Australian hybrid securities: two decades of evolution

The Australian hybrid market is a great example of financial innovation to meet a changing issuance landscape, with the market increasing fourfold to $20 billion this decade. This growth has been driven by regulatory changes, investor demand and issuers looking for funding alternatives.

MICHAEL SABA is Executive Director, Institutional Derivatives, Goldman Sachs JBWere. Email: michael.saba@gsjbw.com

DAVID FINLAY is Director, Epsilon Capital. Email: david@epsiloncapital.com.au

HYBRID SECURITIES have been present in the Australian financial landscape for over 20 years in various forms. Australian companies have issued hybrid securities to raise funds and because of perceived regulatory or balance sheet benefits. Changes to hybrid security design have been a constant over the past two decades and, as complexity has emerged, the pace of change in security structures has gained momentum. The survival and strong growth of the Australian hybrid market reflects the demand from both issuers and buyers and, undoubtedly, this evolution will continue.

Three categories of factors have driven the evolution. First, security structures have adapted in response to regulatory changes such as their tax treatment, capital requirements by the Australian Prudential Regulation Authority (APRA), accounting changes and Australian Securities and Investments Commission (ASIC) regulation. Second, investor demands have driven change in yield requirement, franking demand, call option-like exposure and buyer protection under various scenarios. Third, issuing companies have found hybrids appropriate in situations such as pre-IPO capital raisings, ordinary share buyback and takeover funding, capital reconstructions and private equity buyouts.

The term 'hybrid' refers to a large and diverse group of securities that do not fit into the standard description of debt or equity, but have characteristics of both in varying proportions. Despite issuing companies using many different acronyms, most hybrids can be placed in a small number of categories, each with more or less standard features (despite much variation within each group).

Hybrids provide investors with fixed or floating interest rate exposure, as well as exposure to the performance of issuing companies. Many investors use hybrids for de facto cash or bond exposure to either enhance yield or to add diversity to an income portfolio. Hybrids with equity optionality typically give equity-focused investors conservative share price exposure – that is, less upside than holding the ordinary share but a cushioned downside if the share price falls (due to their fixed interest nature). The ASX-listed hybrid market has become a de facto corporate bond market. ASX listing gives transparency and easy access for all investors, giving this market broad public appeal. Market capitalisation of the sector has increased fourfold over this decade to more than $20 billion (see Figure 1).

Hybrids provide companies with another pool of investors, giving funding diversity. Their use can improve a company's average cost of capital. Regulatory authorities generally recognise hybrids as part of the capital base. Payment of franked dividends allows a lower distribution rate than would otherwise have been necessary. All these factors legitimise hybrids as a funding instrument.

