

# Special Report

## Hybrids – Back to basics

### What are hybrids?

Given the recent onslaught of income security issues, we have decided to go back to basics

Hybrids have been around for over 20 years. The structure of these securities has changed over time, as there have been changes in accounting and taxation rules and requirements by regulators and ratings agencies.

"Hybrid" is a broad term for securities which have both debt and equity characteristics. While not technically correct, the term is also commonly used to include pure debt securities such as retail bonds, floating rate notes and perpetual notes.

The more correct term is "interest rate security". There is not one generic type of security on issue. While some are quite similar, each has its own specific terms and conditions.

In the listed space, the bank-issued hybrids dominate in terms of size and the number of issues, in particular the major banks. They form an important part of banks' regulatory capital structure. Banks have strict regulatory capital requirements that need to be met.

For industrials, they also form part of a firm's capital management strategy, but without the regulatory requirements. A number of recent issues have been structured so they can be treated as equity by some ratings agencies for a specific period.

### Types of interest rate securities

At a high level there are basically two types of interest rates securities: pure debt and hybrids. Within each category, there are a myriad of specific terms and conditions to distinguish each.

- ▶ **Pure debt securities:** These securities are like loans made by an investor to an issuer, which can be traded on the ASX. They pay interest periodically. But unlike ordinary loans, sometimes interest is deferrable – perhaps indefinitely. Being an interest payment as opposed to a dividend, they are not franked. These securities can be secured or unsecured with a fixed or perpetual term. Examples of these securities include retail bonds, subordinated notes and perpetual notes.
- ▶ **Debt/equity (hybrid) securities:** These are more like investments than loans as they can convert into equity. They are often referred to as convertible preference shares or convertible notes. Their terms and conditions are more complicated than pure debt securities and repayment of the principal can be in the form of cash or ordinary shares of the issuer. They pay franked or unfranked distributions periodically and tend to be unsecured, ranking just above ordinary equity. While they typically have some date at which redemption or conversion may occur, they are usually classified as perpetual as repayment or conversion is subject to conditions. So, they could potentially remain on issue indefinitely.

### Risks

*Investors should seek independent advice from a professional adviser before making an investment decision.*

Investors need to understand the risks of investing in income securities. The old adage of "higher return equals higher risk" applies! These are not bank deposits and do not come with a government guarantee. They carry more risk.

While there may be opportunities for capital gains, the primary purpose of investing in an income security should be to derive a regular income stream. They should also be part of a diversified portfolio. "Don't put all of your eggs in one basket."

Typically, these securities rank just above equity and are unsecured, so in a wind-up scenario, an investor could lose all their capital, which  
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## How to buy and sell income securities

Listed income securities trade on the ASX and can be bought and sold in the same fashion as ordinary shares.

happened to holders of hybrids issued by Babcock and Brown and Allco Finance.

Dividends for hybrids are often optional and non-cumulative, but typically there is a dividend stopper for the ordinary shareholders. So for a lot of hybrids, dividends don't have to be paid! A scenario would be where cash flow is tight, there is earnings pressure and gearing is too high. If dividends are non-cumulative, then missed dividends don't have to be made up. However, there is usually a dividend stopper, which means dividends on ordinary shares cannot be paid if dividends on hybrids are stopped.

There are a number of specific risks:

- ▶ **Liquidity risk:** While they are listed, liquidity can be low, with the effect of making the bid/ask spreads wide. Timing entry and exit is therefore important.
- ▶ **Credit risk:** This is the risk that the issuer can't pay distributions or repay the principal. A higher risk demands a higher return.
- ▶ **Interest rate risk:** Changes in interest rates will impact distributions for floating-rate securities. While distributions of fixed-rate securities will not be impacted by interest changes, their price is more likely to be impacted – a declining interest rate environment would likely be a positive for the price, while a rising interest rate environment would be a negative.
- ▶ **Spread risk:** Credit spreads move around due to changes in the actual or perceived risk of the issuer or the market. An increase in risk will likely see credit spreads widen, meaning the price of the security has fallen.
- ▶ **Term risk:** This is the risk of the security staying on issue for a shorter or longer period than expected.
- ▶ **Conversion risk:** If a security is converted into ordinary shares, then an investor wishing to exit and reinvest in another income security could be left holding the shares and would therefore be exposed to adverse moves in the share price.

### Benefits of investing

Yes, there are benefits as long as investors understand the risks. Small retail investors looking to earn a higher rate above bank deposits are limited in choice. Income securities provide investors with the ability to do this. But bear in mind that a "higher return equals higher risk".

