## Module 3 Readings

3–3 Swiss S, "High on Hybrids", Insto, October 2002, pp 38–40.

# High on hybrids

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**Performance data shows that in the year from 1 July 2001 to 1 July 2002, the UBS Warburg Franked Hybrid Index outperformed both the comparable equity and bond indices. In recognition of the emergence of hybrid securities as an asset class in its own right in the Australian market, INSTO is pleased to introduce its inaugural league tables for public hybrid transactions from Australian issuers in the year to 30 September 2002. Reset securities dominate domestic transactions, while convertible debt seems to be the favoured structure for Australian companies issuing offshore. A healthy pipeline to the end of the year should firmly establish the appearance of hybrid securities on the radar screens of fixed income and equity, as well as institutional and retail investors.**

A glance at the performance of the UBS Warburg Franked Hybrid Index compared with the S&P/ASX300 Accumulation Index and the UBS Warburg Fixed Interest Index shows immediately why Australian investors are increasingly tuning in to this emerging asset class. According to UBS Warburg data, hybrid securities outperformed both Australian equities and bonds in the year to 1 July 2002. The Franked Hybrid Index returned 8.66 per cent over the year. In contrast, the sell off in world equity markets and collapses such as WorldCom resulted in the S&P/ASX300 Accumulation Index losing 8.20 per cent in the same period. At the same time, the UBS Warburg Fixed Interest Index yielded a return of 6.87 per cent.

In the first three quarters of 2002, A$3.239 billion (US$1.77 billion) of hybrid securities were brought to market by Australian issuers in public transactions (this excludes deals of A$50 million and below, except for increases, which are included). This compares with A$3.565 billion of hybrid securities brought to market by Australian issuers in public transactions in 2001, according to UBS Warburg data. Of the securities issued in the year to the end of September, A$1.995 billion (or 61.6 per cent) was raised by corporations, while A$1.244 billion (or 38.4 per cent) was raised by financial institutions. In terms of the securities chosen, the most popular – 47.7 per cent – were reset preference shares and units. These were followed by the two zero coupon convertible note deals issued by QBE Insurance (QBE) (27.3 per cent), then convertible notes (18.5 per cent) and reset convertible notes (6.5 per cent).

INSTO is pleased to introduce its inaugural league tables for public hybrid transactions from Australian issuers in the year to 30 September 2002 (see table page 39). The minimum size for inclusion of deals is A$50 million – except for increases, where the amount of increase only is included at the time of the increase. Merrill Lynch tops the league table, with a volume of A$884 million from two deals – both for QBE. All other public hybrid transactions to the end of the third quarter were issued in the domestic market. Macquarie Bank ranks a close second, leading A$800 million from four transactions, including one transaction totalling A$140 million for Macquarie Goodman Trust and a A$10 million increase to Bank of Queensland's reset preference shares. In third place is UBS Warburg, with a total volume of A$500 million, from three transactions. The only public deal of the year which is not included in the league table is the A$600 million convertible note transaction from Hutchision Telecommunications (Australia) (Hutchison). The deal does not meet one of the criteria for inclusion in the league tables, which states that where an associated company purchases up to 25 per cent and above of securities on offer, that percentage is removed from the deal total. In the Hutchison deal, led by Salomon Smith Barney (SSB) and ABN AMRO Rothschild, the issuer's parent – Hutchison Whampoa – not only underwrote the issue but also bought 99.7 per cent of the securities on offer.

## Convertibles versus reset securities

In the domestic market, eight well-known Australian corporations and financial institutions brought reset deals to the Australian market in the year to 30 September, totalling A$1.755 billion. These include reset preference shares – from Smorgon Steel, Jupiters, Insurance Australia Group, Bank of Queensland and David Jones – reset preference units – from Southern Cross FLIERS Trust and Macquarie Goodman Industrial Trust – and reset convertible notes – from Amcor. In addition, A$1.35 billion of reset preferred securities are due to be listed in October by AMP, which makes resets the favoured hybrid security of Australian companies. The reset securities have been individually structured to cater to the differing needs and requirements of the issuing companies – whether this be T1 regulatory capital or high delta securities with equity credit.