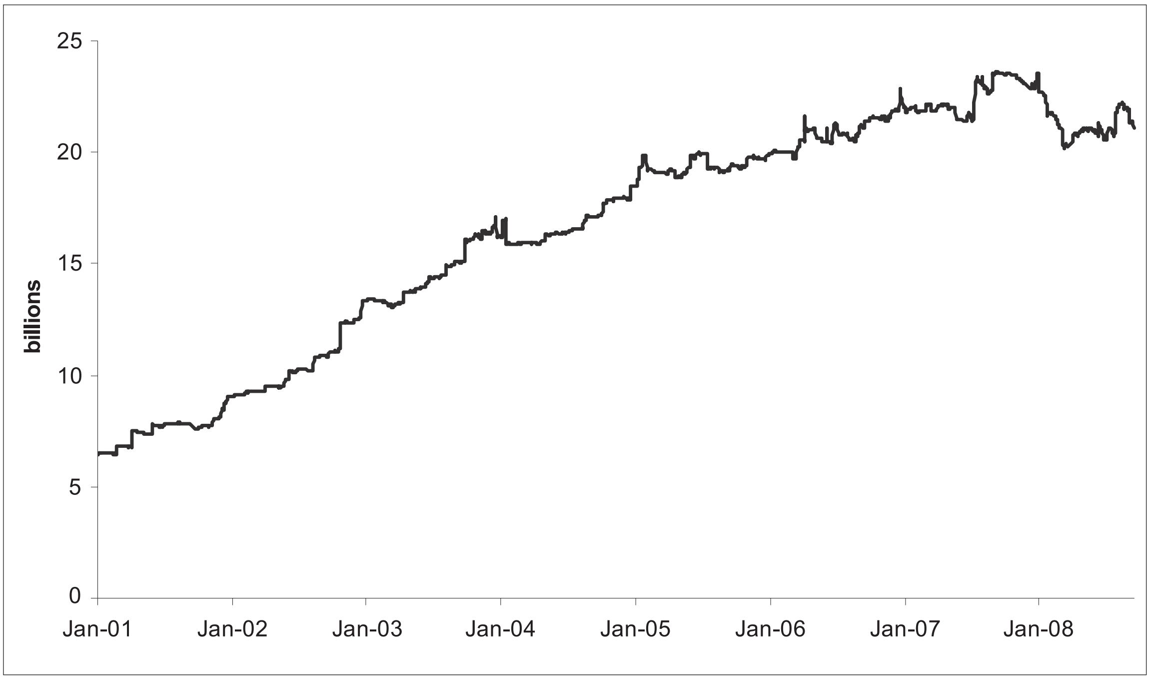
Hybrid issuance over time

Different security types have been popular at various points in time, driven by factors that will be discussed below. Table 1 shows the major types of securities and their time of issue.

The classic and initial forms of Australian hybrid securities were convertible notes and preference shares, which give interest rate (or dividend) payments combined with direct share price exposure via fixed conversion ratios.

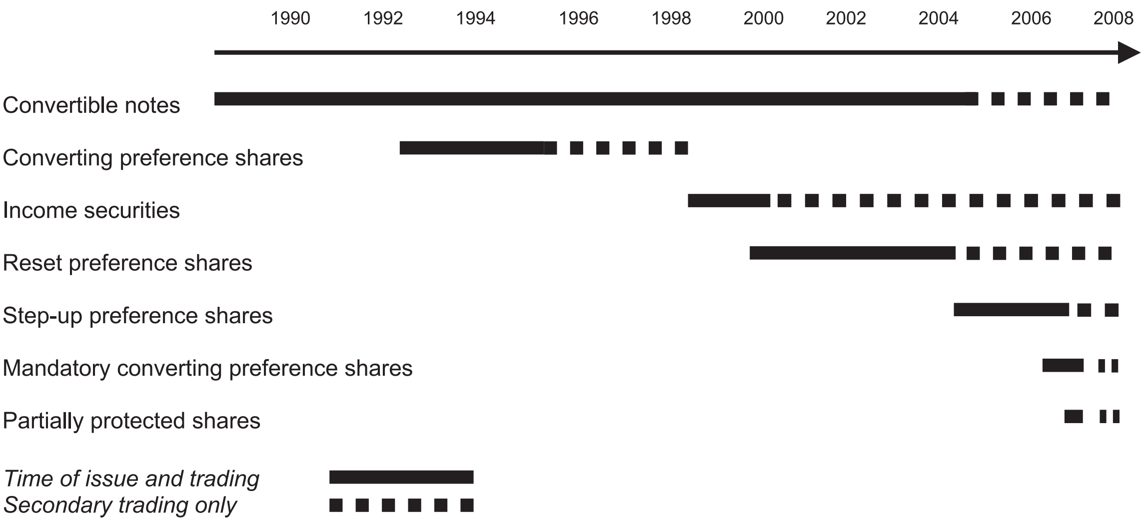
The converting preference share (CPS) structure emerged in the early 1990s. Its basic form resembles the payoff of a bond, with regular defined distributions and a

FIGURE: 1: **Capitalisation of the Australian hybrid market since 2001**



Source: GSJBW.