These securities are listed, so unlike a fixed term deposit, they can be sold on market if

access to the principal is required, without incurring break fees.

They can provide regular distributions. If they are floating rate, distributions will change with movements in interest rates. If fixed, interest payment will be the same for the entire term.

They can have potential tax benefits for some holders, as some pay franked distributions. However, the tax advantage is often priced in.

They rank above ordinary equity and prices tend to be less volatile than underlying equity.

### What do we look for? Morningstar's hybrid research methodology

We look for a high degree of certainty of getting your capital back, certainty that dividends will be paid, and obviously the return. On a risk/return basis, we prefer exposure to major bank hybrids and high-quality industrials.

The focus of our analysis is answering the question: To what degree is the underlying business capable of supporting the commitments required by these securities? What yield does this then justify?

We place the security in one of the following categories:

- ▶ **Excellent**, essentially the big four banks. This equates to Low Risk.
- ▶ **Investment Grade**, equates to Medium Risk.
- ▶ **Speculative**, for companies not in the above categories which nevertheless have reasonable ongoing businesses. This equates to High Risk.
- ▶ **Distressed**, for businesses where identifiable short to medium-term future events pose substantial risks which may cause a default.

For each of these categories, we have identified a range of credit spreads corresponding to default risk based primarily on historical data, but also from examining market spreads for corporate debt and market spreads for credit default swaps.

These yield spread ranges change with economic conditions, so in recession-like conditions, we use different bands based on default rates in the 1980s and 1990s recessions.

The default risk calculation is based on a transition model. Based on a range of factors, primarily interest cover, free cash flows and total

gearing we place the company in one of the four risk categories.

We also analyse the fundamentals of the company and the management to determine if it is at the safer or the riskier end of its particular category to produce a yield spread.

In particular we examine the variability of cash flows and future events (for example, large refinancing events) which may adversely affect the business. It is assumed that hybrid securities pay 0c–10c in the dollar in the event of default.

We add a spread to account for transaction costs associated with illiquidity, and small additional spreads to represent the inconvenience or risks of other characteristics of the security, such as having perpetual or non-cumulative distributions, and the maximum number of shares on conversion conditions etc.

This gives a target yield from which we derive a fair value. We calculate the fair value both as a perpetual and assuming redemption, and calculate a weighted average based on the analyst's estimate of the probability of redemption. This fair value is compared to the market price to give a recommendation.

"Reduce" and "Accumulate" recommendations indicate the security is trading above and below fair value respectively. A "Hold" recommendation indicates the security is trading at fair value.

"Buy" and "Sell" recommendations are used in those instances where in the opinion of the analyst there has been a fundamental mispricing of the security on market, and there is the distinct possibility of substantial gains or losses for investors.

"Avoid" indicates we believe the security should be avoided by all investors.

#### Factors that can impact prices

► **Changes in credit spreads:** A credit spread is the interest rate differential between a benchmark interest rate such as a government security and a non-government security. Credit spreads can change with changes in actual risk or perceptions of risk. A higher spread implies higher risk. For example, if there are concerns about the financial stability of banks, the spreads on bank-issued securities will widen.

This is the same as saying prices for those securities will fall or yields will increase. This may adversely impact bank hybrid prices.

- **Changes in interest rates and interest rate expectations:** Fixed-rate security prices will be impacted by interest changes.
- **Pricing of alternative investments:** If, for example, competition for bank deposits intensifies and rates increase, this makes an investment in a riskier security such as a hybrid less attractive. If, for example, sentiment towards equities improves and the equity markets run, this may see a switch from income-type investments into growth-type investments.
- **The financial position of the issuer and/or peers:** A change in the financial condition of the issuer can impact its ability to pay distributions or repay principal and will also impact the price. For example, if an issuer or a peer breaches a debt covenant, this would adversely impact the price. If that issuer conducts an equity raising, this could be positive for the security price as it would improve the issuer's financial position.
- **Conditions specific to the security:** For example, a security approaching maturity is likely to trade closer to face value if redemption or conversion is likely. If such a security is unlikely to satisfy redemption or conversion conditions, the price would move away from face value.
- **Change in regulation/legislation:** Changes to regulation may make it favourable or less favourable to hold an existing security.
- **Corporate activity:** Income securities often have acquisition trigger events, which can see them being redeemed early if there is a takeover. For a security trading below face value, such an event would see the price rise.
- **Liquidity:** Securities with low liquidity may trade at a lower price than an equivalent security with higher liquidity.

