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The Hybrid Mixmaster: What could go wrong?



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Hybrids – What are they and what can go wrong?

Hybrids

- What are they?
- What are the different types?
- History of hybrids
- Why do companies issue them?
- Why do investor buy them?
- What could go wrong?

What are hybrids?

- Securities with debt and equity like characteristics
- Issued by banks and other companies
- Usually have debt-like returns (fixed return of capital, periodic coupons)
- Have more equity risk than corporate bonds
- Trade on the ASX like normal shares

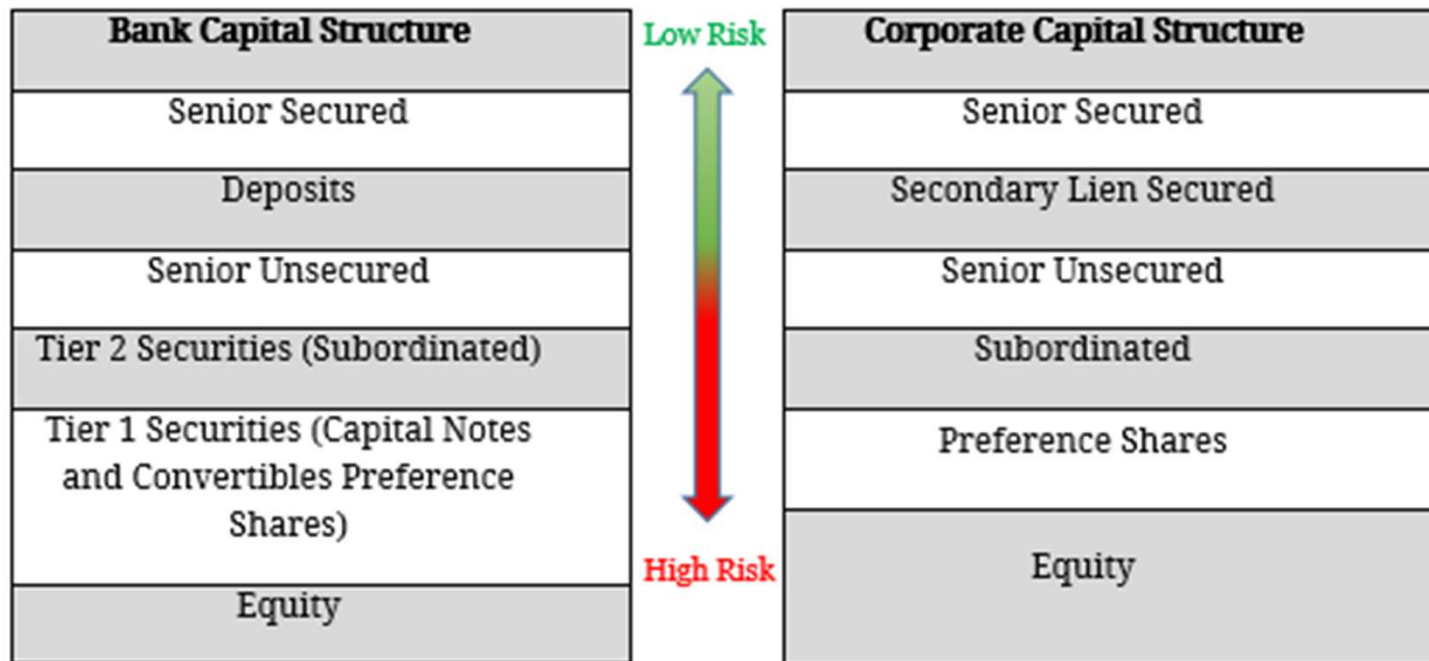


Types of hybrids

- Convertible/converting debt
- Converting preference shares
- Capital Notes (subordinated)
- Perpetual securities



Types of hybrids



Source: BondAdviser

History of hybrids

- First hybrid issue was Westpac in 1993 to recapitalise the bank after property crash
- Second issue was by TNT as alternative to dilutive rights issue
- Large number of bank issues in 2000 -2003 as dividends could be franked and issues counted as Tier 1 or 2 capital
- Under Basle 3, issue terms must be more favourable to the banks



Why issue hybrids?

