

Hybrid Securities Bonds Debentures Floating Rate Notes

An Investment for Income

Hybrid Securities, a new category of investment, are gaining momentum as the short term uncertainty in equity markets around the globe continues. Essentially, Hybrid Securities are corporate or company debt taking various shape and form and are gradually replacing the ever shrinking Government debt market.

So what are Hybrid Securities?

Hybrid Securities are tradable securities possessing characteristics borrowed from both debt and equity instruments. Their myriad forms make understanding and evaluating the risk / return trade-off imperative if investors are to make informed decisions to include or exclude a component of these securities in their portfolios.

Hybrid Securities pay a predictable (fixed or floating) rate of return or dividend for a certain period of time, usually until a maturity or conversion date. At that date the holder has a number of options including converting the securities into the underlying share or cash or more commonly reset for another term. Each issuer determines the specific terms of the conversion.

Therefore, unlike a share the holder has a “known” cash flow, and, unlike a fixed interest security, there is an option to convert to the underlying equity. More common examples include convertible and converting preference shares. Converting preference shares means that at the maturity date (or conversion date) the security converts into ordinary shares whereas with a convertible preference share, the holder has the option of redeeming to cash or converting to shares.

It is important to note that Hybrid Securities are structured differently in so far that some behave more like fixed interest securities and others behave more like the underlying shares that they convert into albeit with less risk than holding the share.

Because they are designed to appear to be equity, they must have equity risk factors built in. In a risk sense, therefore, they are more risky than debt. However, they are not as risky as equity – they have a risk profile between debt and ordinary equity.

How secure is the rate of return?

The rate of return is the coupon rate that is attached to the security. For example, the recent IAG Reset Converting Preference Share was issued at \$100 face value with a coupon of 5.8% per annum fully franked. That means for every \$100 security the holder will be paid \$5.80 each year for the period of the security.

So what is the risk that the coupon or interest payment will not be paid?

In short, the penalty for the issuer for not paying interest is rather severe. For example, let us look at the floating rate notes that were very popular when they were issued over 3 years ago. They are usually referred to us Income Securities. If an interest payment is missed for any quarter on say a NAB Income Securities, then no dividend will be paid on the NAB ordinary shares until 4 consecutive interest payments are made on the Income Securities. Clearly, it is unlikely that the issuing companies of any hybrids will miss an interest payment because of the impact on the ordinary shares. While nothing is guaranteed, the payments appear very secure.

Another important factor is the credit quality of the issuer of these securities to meet its financial obligations e.g. pay interest on due dates and repay principal on the maturity date.

Why do Companies issue “Hybrids”?

These securities allow large, reputable companies to diversify their funding sources, to better manage their funding structures and capital costs, since “hybrids” constitute a cheaper form of capital than equity, which in turn, improves shareholder returns. No surprises then that “hybrids” have a high take-up rate with existing shareholders who are usually offered first refusal of part of each issue. While shareholders accepting these offers increase their exposure to that company, they have already accepted the equity risk and their decision then becomes one of earnings, or yield.

Are they risky?

As Graeme Lee, Standard & Poor’s (S&P) Australian and New Zealand Managing Director was quoted last year, “The challenge for investors is to develop a full understanding of the features and risk nature of the securities and then gauge the adequacy of the return relative to the risk”. Lee went on to say “The credit risk assessment should include an evaluation of both the creditworthiness of the issuer and the specific features of the securities themselves.”

Some key specific features that S&P suggest should be considered are:-

- **Early Redemption Risk** – Whether the issuer has the right to redeem the securities.
- **Conversion Risk** – Under what terms and conditions does the issuer have the right to convert these “debt” securities into “equities” or “quasi-equities” (e.g. Preference Shares).
- **Earnings-related Risk** – The implications (if any) of interest payments being tied to “tests” of capital adequacy or trading profit levels.
- **Subordination** - The securities’ ranking in the event of winding-up of the issuer.
- **Regulation Risk** – Does a Corporate Regulator have the right to step in to fulfil unsatisfied obligations by the issuer towards investors.

The many permutations of the above as they apply to “hybrids” usually cause Rating Agencies to down-grade ratings of hybrid securities considerably below those of conventional debt instruments, even from the same issuer. As a consequence, the yields attaching to hybrid securities can be significantly higher than other paper issued by top quality companies and therefore seen as an acceptable risk for the return offered.

What affect does the Interest Rate Cycle have on Hybrids?

The market price of traded hybrid securities or other debt instruments are sensitive to movements in interest rates as well as other factors dealing with the creditworthiness of the issuer and the underlying equity or share.

Under a scenario of a **rising interest rate** environment, hybrid securities may weaken in their market price, as most hybrids or debt instruments are listed on the Stock Exchange. As fixed rates rise for a particular investment term, the underlying price of the security will fall so that the overall return to an investor is equivalent to the new higher rates in the market place.