TABLE: 1: **Major types of Australian hybrid security issuance time line**



Source: GSJBW estimates.

conversion feature allowing the issuance of a specified dollar value of shares as the repayment amount rather than cash.[1] In contrast, convertible notes or preference shares convert into a fixed number of ordinary shares and thus have their value tied to the underlying share price.

A modification to the CPS conversion feature created share price exposure by placing constraints on the number of shares to be issued (minimums and maximums). A conversion minimum was a popular way to build in call option-like exposure to give more value at issue date (and lower the distribution rate). This created an instrument akin to a convertible bond. Including a conversion maximum (which for investors represented sold put options to the company) prevented share price dilution, but gave downside share price exposure.

In 1998, accounting reclassification of CPS as debt led to an end to basic CPS issues. More than 20 CPS were issued during a six-year period in the mid-1990s, representing well over $3 billion and focusing attention on hybrids as viable investment securities with a conservative return profile. Issues were large in size, came from household-name companies and were marketed to retail and institutional investors, with enough critical mass to underpin the creation of some specialist managed funds known as 'enhanced cash funds'. Despite the CPS demise, this structure would form the backbone of many hybrid security forms to come.

In late 1999, more than $4 billion of income securities were issued by banks and several high-profile and well-rated corporates. These had a simple structure, paying unfranked cash distributions at a fixed rate over a short-term reference rate, such as the 90-day bank bill rate. Income securities had no repayment date, with an issuer option to repay any time after five years. Their structure gave the issuer tax deductibility (including via SPVs or offshore entities) and classification as equity due to their perpetual nature, given distributions were subject to company profitability.

The demise of income securities began once investors started to focus on the lack of a hard repayment date and the lack of holder exit rights other than secondary market sale. They were, in reality, floating rate notes with, subsequently at times, uncertain tax deductibility for the issuer.[2] New issues ceased almost as quickly as they began, especially once the potential perpetual nature became priced into the securities, resulting in all issues trading substantially below face value.[3]

In late 2000, the basic CPS structure was modified to introduce potential longevity and overcome the debt classification problem. A hard 'reset' date (generally three to five years) was nominated when the issuer could offer holders the option to continue under original terms or with some key terms/parameters reset. Companies were not compelled to offer reset terms; they could simply redeem the issue. Holders did not have to accept the reset terms if offered, but could opt for repayment, giving certainty of exit. In the case of repayment chosen by the holder or the company, the mechanism at the companies' choice was to be either cash or conversion into a fixed

More than 20 CPS were issued during a six-year period in the mid-1990s, representing well over $3 billion and focusing attention on hybrids as viable investment securities with a conservative return profile.

dollar value of shares. As with the basic CPS structure, issuing companies could build in call option-like exposure and structure them with or without franking.

Such reset preference shares (RPS) became immediately popular with more than $2 billion raised in 2001 and another $7 billion to 2005 via some 30-plus issues. Banks were large issuers since the non-cumulative nature of the securities provided Tier 1 capital status. RPS could be treated as equity on the balance sheet, since the issuer could redeem them by issuing ordinary shares. During this period of contracting credit spreads, investor demand for this return profile was strong, resulting in the emergence of specialist hybrid funds. Direct retail appetite was also growing fast, especially once legislation allowed franking credits to be fully rebatable. Issuing a hybrid security with franked payments gave companies another avenue to value for excess franking credits. Floating rate style distributions were popular with retail investors, giving them direct exposure to rising interest rates, a return profile otherwise not readily available.

Issuers of Australian hybrids have always sought certainty as to the taxation consequences, although these are often a residual consequence of the specific terms and conditions typically drafted to meet regulatory, investor and economic requirements (such as those imposed under financial covenants or rating agencies). The taxation characterisation could fall on either side of the debt to equity spectrum. Additionally, as funds raised from a hybrid were often used to capitalise or refinance offshore operations of the issuer, the tax outcomes in jurisdictions in which those funds were deployed became relevant.