- Potentially less dilutive than a rights issue
- Can count as regulatory capital for banks
- Can help a company's credit rating if issue is treated as equity by Moody's, S&P, etc
- Can be tax efficient for the issuer – either deductible or frankable



Why buy hybrids?

- Generally have a higher income than other products – term deposits, senior debt
- Less price risk than ordinary shares
- Diversify your sources of income
- A high chance of getting your capital back – in shares or cash - *though not always!*
- Easy to buy on ASX



What are main risks?

- Credit – will I get my money back?
- Liquidity – can I sell my hybrids when I want?
- Call risk – when will I get my money back?
- Regulatory – where APRA decides you don't get your money back?



What can go wrong? Examples

Three examples of the regulatory risks in hybrids:

- One actual
- Two theoretical

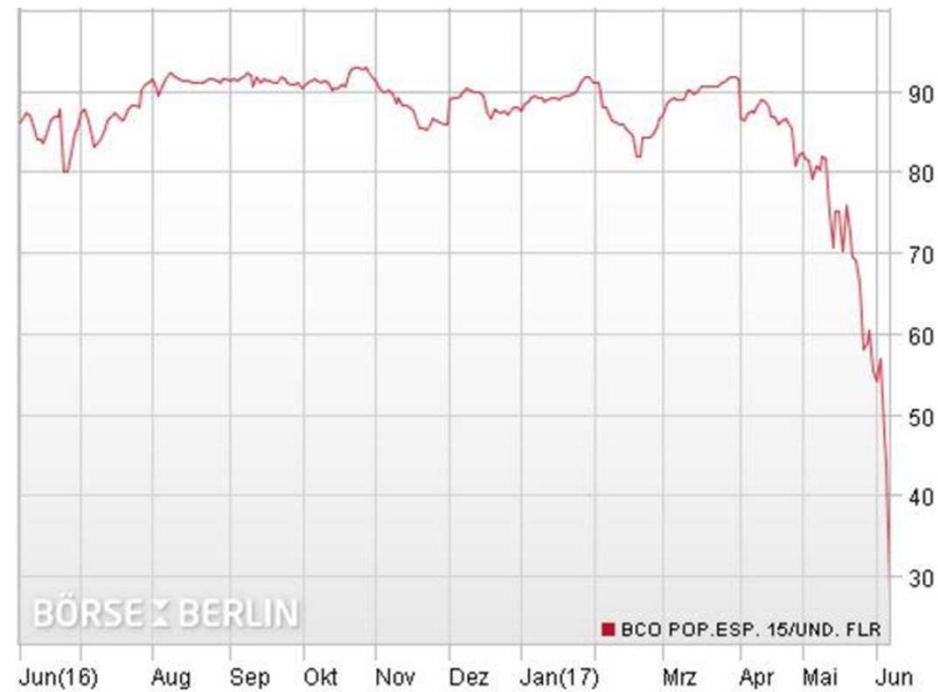


What has gone wrong? International example

- Banco Popular Espanol
- Issued Contingent Convertibles (CoCos)
- CoCos had to have a “Non-viability” clause to count as Additional Tier 1 capital for ECB
- On 7 June 2017, ECB (through the SRB) deemed all the ordinary shares and CoCos were worthless



What has gone wrong? International example



What has gone wrong? International example

- CoCos paid coupons between 8 – 11% when Euro deposit rates were 0.5%?
- Bank had 11.9% capital ratios (minimum is 5.125%)
- Banco Popular acquired by Banco Santander for 1 euro



What might go wrong? Local example

- Suncorp Capital Notes (ASX Code: SUNPF)
- Issued in April 2017
- \$375 m issue at \$100 note – trading at \$102.21
- Issue Yield was 4.10% > 3 month BBSW (about 5.80%)
- Maximum number of ordinary shares issued:
 - Mandatory conversion – 14.8148 per Note
 - Any other conversion – 37.037



What might go wrong? Suncorp

- Unsecured, subordinated notes
- Perpetual –scheduled to convert in 2024
- Non-Viability Trigger so can be AT1 Capital
- Ranking in a winding up:
 - Above ordinary shares
 - Equally with converting pref shares
 - Behind senior debt and depositors



