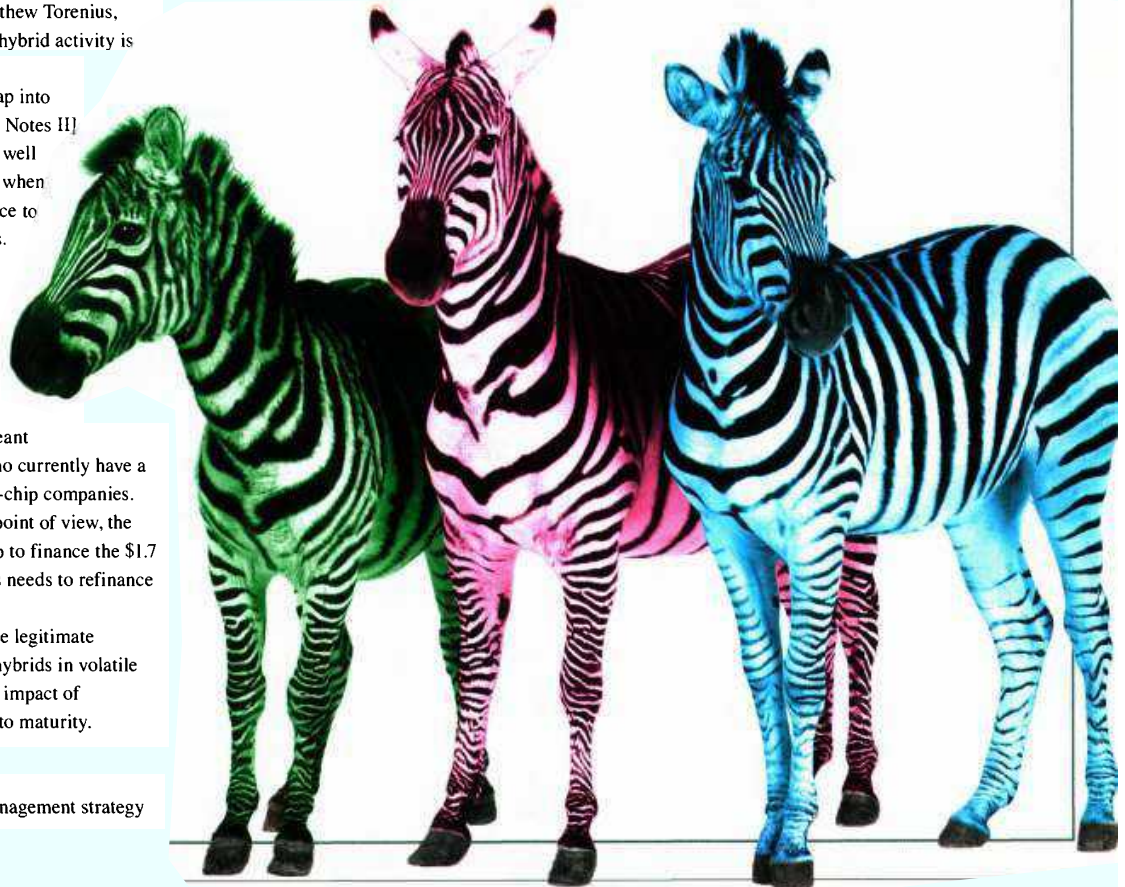
Hybrid refers to the fact these investments are both debt and equity. They pay either a fixed or

floating rate of return or dividend until a certain date when the issuer has a number of options, including converting the securities into shares.

According to FIIG Securities, Australia's largest non-aligned fixed income broker, there are currently five types of hybrid securities available in the Australian market, the most common corporate hybrid being step-up preference shares.

It says these preference shares normally pay a floating rate coupon and have a call date after a set period, normally five years.

If these securities are not called at the first call date, then the coupons 'step up' to a higher rate to compensate investors for non-redemption.





Woolworths Notes II is the most recent example of a step-up preference share available on the market. Other examples include Fairfax Stapled Preference Securities and Orica Stapled Preference Securities.

Over their long history, the structure of hybrid securities has evolved due to changes in taxation rules and legislative requirements. These changes have also facilitated the diversity in the type of investments now on offer.

Other hybrids typical in Australia include income notes and securities, reset preference shares, converting preference shares and stepped up preference shares.

#### LOWING HYBRIDS

The oversubscription of the recent Woolworths hybrid offer demonstrates the marked interest investors have in hybrid securities.

And certainly environmental issues have served to facilitate this interest. The uncertain global economic outlook and investor appetite for interest-bearing investments draws investors into this space.