#### Common terms

- **Running yield:** This is a simple calculation of current annual distributions divided by the clean price (that is, the current price adjusted for notional accrued distributions). This gives an idea of the yields under the assumption the price of the underlying security remains constant. The calculation is grossed up for franking credits.
- **Yield to maturity/reset:** This is the discount rate at which the sum of the future discounted

cash flows is equal to the current traded price. The calculation grossed up for franking credits. The cash flows will include an estimated regular interest-style payment and final redemption of the share at the price specified in the contract. This is also known as an internal rate of return or IRR. Many hybrids have a step-up condition, where at a particular date the interest or dividend of the security increases by a fixed amount. For a healthy, well-managed company in an environment where credit flows easily and where the original share was offered at a fair margin, the step-up date is essentially a maturity date, as the debt ought to be rolled over at a margin lower than the step-up margin. In this case, the yield on the security can be estimated as being close to the yield to maturity.

- ▶ **Margin:** This is the per annum spread above a benchmark interest rate that distributions are based upon.
- ▶ **BBSW:** The Bank Bill Swap Reference Rate is a commonly used benchmark for financial instruments, which is published by Australian Financial Markets Association (AFMA). It is set once a day at around 10.00am each business day. It covers terms from one month to 15 years. Floating-rate hybrids are priced off either the 90-day or 180-day BBSW. The previous business day's BBSW rates can be found in The Australian Financial Review or on the AFMA website (<http://www.afma.com.au/home.html>). Only paid subscribers get access to the latest BBSW rates.
- ▶ **Interest rate:** For a floating rate security, the interest rate is the sum of the margin and benchmark interest rate. For a fixed-rate security, the rate is set at the issue date. It may be set at a margin above a benchmark or just be a specified rate.
- ▶ **Step-up margin:** This refers to an increase in the margin for a specific reason or at a specific date. For example, the margin on Woolworths Notes II (WOWHC) increases by 1.00% per annum to 4.25% per annum above the 90-day BBSW rate if Woolworths does not redeem the notes on the 24 November 2016 step-up date.
- ▶ **Franking:** Distributions can come with or without tax credits attached. If a distribution is franked, then the cash payment amount will be equal to the face value x interest rate x (1-corporate tax rate). The balance will come as a tax credit. It works the same as franking on dividends from ordinary shares.
- ▶ **Fixed-rate security:** The interest rate for such a security does not change during its entire term, so the annual distribution amount will be the same for each payment.
- ▶ **Floating-rate security:** The interest rate for such a security is reset periodically, most commonly every 90 or 180 days, so the distribution amount will potentially be different for each payment.
- ▶ **Mandatory conversion:** Where the hybrid securities are converted into ordinary shares of the issuer at a specific date, subject to conversion conditions. For example, Westpac SPS (WBCPA) have a mandatory conversion date of 26 September 2013, subject to conversion. If conversion occurs, note holders will receive Westpac (WBC) shares worth \$101.01 for each WBCPA security held.
- ▶ **Conversion discount:** This refers to the discount to the conversion price. For example Westpac SPS (WBCPA) have a 1% conversion discount and \$100 face value. This means for each security a person owns, they will receive \$101.00 worth of WBC shares:  $\text{face value} / (1 - \text{conversion discount})$  or  $\$100 / (1 - 0.01)$ .
- ▶ **Maximum number of shares on conversion:** Under such a condition, a hybrid holder could potentially receive shares worth less than face value. For example, if the maximum number of shares on conversion was 10 and the ordinary share conversion price was \$5, and the hybrid had a face value of \$100, then upon conversion the holder would only get 10 ordinary shares worth \$50 instead of getting 20 shares ( $\$100 / \$5$ ) worth \$100.
- ▶ **VWAP:** Daily volume-weighted average sale prices of a security over specific period. This is typically used to determine a conversion price for conversion into an ordinary share. For example, for Westpac SPS (WBCPA), the conversion price is the VWAP of WBC ordinary shares 20 business days before, but not including the conversion date. The reason a VWAP is used rather than, say, a closing price on a single day is that it is an average price where a closing price is the just one trade, that is, the last trade. This limits the risk of someone being able to drive the ordinary share price down in order to increase the number of shares on conversion.
- ▶ **Dividend stopper:** This is a condition which stops the issuer paying distributions on some or all other securities on issue if it misses a payment on the security. Typically, such a condition stops distributions on

ordinary shares of the issuer and other equally ranking securities.