SUNCORP



What might go wrong? Suncorp

- “A Non-viability Trigger Event is determined by APRA and could happen at any time” Page 62 of Offer document.
- APRA determines what happens:
 - Notes are converted to ordinary shares
 - Notes are written off
- Can be caused by potential insolvency, inadequate capital ratios, or a systemic shock to financial system (GFC 2) – all at APRA's discretion

The background of the slide features a large, semi-transparent image of a Suncorp storefront. The word 'SUNCORP' is prominently displayed in large, white, sans-serif capital letters on a dark teal background. Below the sign, the glass entrance of the store is visible, showing interior displays and posters, including one for 'Insurance Business'.

What might go wrong? Suncorp

Two possible worst case scenarios:

1. Suncorp stops paying dividends on ordinary shares

- No distributions payable on Notes
- No catch up for missed distributions

2. Suncorp is wound up

- Depositors and senior bonds paid first
- Capital notes and converting pref shares next
- Ordinary shares last



SUNCORP



What might go wrong? Suncorp

- Stop paying dividends - maybe
- APRA exercises the Non-viability Trigger – unlikely
- Bank deposits up to \$250k are guaranteed by Federal Government

The background of the slide features a large, semi-transparent image of a Suncorp storefront. The word 'SUNCORP' is prominently displayed in large, white, sans-serif capital letters on a dark teal background. Below the sign, the glass entrance of the store is visible, showing interior displays and posters. One poster on the right side of the entrance is titled 'Insurance Business' and features a woman in a business suit. The overall image is slightly faded to serve as a background for the text.



What might go wrong? CBA PERLS

- CBA PERLS V111 (ASX Code: CBAPE)
- Issued in April 2016
- \$1.45 bill issue at \$100 note – trading at \$105.80
- Current Yield is 3.70% > 3 month BBSW (about 5.80%)
- Maximum number of ordinary shares issued:
 - Mandatory conversion – 2.649 per Note (\$37.75)
 - Any other conversion – 6.6224 per Note (\$15.10)

Commonwealth


What might go wrong? CBA PERLS

- Unsecured, subordinated notes
- Perpetual – mandatory exchange 2023
- Non-viability Trigger and Capital Trigger
- Capital Trigger – PERLS must immediately be exchanged for ordinary shares

Commonwealth

What might go wrong? CBA PERLS

1.1.2 Ranking of PERLS VIII in a winding up of CBA

Existing CBA obligations / securities ¹		
Higher ranking 	Secured debt	<ul style="list-style-type: none"> Covered bonds
	Liabilities preferred by law	<ul style="list-style-type: none"> Liabilities in Australia in relation to protected accounts Other liabilities preferred by law including employee entitlements
	Senior Ranking Obligations	<ul style="list-style-type: none"> Deposits (other than protected accounts) Senior debt General unsubordinated unsecured creditors Tier 2 Capital
	Equal Ranking Securities	<ul style="list-style-type: none"> PERLS VIII² PERLS VII² PERLS VI² Any preference shares or other subordinated unsecured debts³
Lower ranking	Junior Ranking Securities	<ul style="list-style-type: none"> Ordinary Shares

¹ This is a simplified capital structure of CBA and does not include every type of security issued or that could be issued in the future by CBA. CBA could raise more debt or guarantee additional amounts at any time

² Ranking prior to Exchange

³ Excluding Junior Ranking Securities



What might go wrong? CBA PERLS

- “Too big to fail”
- Unlikely to stop paying dividends
- Capital Trigger would require substantial increase in loan losses
- Non-viability Trigger is very unlikely

Commonwealth



Current trends in Hybrids

- Banks are redeeming older style issue – WBCCHA in August 2017 - \$1.6 billion
- NABHB, HBSHB and ANZHA were redeemed in May and June - \$2.4 billion
- APRA expected to release guidance on higher capital ratio “mid-year” – should lower credit risk
- Expect more Tier 1 issues with more risk for investors



Sources of Advice on Hybrids

- ASIC MoneySmart website
- Broker research
- Investment newsletters
- Invest in diversified portfolios of hybrids



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