The debt/equity rules introduced in 2001 provided a methodology to classify financing instruments. They provided relative transparency, although questions of interpretation and discretions, together with the complexity of some commercial arrangements can still leave the result uncertain and subject to debate.

The ability of domestic investors since 2000 to obtain a refund of excess franking offsets (rather than the prior ability to offset only against other income), drove the franking credit to be valued as cash. This was a boon for issuers as, effectively, the market moved from discounting the value of the credit to some 70%, to ascribing fair value of 100%, despite a lag until credits can be received via tax returns.

Changes to regulation

In 2004 there were a number of important regulatory changes, including International Financial Reporting Standards (IFRS) and subsequent adjustment in APRA's criteria for what could qualify as regulatory capital. From January 2005, RPS (which, up to that time were accounted for as equity) were reclassified as debt on the balance sheet, because the security could be repaid in cash or converted into a fixed dollar value (i.e. variable number) of ordinary shares. (Accounting reclassification as debt could also have other implications, such as issuers potentially breaching gearing covenants).

The biggest impact of the reclassification was felt by financial issuers. Grandfathering was allowed by APRA but future issues of RPS for financials were effectively dead. Several non-bank issuers were able to call their RPS as the terms contained a 'change to accounting treatment' clause.

In 2005, APRA proposed that Residual Tier 1 (the classification that includes hybrids) could make up 25% of total Tier 1 capital. The 25% includes 15% that can be innovative hybrids, and the remaining 10% non-innovative Tier 1, initially defined as irredeemable non-cumulative preference shares. Under the standards this allowed for mandatory or step-up features with a non-call period.

Demand to use hybrids as Tier 1 capital led to the adoption of the popular European hybrid 'step-up' structure in the second half of 2004, led by several financial institutions. Step-up preference shares (SPS) are perpetual, and pay fixed or floating rate payments, with the issuer having the option to repay the security usually at five to 10 years, or face an increased interest rate. The period to the repayment date is termed the 'non-call' period. The rate increase (e.g. 100 basis points for banks or 225 basis points for a BBB+ corporation) is a disincentive for companies not to repay. If issues did step up, issuers could repay at any future distribution date. Holders have no repayment options, which is significant from the perspective of the rating agencies (who may treat SPS as equity) and regulators (who gave them Tier 1 regulatory capital classification).

Step-up style hybrids began to be issued in the second half of 2004, importantly led by several financial institutions. They were initially structured to achieve Tier 1 regulatory capital classification and included step-ups of 100 bps after a 10-year 'non-call' period. Demand was strong signalling good investor acceptance. Investor protection included a clause preventing payment of ordinary dividends for a period if SPS distributions were not paid. Additionally APRA decoupled Tier 1 capital instruments from Australian accounting standards, removing the requirement that to qualify as Tier 1 capital, the security had to be equity for accounting purposes.

In 2005–06 more than $5 billion of SPS were issued, with non-financials accounting for over 65% of issue size. With franking credits being fully valued by investors and credit spreads tight, the final cash rate paid by many banks was sub-swap cash rates.

In 2006, a number of Australian corporate issuers raised hybrid funds with a beneficial senior ratings outcome. All hybrids have, to varying degrees, equity-like factors such as no ongoing payments, permanence and cushion in event of default. After balancing these factors, the ratings agencies split the hybrid into debt and equity proportions for the analysis of the capital structure, as well as of cash flows and fixed charge coverage. This can support the senior capital outcomes. The absolute impact is tempered by the agencies limiting the amount of hybrids that can be used in a capital structure. Given the cost of a hybrid compared to the cost of equity, the benefit from a weighted average cost of capital can be compelling. The ratings on hybrids are always lower than the senior unsecured rating level of the issuer, reflecting the equity-like nature of the hybrid. The rating is typically two notches below the issuer's senior rating.

Issuers of Australian hybrids have always sought certainty as to the taxation consequences, although these are often a residual consequence of the specific terms and conditions typically drafted to meet regulatory, investor and economic requirements.