- ▶ **Distribution payment test:** These are specific hurdles the issuer must meet to be able to pay distributions on the security. For example, with Westpac SPS (WBCPA), the material part of the payment test is that WBC directors must approve the payment. The hurdles can be specific financial metrics such as gearing and/or interest cover ratio, such as the case with the Origin Energy Notes (ORGHA).
- ▶ **Trigger events:** These are specific events such as an acquisition, or a change in regulation or taxation rules which can give the issuer the right to redeem or convert a security early. It may also give the securityholder a right to request redemption.
- ▶ **Cumulative distributions:** Such a condition means missed distributions must be made up.
- ▶ **Non-cumulative distributions:** Such a condition means missed distributions do not have to be made up.
- ▶ **Ranking:** Think of being in a queue in a wind-up scenario. Ranking refers to your position in the queue. The closer to the front you are, the better your chance of getting your capital back. For a bank, covered bond holders are at the front, followed by deposit holders and other secured creditors, senior debt holders, hybrid and other subordinated creditors, and equity holders. We note that subject to limits deposit holders do have a government guarantee, but this would come into play if the wind-up proceeds were insufficient.
- ▶ **Secured:** The security is backed by collateral.
- ▶ **Unsecured:** The security is not backed by any collateral. In a wind-up scenario, unsecured creditors join the queue for remaining assets after all secured creditors' obligations have been met.
- ▶ **Reset date:** This is a date when the terms of a security (including the margin) may be changed.
- ▶ **Remarketing date:** This is an older term but is similar to a reset date.
- ▶ **Maturity date:** This is the date on which the security must be redeemed.
- ▶ **Mandatory conversion date:** This is the date on which the security must be converted into ordinary shares of the issuer, subject to conditions being satisfied.
- ▶ **Optional conversion/redemption date:** This is a date before the maturity date that gives the issuer an option to redeem/convert early. If not exercised, usually the issuer has the option to convert/redeem at any subsequent distribution payment date.
- ▶ **Step-up date:** This is the date the margin increases, unless the security is not redeemed or converted.
- ▶ **Issuer call rights:** Relates to what rights the issuer has to redeem/convert a security.
- ▶ **Holder call rights:** Relates to what rights the securityholder has to redeem/convert a security.
- ▶ **Exchange:** Can be either a redemption or conversion.
- ▶ **Redemption:** Where face value plus accrued interest is returned in the form of cash to the securityholder.
- ▶ **Resale:** Where the issuer organises a third party to acquire the hybrid for face value. For a security holder, the effect is essentially the same as a redemption.
- ▶ **Conversion:** Where the security is converted into another type of security, usually into ordinary shares of the issuer.
- ▶ **Face value:** This is the issue price. Most income securities have a \$100 face value.
- ▶ **Issuer:** The company that issued the security.
- ▶ **Trading margin:** In simple terms, if an issuer already had securities on issue, they could expect any new securities with \$100 face value to trade close to the trading margin. The trading margin of a security (s) is the effective margin at which s trades – it is the margin which a new security (n) with face value of \$100 would need so the sum of the discounted cash flows of n equal the discounted cash flows of s, assuming redemption of both s and n at the pseudo-maturity date of s. The calculation is grossed up for franking where appropriate.
- ▶ **Fair Margin:** This is our estimate of the margin above a benchmark that a security should trade at to compensate for the risks inherent in holding a security. It comprises a credit spread and additional spreads to account for transaction costs associated with illiquidity, and small additional spreads to represent the inconvenience or risks of other characteristics of the security, such as having perpetual or non-cumulative distributions, and the maximum number of shares on conversion conditions etc.
- ▶ **Bid/Ask Spread:** This is the percentage difference between the lowest price a seller is willing to sell a security and the highest price a buyer is willing to buy a security. Securities with relatively low liquidity will tend to have wider bid/ask spreads than those with higher liquidity.

- **Ticker symbol:** This is often called the security code. This is the unique symbol given to each security listed on an exchange. For an income security, it is either a four or five-letter symbol with the first three letters representing the issuer's code and the fourth identifying the type of security: H for an unsecured note; G for a convertible note; and P for a preference share. For example, the Origin Energy Notes have a symbol of ORGHA, where ORG is the symbol for Origin Energy, H refers to the security being an unsecured note, and A refers to this being the first security issued by ORG in this series. ■■



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### Where to find more information

**Morningstar:** Morningstar provides research coverage, with recommendations on 32 ASX listed income securities (as at 9 March 2012). This will increase to 37 once the recent offerings list.

**The ASX provides:**

**Prices:** These are delayed prices.

<http://www.asx.com.au/asx/markets/interestRateSecurityPrices.do?type=HYBRID>

**Information:** <http://www.asx.com.au/products/types-of-interest-rate-securities.htm>