Australian issuers can also access the offshore convertible and arbitrage investors in the US, Europe and Asia through convertible notes. QBE issued two deals of liquid yield option notes (LYONs) into the US market this year, first in April (US$300 million) and then in September (US$172.5 million). The combined offering of an exotic convertible (zero coupon) represents the biggest public hybrid transaction from Australian issuers in the year to 30 September. Convertible debt provides Australian companies with further opportunities to broaden their investor base with conventional convertible bonds attracting a mix of outright holders and arbitrage investors.

Explaining the key differences between reset and convertible securities, UBS Warburg's John Needham, director and head of hybrid capital, says the reset structure provides issuers and investors with greater flexibility. He comments: "The resets offer the issuer ratings agency benefits with possible equity credit in the order of 60 per cent. Furthermore, resets are generally outside senior debt and banking covenants due to their subordinated nature. The floating rate IPO exchangeable reset securities (FLIERS) issued by the Southern Cross FLIERS Trust differ considerably from the LYONs, for example, as they are preference shares with deferrable dividend payments and are subordinated to all other debt funding, providing the issuer with significantly more flexibility than a traditional convertible security. The FLIERS are unique in that they allow Southern Cross the ability to issue quasi equity pre-IPO of the company."

Bryan Davies, head of structured capital markets at SSB, adds: "In contrast to convertible deals, reset preference shares provide permanent funding to issuers, and typically incorporate flexibility for the issuer to cancel payments in times of distress. Also, reset preference shares typically include relatively low or no equity participation, and are therefore minimally or not dilutive to the issuer."

For investors, resets provide purchasers with a yield security that will be paid in preference to ordinary shares, says Needham. He comments: "They also provide investors with the ability to obtain ordinary shares in the future – sometimes with equity participation – at a discount of between 2.5 per cent and 5.0 per cent to the then share price."

For Merrill Lynch's Paul Harris, director in equity-linked capital markets, the key difference between issuing perpetual preferred shares with a five-year reset in the domestic market and issuing LYONs in the US market is in the attitudes of domestic and international investors. He comments: "The majority of Australian resets have optionality well out of the money. For the issuers, there is no honey in the call options offered because convert investors

**League Table of Public Hybrid Transactions by Australian Issuers**
**1 January–30 September 2002**

| Bookrunner | Total volume (A$m) | No. of deals |
|---|---|---|
| Merrill Lynch | 884 | 2 |
| Macquarie Bank | 800 | 4 |
| UBS Warburg | 500 | 3 |
| Salomon Smith Barney | 285 | 2 |
| JBWere | 105 | 1 |
| Deutsche Bank | 65 | 1 |

Criteria: Minimum size A$50 million except for increases, where the amount of increase only is included at time of the increase
Where an associated company purchases up to 25 per cent and above of securities on offer, that percentage is removed from the deal total
Date of issue of securities is the determining date for inclusion of deals in each quarter/year
Nationality – there must be some relationship with the domestic market for inclusion in a domestic hybrid league table. Deals from Australian issuers to the international markets will be included if the deal is predominantly arranged by Australian bookrunners and the company's headquarters is in Australia. Deals from international issuers to Australian investors will be included if the sale of the securities is coordinated by an Australian arranger
Allocation – equal split of total deal size between joint bookrunners unless otherwise indicated by joint bookrunners

in Australia don't properly value them – issuers are forced to give the optionality away." With international convertible securities, says Harris, global investors give the issuers value for each component part – they value both the bond and the option.

Needham agrees that typically, Australian retail investors don't fully value the optionality in resets. However, he says, Australian convertible investors do. He comments: "The flipside of this is Australian retail investors price credit differently from institutions and, accordingly, issuers can achieve significant volume of subordinated funding at attractive levels. The FLIERS are a prime example of this, with Southern Cross issuing A$600 million of securities that sit in the company's capital structure as subordinated debt – a volume that is unseen in the institutional markets."