While hybrids can often have a perpetual legal form, there is often a periodic decision point for the issuer or investor. This could include a conversion, exchange or call event, or a reset in the distribution rate. One feature that the agencies are interested in is an uneconomic 'step-up' in a security as it creates a synthetic tenor on an otherwise permanent security, and means an issuer is economically compelled to redeem or refinance a security. The treatment applied by the ratings agencies has been tightened over time, and a step-up of greater than 100 basis points for investment-grade issuers is viewed as an effective maturity date of the security for the issuer.

The popularity of the hybrid market continued in 2006 when private equity firms used the sector to fund buyouts, issuing bond-like structures with attached rights for the potential of an IPO during the bond life.

Effective from the second half of 2006, APRA revised the rules as to what constitutes Tier 1 and upper and lower Tier 2 capital. Non-innovative instruments could no longer have a synthetic maturity such as a step-up feature. Mandatory conversion into ordinary shares in certain circumstances was, however, an allowable feature and presentation of the security under IFRS was decoupled from the regulatory treatment.

Reflecting this, the basic CPS structure was modified to include a mandatory conversion feature (involving either cash repayment or a dollar value of shares) at a defined date (usually five years), but with conversion subject to a share price test in accordance with APRA requirements. If the share price is below a certain level (around 50% of the price at the initial issue date), conversion is deferred until the share price recovers. Hence the security may not be converted and may remain in place under original cash flow terms. This 'extension risk' was largely ignored given that the share price test was well out-of-the-money, and the market was keen to have a replacement for the step-up structure.

Subsequently, APRA relaxed its requirements, allowing companies to repay the issue at face value even when the conversion test failed. Mandatory CPS are then, in effect, bond-like structures with the issuer having to repay at a fixed date with the option to continue the issue if the share price fails the redemption condition. Subsequently, many banks have raised more than $3 billion up to September 2008. Another bank used the structure in a non-Australian dollar format and sold into offshore markets.

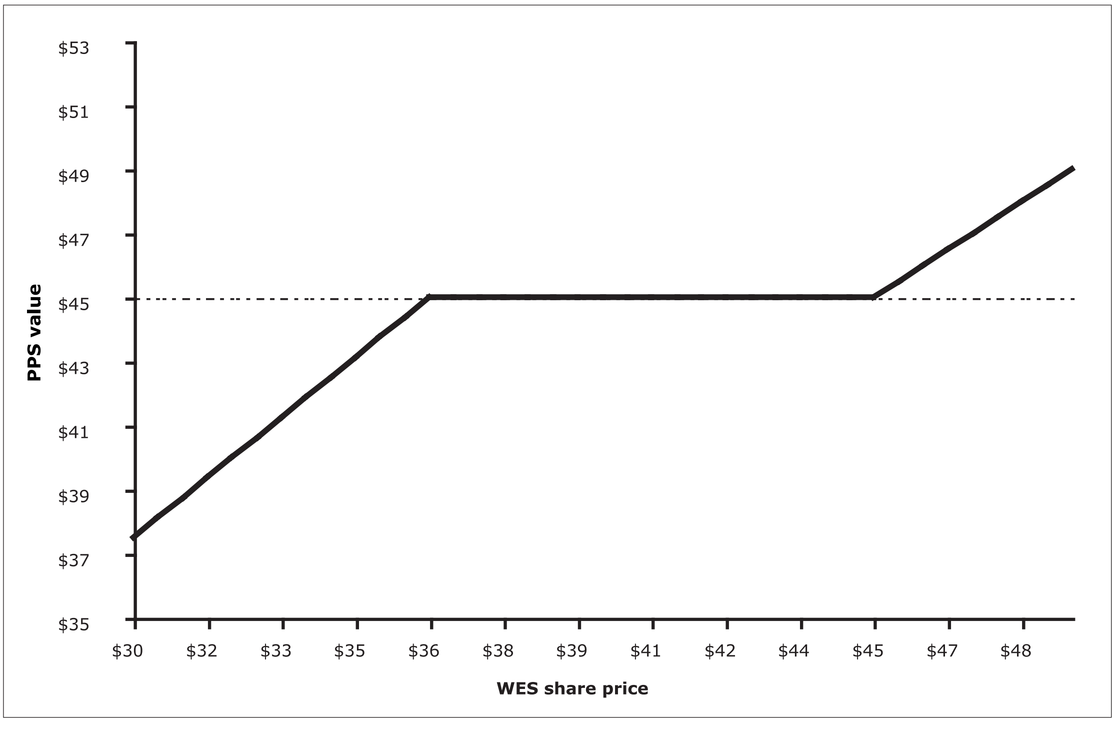
The (so far unique) issue of partially protected shares (PPS) in 2007 by Wesfarmers to provide extra incremental value in the Coles takeover is worth attention, especially given its $6 billion size. The structure was new and more closely related to ordinary equity than other recent issues as described above. The PPS are effectively ordinary WES shares (pay the same dividends) with some additional stipulations in relation to the level of the underlying company share price at maturity. If the WES share price is less than $45, then extra WES shares are issued to the holder to 'top up' to $45 of total value. A maximum conversion ratio is also present, in this case 1.25, which results in exposure to the share price below $36. The payoff from holding these PPS is shown in Figure 2. The PPS holder gets a larger return than the ordinary shareholders at all prices under $45. Effectively, the Wesfarmers PPS holder is long one ordinary share plus a $45 put and short 1.25 x $36 puts.[4]