Adviser support in this space is significant and has grown over the past decade. Centric Wealth portfolio manager Mark Cox estimates up to 50 per cent of retail advisers use hybrids in their clients' portfolios.

"It's quite an important asset class," Cox says.

He says Centric Wealth has been active in the hybrid market for many years. The business secured an allocation to Woolworths Notes II and says most of its clients will have an allocation to it.

"Generally, Centric only accepts [hybrids] from the larger blue chips, predominantly the banks, and now we are adding Woolworths," he says.

He says there are also some legacy hybrids to which its clients have exposures, but as a rule, it does not go for low or unrated hybrid issues.

Woolworths is one of the best-quality companies in Australia given its benign debt levels, he says. "Its capacity is very high," he says.

Meanwhile, Shadforth Financial Group was unable to secure any of the Woolworths Notes II issue, but says it has been using hybrid securities for a long time in its clients' portfolios.

"It is regarded as fixed interest although we do have to make the client aware it is not a term deposit," Torenien says.

Although there is obvious interest in hybrids, not everyone is completely sold on what they have to offer.

Stewart Partners chairman Nigel Stewart believes most people who invest in hybrids would not be aware of the risk.

"They are just focusing on the bill rate. It sounds okay, but what if they trade lower than the bill rate or if rates go a different way," Stewart says.

He says he did have a client contact him looking to invest \$400,000 in the Woolworths Notes II issue. "I said no, we wouldn't recommend it at all," he says.

Morningstar equities analyst Ravi Reddy says it is important people keep in mind the sector is not without its dangers and that money has been lost from hybrid issues.

"People have to be aware that while yields are higher than putting money in banks, it does carry more risk, so this is why we prefer issues by the major banks or higher-quality industrials. The bank issues are much more liquid," Reddy says.

No hybrids fit the bill for Stewart Partners. "With all the research we've done on hybrids, we can't get comfortable with them," Stewart says.

#### HYBRID ACTIVITY PROTECTED

More hybrid securities issues are expected in the coming calendar year, partly in response to the rise in corporate financing costs as well as increasing bank funding costs.

But stock market volatility is also having other effects, honing investor appetite for safer income-generating investments from brands they know and are comfortable with.

While Reddy says he does expect some more hybrid issue activity, especially from the major banks, he does not predict a rush.

"Corporate balance sheets are much better capitalised," he says.

In August, ANZ conducted a \$1.34 billion listed hybrid securities raising. Meanwhile, Santos and Origin Australia conducted international raisings in the European debt markets late last year.

In October this year, Woolworths redeemed its previous \$600 million issue of listed hybrids. These were issued in 2006 and last month represented the earliest possible call date.

Reddy says originally the Woolworths issue was to raise \$500 million, but was increased to \$700 million. The general offer was cancelled so the issue was made



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**RAVI REDDY**  
Morningstar

available to broker clients or shareholders only.

#### WHAT HYBRIDS CAN DELIVER

For corporations using hybrid securities, it forms part of their capital management strategy. For them, it is similar to raising debt but with more flexibility in terms of dividends, which can be discretionary.

Attractive to investors for a variety of reasons, probably topping the list is the regular payment of distributions either quarterly or half yearly.

They also have a higher yield than banking deposits.

"Some bank deposits get 6 per cent, but some bank ones [hybrids] are closer to 8 per cent," Reddy says.

Most are priced at the 90-day bank bill swap rate (BBSW). The Woolworths Notes II offer will pay quarterly interest at 3.25 per cent above the BBSW. Further, on 24 November 2016 and at Woolworths' discretion, it can redeem the notes at face value of \$100, or let the margin increase 1 per cent. The notes mature in November 2036.

Some hybrid securities also carry franking credits.

"Typically hybrids (are) for the retail investor, the focus is on yield or income, particularly in the pension phase," Cox says.

"They tend to be a good option to access income securities, otherwise the corporate bond market is not as accessible."

#### THE PERILS OF HYBRIDS

Credit and interest rate risks pose the most significant risks when investing in hybrids.

Credit risk refers to the risk that the issuer will not be able to meet the interest or capital payments on the hybrid when they fall due. In hybrid securities, dividends are discretionary and can be stopped. Further,

#### Top three questions to ask when assessing a hybrid issue:

1. How does it stack up to similar quality issues?
2. What changes have been made to its structure?
3. What is the ability to use franking credits?

**Source:** Shadforth Financial Group principal and senior financial adviser Matthew Torenien



some dividends are non-cumulative and therefore do not have to be made up.

"During the GFC (global financial crisis), some were suspended. But some [suspensions] have come off since the market has recovered," Cox says.