Explaining how global investors value LYONs, Harris says: "Investors have puts at years two, three, five, seven, 10 and 15, where they can put the securities back to the issuer and receive either cash or shares." Harris says based on his experience in previous issues, the puts are rarely exercised unless there is a serious credit event.

"Therefore," he continues, "when investors value the LYONs issued by QBE they are looking at a two-year bond and a three-year call option. So they compare the price to QBE's two-year funding rate. But because they know it's unlikely that the securities will be put in two years' time, it is a win for investors as the sum of the bond and the option add up to more than what they paid for the LYONs." In addition, says Harris: "The QBE LYONs are 20-year debt securities and are three-year non-call, after which they can be called at the value of the bond. So the issuer has better terms than with the domestic resets."

However, market participants note that the predominance of hedge fund investors in exotic convertibles means there is no free lunch. They price LYONs like two-year securities, not 20-year securities, and when a company is under financial stress, bonds are put back to the company at exactly the wrong time – for example, the Tyco and Enron convertible bonds. Says Needham: "Where the investor can put the bonds and only receive shares, the security is similar to the reset security. Issuers then need to consider their respective positions regarding the mix of cash yield, subordination, call options and ratings agency equity credit to determine the most cost-effective position."

## Healthy pipeline

By the end of the third quarter two hybrid transactions were in the offering period – from Seven Network and AMP. In addition, two banks have confirmed their intention to issue hybrid securities.

On 21 August Commonwealth Bank of Australia (CBA) confirmed that it continues to focus on optimising the level and mix of capital supporting its operations, while maintaining a prudent and high quality capital base. Says John te Wechel, general manager, group funding at CBA: "Consistent with this strategy, the group intends to issue hybrid securities to enable it to undertake a share buyback of around A$500 million. Subject to the receipt of regulatory approvals, we hope this initiative can be completed by the end of 2002. The form of the hybrid securities is being determined." te Wechel says the appeal of hybrid securities is that they can assist to lower the cost of capital. He comments: "It is important for a bank to assess the level of ordinary equity required for the risks in its business. If this is below the regulatory capital ratio a bank would target, it makes sense to fill the gap with hybrids." Central to CBA's capital management strategy, says te Wechel, is maintaining the bank's credit rating. He says: "The key issue is ensuring our capital base is prudent for the level of risk in our business and can sustain planned growth in our balance sheet. In assessing the mix and level of our capital, we work closely with the credit rating agencies to ensure our capital position can comfortably sustain our target AA credit ratings." CBA last issued hybrid capital in April 2001, when it raised A$700 million through Preferred Exchangeable Resettble Listed Shares. SSB and Commonwealth Securities were joint bookrunners on the deal.

**Public Hybrid Transactions Completed by Australian Issuers**
**1 January–30 September 2002***

| Issuer | Type of security | Date of issue of securities | First reset | Issue size (A$m) | US$m | Credit rating of securities | Bookrunner(s) |
|---|---|---|---|---|---|---|---|
| Smorgon Steel Group | Reset preference shares | 31 Mar 2002 | 31 Mar 2005 | 190 | | Unrated | SSB |
| QBE | Liquid yield option notes; US dollar issue | 8 Apr 2002 | 15 Apr 2022 | 568 | 300 | A+ | ML |
| Jupiters | Reset preference shares | 3 Apr 2002 | 9 Apr 2007 | 190 | | Unrated | UBS, SSB |
| Macquarie Goodman Industrial Trust | Reset preference units | 23 May 2002 | 30 Jun 2007 | 140 | | Unrated | MB |
| Amcor | Reset convertible notes | 28 May 2002 | 30 Apr 2007 | 210 | | BBB- | UBS, JBW |
| Insurance Australia Group | Reset preference shares | 31 May 2002 | 15 Jun 2007 | 350 | | A-/A3 | MB |
| David Jones | Reset preference shares | 1 Jul 2002 | 1 Aug 2007 | 65 | | Unrated | DB |
| Bank of Queensland | Reset preference shares (increase) | 7 Jul 2002 | 15 Oct 2005 | 10 | | Unrated | MB |
| Hutchison Telecommunications (Australia) | Convertible notes | 12 Jul 2002 | 12 Jul 2007 | 600 | | Unrated | ABN/SSB |
| Southern Cross FLIERS Trust | Reset preference units | 12 Aug 2002 | 28 Jun 2007 | 600 | | BBB/Baa3 | MB, UBS |
| QBE | Liquid yield option notes, US dollar issue | 5 Sep 2002 | 115 Apr 2022 | 316 | 172.5 | A+ | ML |