All hybrids have, to varying degrees, equity-like factors such as no ongoing payments, permanence and cushion in event of default. After balancing these factors, the ratings agencies split the hybrid into debt and equity proportions for the analysis of the capital structure, as well as of cash flows and fixed charge coverage.

The PPS also had a 'knockout' clause whereby the $45 top-up mechanism is cancelled if the average ordinary share price exceeds $45 for 20 days, thus requiring valuation using a modified knockout barrier option model.

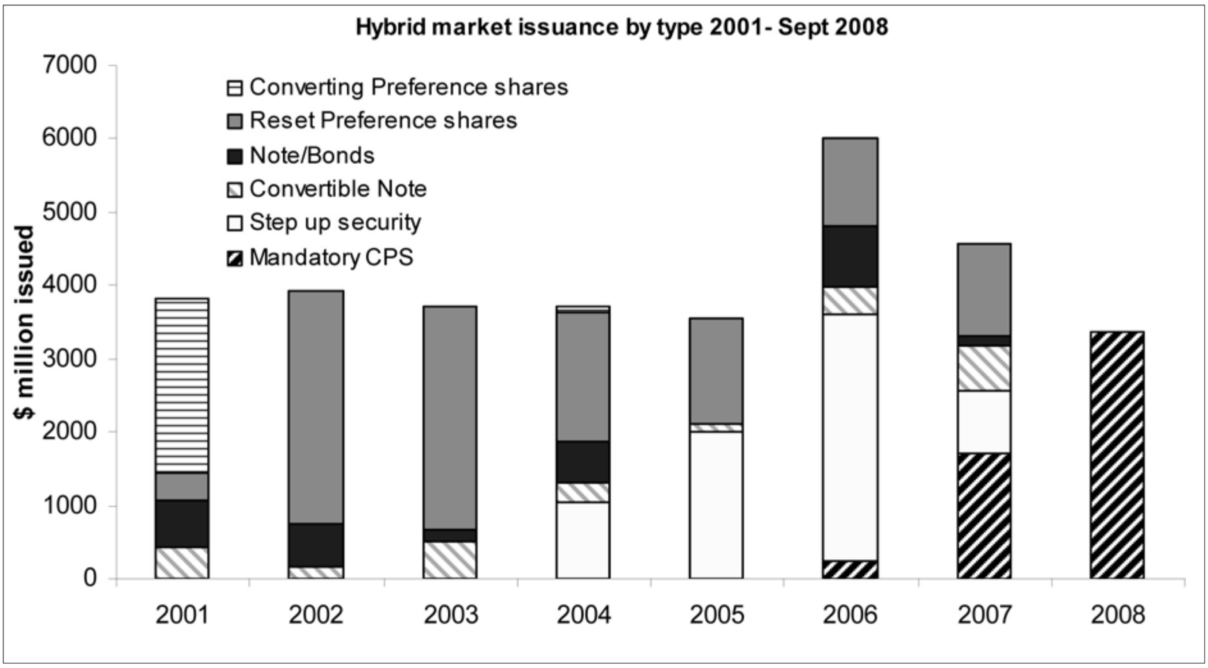
There is no natural home for such a security, except for long-term investors seeking equity exposure with some level of protection. Typical hybrid buyers are yield based and are looking for a hard exit value, rather than share price exposure. In practice, investors apply a significant discount to theoretical value because the knockout feature can cut short the protection and is difficult to hedge, resulting in little arbitrage activity. Nevertheless, the Wesfarmers PPS trades with good liquidity, albeit well below theoretical value.

