

Pitcher Partners *Investment Services*

HYBRID SECURITIES

There are many and varied characteristics of fixed interest securities.

Gone are the days of the “one size fits all” debt instruments, 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, traditionally used in the wholesale end of the market, have found ready acceptance by retail investors. In addition, these investors are also catered for by an increasing selection of offering by fund managers.

The traditional hybrid was a convertible bond that was structured to exhibit similar price movements to the ordinary shares of the issuer. This has changed over time and hybrids are now priced more like bonds. As such, a current price may reflect a combination of the face value of the original security, interest accrued from the last payment date and possible adjustments for perceived changes in credit risk.

Although there is an element of risk attached with these securities, the risk is usually diminished if the securities are held to maturity. At maturity a hybrid may convert to ordinary share, cash, or a mixture of both.

Hybrid Securities offer the investor an alternative asset class to the traditional fixed interest investment and the opportunity to enhance returns. 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.

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 a particular benchmark (eg. 90 day Bank Bill Rate or 5 year government bond).
- **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 (which 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 pre determined 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.

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Benefits and Risks associated with Debt Instruments

	Benefits	Risks
<p>Bonds & Debentures Issued by government agencies, companies and financial institutions. These may be unsecured debt, or secured against the company's assets.</p>	<ul style="list-style-type: none"> • Known rate of interest. • Return of capital at maturity. • Ranks ahead of equity and hybrid for payment of interest and capital. 	<ul style="list-style-type: none"> • Value can fluctuate if traded on a secondary market. • Sensitive to interest rate movements. • Less liquidity if there is not an active secondary market. • Price volatility if not held to maturity. • Issue default.
<p>Hybrid Securities Popular method for companies to raise funds by issuing a form of hybrid debt that has characteristics 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 credit risk associated with these securities. • Potential upside through share conversion option. • Some downside protection if an option for cash back at issue value is offered at maturity. • Potential tax benefits from franking credits. • In some instances a dividend on ordinary shares cannot be paid until after the distribution on the hybrid is paid. 	<ul style="list-style-type: none"> • Generally ranks behind traditional debt obligations but ahead of equity. • Subject to issuer's capacity to meet its financial obligations and other balance sheet fundamentals. • Sensitive to interest rate movements. • Share price movements of the ordinary share may impact either positively or negatively. • Security price may fall as a result of a credit rating downgrade.
<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 and decreases in a falling interest rate environment. 	<ul style="list-style-type: none"> • Securities tend to be long dated or perpetual. • Price determined in secondary market if not held to maturity. • Floating rate income payments decrease in a falling interest rate environment. • Need to assess and monitor credit quality and security ranking of the issuing company.