*Minimum size A$50 million except for increases which are included. ABN=ABN AMRO Rothschild; DB=Deutsche Bank; JBW=JBWere; MB=Macquarie Bank; ML=Merrill Lynch; SSB=Salomon Smith Barney; UBS=UBS Warburg. *Source: INSTO, 30 September 2002*

## Diversity of securities and issuers in Q3

There were four public hybrid transactions from Australian issuers in the third quarter. The first was the pro rata renounceable rights issue of convertible notes by Hutchison Telecommunications (Australia) to raise A$600 million (US$324 million). The transaction was led by ABN AMRO Rothschild and Salomon Smith Barney. The deal was underwritten by the company's parent, Hutchison Whampoa, which also purchased 99.7 per cent of the securities on offer. The unrated notes were issued on 27 May and listed on 12 July. Each convertible note will be issued for a term of five years and provides a cash coupon of 5.5 per cent per year, payable until the earlier of conversion or the maturity date. Each note issued at A$0.66 is convertible into one share, which was a 70 per cent premium to the ordinary share price at the prospectus date.

### DJs performs well on secondary market

Deutsche Bank made its debut in bringing a domestic hybrid deal during the third quarter – arranging an inaugural issue of A$65 million of reset preference shares for David Jones. The issue was announced on 14 May, with the offer period closing on 21 June. The securities were listed on 2 July and the first reset will occur on 1 August 2007. The unrated securities are fully franked at 8.1 per cent per year and will convert into David Jones ordinary shares at a 5.0 per cent discount to the 20 business day volume weighted average price at conversion. If David Jones' share price is greater than A$1.50, the minimum conversion number is 70.1754.

According to Linda Thomas, treasurer at David Jones, the reset preference share issue was one of the outcomes of the company's annual business strategic review. She comments: "The main reason for choosing the hybrid capital was to diversify our sources of funds. Reset preference shares are innovative, highly flexible instruments that offer a fairly straight-forward capital raising with a short lead time. The product is well understood in the marketplace and it was the appropriate instrument for the amount we wanted to raise – between A$60 million and A$100 million."

With regard to the small size of the issue and balancing the competing needs of maintaining liquidity and the amount of funding required by the issuer, Thomas comments: "It was quite difficult to gauge how much the market could bear, given that our ordinary share price had not performed as well as we would have liked." Geoff Tarrant, head of structured debt at Deutsche Bank, says there is no doubt the necessary scale back of retail investors in the primary transaction due to the level of demand contributed to the initial strength of the securities on the secondary market. He comments: "Retail investors are extremely important in the hybrid market to increase market depth and provide stability in the sector."

### Instos flock to FLIERS

Macquarie Bank and UBS Warburg were joint bookrunners on the most innovative hybrid transaction of the third quarter – the A$600 million floating rate initial public offering (IPO) exchangeable reset securities (FLIERS) issued by the Southern Cross FLIERS Trust. Final allocations to institutional investors were made on 8 July. They were offered around two-thirds of the reset preference shares on offer, which mature on 28 June 2012.