FIGURE: 2: **Wesfarmers partially protected share initial payoff**



Source: GSJBW.

FIGURE: 3: **Issuance of Australian hybrids by security type**



Source: GSJBW estimates.

As the hybrid market has grown, a diverse range of investors has used this asset class. As well as retail investors adopting this market to gain bond-like returns (and hybrid funds emerging to cater for them), other users of interest rate markets have looked to hybrids in this period for de facto bond and floating rate note exposure. These included general institutional interest rate investors seeking alpha in their portfolios and especially small-to-medium sized fund managers looking for cash alternatives. Also, general equity fund managers have used RPS with embedded equity exposures, as have hedge fund style investors arbitraging share price volatility. Growth in investor types and styles is also a hallmark of the Australian hybrid market.

The next evolutionary step

We will continue to see incremental changes in the regulatory and legislative framework affecting issuers and investor behaviour. There is currently some uncertainty, for instance, as to the taxation outcomes for banks and other APRA-regulated entities issuing Upper Tier 2 capital. While clarification of the debt treatment was an issue that was identified under the previous government, regulations have not yet emerged. However, the May 2008 Federal Budget flagged that forthcoming regulations would clarify the treatment.

Capital markets in recent times have shown greater uncertainty. In credit markets, liquidity is being rationed, and the cost of credit has widened. Equity markets have shown increased volatility. Issuers will continue to explore the use of hybrid securities in these times, looking to access cost-effective pools of capital. For example, a convertible note can provide investors with attractive participation in the equity upside, with certainty of a regular distribution and the protection of a bond floor, rather than exposure to the downside risk of ordinary shares. This can be an alternative to companies issuing equity at a discount.

We also anticipate that issuers will structure securities to accommodate preferences of investors so as to be able to access pockets of liquidity. A higher interest rate environment may see investors attracted to fixed-rate issuance at this point in the credit and interest rate cycle. While investors look to lock in rates, issuers could be encouraged to assess appetite in fixing the cost of their hybrid capital requirements.

The hybrid market is a great example in Australian finance of innovation to meet a changing issuance landscape. It has been characterised by many changes in security design, especially during this decade. Despite the many changes driven by regulatory and accounting bodies, the main factors driving these issuance changes have been investor appetite and the attraction of issuers to this viable funding alternative. Without these factors, financial engineers would have had to turn their skills to other areas.

Notes

1 The share price level at maturity is relevant only in that it determines the number of ordinary shares to be issued, the value of which adds up to the particular defined dollar value.
2 The ATO successfully argued that Part IVA of the Tax Act should apply to deny deductibility of coupons on certain income securities.
3 Several of these securities are still on issue, with most having been repaid after the five to seven years.
4 The strikes were changed as a result of a capital raising in 2008.