This is how traditional Government Bonds react in interest cycles. For example, let us assume that an investor purchases a 10 year Government Bond with a coupon of 5.4%. One year later, the interest rate cycle moves upwards and the 10 year Government Bond rate is now 6.0%. If the investor decides to sell their Bond, then a purchaser would only buy this security at a price lower than the issue price. So who said that you can’t lose part of your capital on Government Bonds?

Therefore, in a rising interest rate cycle, securities with shorter maturity dates are preferred to longer dated investments as well as Income Securities which have a floating rate and are reset periodically in line with the movement of short term interest rates.

Under a scenario of a **falling or benign interest rate** environment, hybrid securities may strengthen in their market price. Falling or benign interest rate environments tend to favour longer dated securities to maximise the potential for capital gain and lock in the higher interest rates relative to future forecasts.

The Main Components of Hybrid and Other Debt Instruments

The main components of a hybrid security are:

- The **face value** (initial principal investment or capital amount) is usually the amount repayable to the investor at maturity. Usually, most securities are issued at a face value of \$100. Once they are listed then the secondary market price may vary from the face value during the term of the security.
- **Interest on the face value**, which accumulates at a predetermined rate referred to as the **coupon**. This can be fixed (for the term) or floating (based upon the 90 or 180 Day Bank Bill Rate).
- **Maturity date** is the date the security expires and principal is either repaid or, in the case of selected hybrid securities, converts to ordinary shares (in which case it is known as the **conversion date**).
- **Conversion ratio** is the ratio of shares offered for each converting security. This may be a fixed ratio (for example, 1:1) or at a discount or premium to the market price.
- **Nominal yield** is the interest income calculated as a percentage of the face value.
- **Yield to maturity** is the interest income calculated as a percentage of the current market price of the security.

Summary of Debt Instruments

	Benefits	Risks
<p>Bonds & Debentures Issued by government agencies, companies and financial institutions. These can be secured (against company's assets) or unsecured debt.</p>	<ul style="list-style-type: none"> • Known fixed rate of interest. • Return of capital at maturity. • High security as corporate bonds/debentures rank ahead of equities and hybrids for the payment of interest and capital. 	<ul style="list-style-type: none"> • Return can be lower than equities. • Values can fluctuate if traded on a secondary market and sensitive to interest rate movements. • Less liquidity if there is not an active secondary market
<p>Hybrid Securities Popular method for companies to raise funds by issuing a form of hybrid debt that carries a mix of debt and equity. Most common form is converting preference shares and convertible notes although there are many variations such as the more popular Reset Converting Preference Shares.</p> <p>Interest payments may also include a franking credit or tax deferred component.</p>	<ul style="list-style-type: none"> • Higher income yields compared to bonds to reflect the higher risk associated with these securities. • Opportunity to participate in the company through the share conversion option. • Some downside protection if an option for cash back at issue value is offered. • Potential tax benefits from franking credits. 	<ul style="list-style-type: none"> • Ranks behind traditional debt obligations but ranks ahead of equity. • The issuer's capacity to meet its financial obligations and other balance sheet fundamentals need to be examined. • Interest rate movements may affect the value. • Share price movements of the ordinary share may impact either positively or negatively.
<p>Floating Rates Notes Common form are the ASX listed Income Securities that pay a floating rate based on a margin over an interest rate benchmark such as the 90 Day Bank Bill Rate.</p>	<ul style="list-style-type: none"> • Higher returns than cash or short term bank deposits. • Rank ahead of ordinary shares and hybrid securities and often carry a credit rating. • Floating rate payments mean income increases in a rising interest rate environment. 	<ul style="list-style-type: none"> • Securities are perpetual and price determined by secondary market. • Floating rate payments mean income decreases in a falling interest rate environment. • Need to assess and monitor credit quality and security ranking of the issuing company.

Conclusion

As mentioned previously, the many and variable characteristics of these securities and the particular shapes favoured by individual issuers means that, on offer at almost any time will be a style that could be of interest to the widest range of investors.

Gone are the days of the “one size fits all” debt instrument, such as the debenture, which by comparison to the “hybrid” had only three moving parts – term, rate and risk level.

It is probably an indication of the level of sophistication of our local market, that hybrid securities have found ready acceptance by retail investors in the wholesale end of the market and by smaller investors who are now well catered for by an increasing selection of offerings by fund managers.

While the traditional “hybrid” was so structured to have the security move in price, parallel to it’s equity cousin, the latest “hybrids” have more in common with “bonds” than shares.

Although there is an element of risk attached with these securities as discussed, the risk is usually diminished if the securities are held to maturity. In other cases, depending on the security issue, there is some other forms of protection on conversion through the use of options.

Hybrid Securities offer the investor with an alternative asset class to the traditional fixed interest investment and the opportunity to enhance returns through higher income in a period where investment returns will be low. The key to these investments is the quality of the asset which will be reflected by the credit rating and the financial abilities of the company to repay the interest payments as well as the capital on maturity or conversion.

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