The BBB–/Baa3 rated securities pay a dividend of 400 basis points over the three-month BBSY, payable quarterly until the first reset date. They are convertible into shares in Sydney Airport Corporation if there is an IPO of the airport once the three-year moratorium on listing is lifted, at a 5.0 per cent discount to the listing price. At year five, the issuer may redeem the securities at 107 per cent. In addition, there is a 50-basis point step up if there is a rating downgrade, and where there is no IPO the dividend will step up by 100 basis points at year five and another 100 basis points at year six.

Institutional fixed income and hybrid investors bought the pre-IPO securities, with the level of demand indicated by the fact they were three times oversubscribed. Paul Donnelly, executive director in Macquarie Equity Capital Markets, says: "Essentially, the securities were sold to fixed income investors on the basis of being 10-year non call five subordinated debt, because that is what will happen if there is no IPO."

John Needham, director and head of hybrid capital at UBS Warburg, says while most hybrid securities issued in the Australian market are perpetual and non-cumulative, the FLIERS are 10-year securities, and they are both redeemable and cumulative. In addition, the FLIERS contain a number of investor protections that are more usually found in subordinated debt issues such as gearing covenants, cash reserves and equity lock-ups.

### QBE issues LYONs II

The second issue of QBE's liquid yield option notes (LYONs), totalling US$172.5 million, completed the public hybrid deals of Q3. The first LYONs issue, completed in April 2002, totalled US$300 million. Both deals were lead arranged by Merrill Lynch (Australia). The second LYONs deal was issued by way of private placement on 4 September, with the same maturity date as the first transaction – 15 April 2022. Compared with a traditional convertible bond, no coupon is paid. The securities were issued at a discount to par and are accretive to par over the life of the instrument. The put option dates are 15 April 2004, 2005, 2007, 2010 and 2015. The securities can be converted into 124.4822 shares and are rated A+ by Standard & Poor's.

Neil Drabsch, chief financial officer at QBE, comments: "The reason for issuing the LYONs was to take advantage of the current low interest yields and to get our gearing back on track, aiming for a debt to equity ratio of 45 per cent. We started on that process with LYONs I in April, where we increased the ratio to just over 40 per cent, from 32 per cent."

Drabsch adds that after 30 June, the credit markets started to dislocate, with substantial spreads at the long end in the financial institution sector. "And particularly with the volatility we've seen in the equity markets," he says, "the LYONs product invoked a great deal of investor interest." The critical criteria for QBE's funding, according to Drabsch, is lowering the cost of debt. "The LYONs give us flexibility – it is 20-year debt with 2.625 per cent interest and zero coupon," he says, adding that the low-cost funds from the LYONs issue are expected to reduce the average annual cost of interest on total debt to around 4.8 per cent, from 7 per cent at 31 December 2001.

According to Paul Harris, director in equity-linked capital markets at Merrill Lynch, a large number of equity funds participated in the LYONs offering. He comments: "The LYONs are high bond floor structures. With these, predominantly in the past there has been much demand from fixed income, convertible and hedge funds, as the issuers have mainly been well-rated companies. However, in recent volatile equity markets there has been a shift so that 'straight' equity investors are looking at convertibles. This is because they offer downside protection, upside participation and advanced yield."

Westpac Banking Corporation (Westpac) has also made it known that it has room in its capital structure for further Tier 1 qualifying hybrid equity issuance. Says Andrew Smith, head of capital management at Westpac: "This arises from how our capital targets work. These capital targets have two dimensions – a range for the ratio of tangible ordinary equity to risk-adjusted assets in a band of 5.6 to 5.8 per cent; and a Tier 1 ratio of between 6.0 per cent and 6.5 per cent." Smith says these two targets are most effectively reconciled by issuing hybrid equity which is included in Tier 1 but not tangible ordinary equity. He adds: "We flagged to the market earlier this year that we intended to increase the representation of hybrid equity in our capital base when our capital ratios moved closer to target levels. The acquisition of the BT Financial Group will bring our ratios closer to our targets, hence our renewed interest in developments in the hybrid market." **insto**