How common is it for a dividend not to be made?

"At the top end, not so much," Torenus says, however he says investors have to keep up with nuances of hybrid issues.

"No two issues are the same," he says.

But it has happened. Reddy cites examples such as Paperlinx and Elders. In the case of the former, the company did not make distributions and then decided to not make them up either due to "challenging market conditions", he says.

Meanwhile, interest rate risk refers to adverse movements in interest rates. According to FIIG Securities, in general as rates fall, the price of a hybrid will rise and vice versa.

"In the middle of the global financial crisis, we did see the face value of a number of hybrids decline. The market was becoming perhaps a little complacent when it comes to hybrids and they do have equity characteristics," Torenus says.

In March last year, Moody's decided to downgrade a range of hybrid securities issued by Australia's major banks after changes it made to its methodology. One of its concerns was the hybrids were now more vulnerable to being hit by defaults following moves by government to stabilise the global banking system.



“The problem with hybrids is they have been very volatile. If they [investors] want to get out before maturity they get a heck of a haircut.”

**NIGEL STEWART**  
Stewart Partners

"The recent GFC may result in the potential weakening of hybrid investor claims to dividends, though this fact has not been widely publicised," Stewart Partners says in a paper titled "Hybrids: Are they a substitute for fixed interest securities?"

At the time, the affected hybrid securities included those issued by ANZ Banking Group, Commonwealth Bank of Australia, Macquarie Group, National Australia Bank and Westpac Banking Corporation. But according to Stewart Partners, such action is not a highly-publicised point and one that impacts on the risk characteristics of hybrid securities.

"If there is a re-rating of the corporate, it will be reflected in the pricing. The cost of debt will go up and the price of equities will fall to compensate investors. You can't escape from that in hybrids," Stewart says.

Another concern over hybrids includes the risk investors take if they do not hold them to maturity.

"The problem with hybrids is they have been very volatile. If they [investors] want to get out before maturity, they get a heck of a haircut," Stewart says.

Stewart Partners notes the example of Commonwealth Bank's Pearl IV issue listed in July 2007 at \$200. If an investor needed their capital in early 2009 at the height of the GFC, it estimates they would have incurred a loss of up to 18 per cent.

There is also a warning that too high an allocation to hybrids can lead to a reduction in the ability for fixed interest to operate as a 'risk dampener'.

"Investing a significant sum in one hybrid issue gives rise to a concentration of risk," Stewart Partners says.

"Diversification in fixed interest portfolios is essential, as these funds provide an 'anchor' or 'risk dampener' for the overall portfolio."

It says its clients typically have a minimum of 120 underlying securities in their fixed interest portfolio.

Torenus says: "It is a bit of an education process with clients that as you go down lower in grade, outside the top major banks, you do have to be more cognisant that the capital base is more volatile.

"You do have to outline to them it is not a term deposit."

**WOLWORTHS NOTES II DETAILS**

Woolworths plans to raise \$700 million in interest-bearing notes, paying quarterly interest at 3.25 per cent above the 90-day bank bill rate.

On the step-up date of 24 November 2016 and at its discretion, Woolworths can redeem the notes at face value of \$100, or let the margin increase by 1 per cent. Minimum subscription is \$5000 or 50 notes.

The notes mature in November 2036.

**ROLE OF HYBRIDS IN AN INVESTMENT PORTFOLIO**

Hybrids are mostly incorporated into the fixed income allocation of a client's portfolio. Reddy says this is because apart from bank deposits, there is not a lot of other fixed income investments on offer.

Typically hybrids are for the retail investor, with a focus on yield or income, particularly in pension phase.

"They tend to be a good option to access income securities. Otherwise the corporate bond market is not as accessible," Cox says.

He says allocations to hybrid securities are made within a client's exposure to domestic floating rate income. He says a client could have a 10 per cent to 50 per cent allocation to domestic floating rate income and within that a sector allocation to hybrid securities of anywhere from 11 per cent to 21 per cent.

"So (it's) fairly significant," Cox says.

One of the features he likes about hybrids is their ability to augment other securities. "They tend to be higher-yielding investments. Notwithstanding their higher risk profile, they enhance diversification and total income," he says.

Torenus says it is difficult to say what sort of allocations an investor might have to hybrid securities, but it would not be unusual for him to have a client who was receiving an income stream from a self-managed superannuation fund to have an allocation of between 10 per cent to 20 per cent.

Because of their characteristics, hybrids are typically a buy-and-hold type of investment and this is the way investors tend to use them.

"People are focusing on them for yield rather than capital gain. These aren't pure debt. They rate just above equities," Reddy says. «