February 2012 New Issues Analysis

This last week has seen the launch of four new income offers: ANZ Subordinated Notes, Colonial Group Subordinated Notes, Tabcorp Subordinated Notes and Westpac Convertible Preference Shares (CPS). We have produced this overview in an attempt to provide some clarity for investors in making a comparison of the offers available.

Comparison of current offers

	ANZ Subordinated Notes ANZHA	**Colonial Group Subordinated Notes CNGHA**	**Westpac Bank CPS WBCPC**
Spot in capital structure	Senior Subordinated - ANZHA Hybrids - ANZPA, ANZPB, ANZPC Ordinary shares	Senior Subordinated - CNGHA Hybrids Ordinary shares	Senior Subordinated Hybrids - WBCPC, WBCPA, WBCPB & WCTPA Ordinary shares
Maturity Date	14th June 2022 (10 years)	31st March 2037 (25 years)	Perpetual - Subject to Mandatory Conversion 31st March 2020 (8 years)
Expected Call Date	14th June 2017	31st March 2017	31st March 2018
Step-up (after initial call date)	None	None	None
Common Equity Trigger Event	None	None	CPS will convert into Westpac Ordinary Shares if Westpac's Common Equity Capital Ratio is equal to or less than 5.125%
Distributions	Unfranked - Floating interest rate, paid quarterly	Unfranked- Floating interest rate, paid quarterly	Franked - Floating interest rate, paid semi annually
Deferral of interest	Not able to defer interest as long as ANZ remains solvent	Issuer option to defer interest. Deferred interest is cumulative and must be paid after 5 years.	Dividends are discretionary. Unpaid dividends are non-cumulative. *If dividends are not paid in full, Westpac must not (subject to certain exemptions), pay dividends on ordinary shares*
Indicative margin	***2.75%-3.00% over 90 day BBSW***	***3.25%-3.75% over 90 day BBSW***	***3.2%-3.5% over 180 day BBSW***

The current focus on income

The recent flood of fixed income issues is a result of the ongoing market volatility and the increased cost of overseas funding. Falling term deposit rates and a negative sharemarket outlook has meant investors are hungry for new hybrid issues. The success of Australian Foundation Investment Company Notes (AFIG), Origin Energy (ORGHA) and Woolworths Notes II (WOWHC) late last year has signalled that investors are willing to release funds from bank deposits in exchange for the higher income offered by hybrid offers.

Ranking of offers in the debt structure

It is very easy to get distracted by the yields on offer but arguably the single most important factor to understand is where the security sits within the debt structure. The greater the risk, the more investors should be rewarded.

The offers launched offer a wide spectrum of income and security with ANZ Subordinated Notes (ANZHA) offering a higher security hybrid at 2.75%-3.00% over the 90 day BBSW and an indicative rate of 7.12%-7.37%pa*, Colonial Group Subordinated Notes (CNGHA) at 3.25%-3.75% over the 90 day BBSW, and lower security Westpac CPS (WBCPC) at 3.20%-3.50% over the 180 day BBSW.

Figure 1: Trading margins on debt and equity securities

	Ranking	Security	Trading Margin over BBSW	Maturity
Higher Ranking	Secured debt	Westpac covered bond (issue margin 175bp)	135bp	Feb 2017
↑	Unsubordinated unsecured debt	Westpac senior debt	156bp	May 2016
	Subordinated unsecured debt	ANZHA	275bp	Jun 2022
		Colonial (CNGHA)	325bp	Mar 2037
↓	Preference securities	**WBCPC**	**320-350bp**	**Mar 2020**
Lower Ranking	Equity	Ordinary Westpac shares	>600bp	Perpetual

SOURCE: YIELDBROKER, BELL POTTER

Although many investors take the view of investing and holding until maturity/call and are often ambivalent to market movements, those looking for stability and attempting to diversify away from equities should be conscious that the further down the debt structure, the closer the behaviour to equities. The same rule applies to lower quality companies. And whilst small falls in sharemarkets has little impact on day to day hybrid pricing, sharp falls such as August last year (ASX 200 fell 8% in 2 days), resulted in around a 4% fall in the bank hybrids (considered the safest of the listed hybrids).

To provide investors with some perspective, Westpac CPS (WBCPC), sits within the same risk band as the current listed bank hybrids.

Our view

Whilst we feel ANZHA, CNGHA and WBCPC are all investible offers, our order of preference is jointly with CNGHA & ANZHA followed by WBCPC and finally Tabcorp.

What we like

ANZ Subordinated Notes – ANZHA

Key features

- **Indicative floating yield of 7.12-7.37%pa -** based on current 90 BBSW of 4.37% and bookbuild margin range of 2.75-3.00%. This provides investors the opportunity to lock in historically high issue margins.
- **Quarterly unfranked interest** - Interest payments are not deferrable so long as the solvency condition is met.
- **Redemption highly likely in 5 years -** although ANZHA has a 10 year maturity, we think ANZ will redeem at the first redemption date in June 2017. Major incentives for

redemption in June 2017 include the potential for reputational damage. Not paying in 5 years is likely to lead to an increased cost of funding on future debt issues.

What we like

1. **Higher level of security** - Unlike previous issues, ANZHA are higher up the debt structure and offer investors greater security and the greatest level of security of the four issues highlighted.
2. **Greater security** - is likely to provide investors with greater protection from market movements and in the unlikely event that ANZ goes out of business is paid out ahead of other hybrid holders such as ANZPA, ANZPB, ANZPC and ordinary shareholders.
3. **Unfranked income** – Investors should be aware that fixed income etiquette dictates that the rate disclosed is inclusive of franking credits, therefore unfranked payments are more attractive as the full payment is received rather than having to claim the franking back at the end of each year.
4. **Attractive to international investors** – Since international investors can't claim back franking credits, unfranked payments are likely to be more attractive to overseas investors.
5. **Credit ratings** – ANZHA has already sought approval from the credit rating agencies that many institutional investors require before investing. We therefore expect the demand for this issue to be significant.
6. **Does not contain the automatic conversion clause** - to ordinary shares should their Tier 1 capital ratio fall below 5.1%. Recent bank issues such as ANZPC and WBCPC contain this clause and whilst we feel it unlikely, in the event of a bank failing and a run on deposits, investors holding these hybrids could find themselves converted to ordinary shareholders.
7. **A fixed maturity date** – The relatively short term (10 years) fixed maturity date means that if the interest rate becomes uncompetitive, investors are assured of their return of capital in 10 years

What we don't like

1. **Low income** - Retail investors are likely to overlook this issue in favour of the high yield offered by other issues on the assumption that the government would ensure the major banks would not go out of business and that the additional security is therefore irrelevant.
2. ANZ issued ANZPC in August 2011 and at the time it was felt that they took everything that they could (within reason). It would not surprise us if this issue was a repeat of last August and limits some of the after-market support. Investors looking for a stag profit in the first week should take note.

Colonial Group Subordinated Notes - CNGHA

Key features

- **Initial floating yield of at least 7.5% -** although the current 90 BBSW provides for a first coupon of at least 7.65%, CNGHA has a minimum first coupon rate of 7.50% which provides some protection if the RBA reduces the cash rate in March.
- **Quarterly unfranked interest -** first interest payment date 29 June 2012.
- **Interest protected** - while the issue terms allow for deferral of CNGHA interest payments at Colonial's discretion for up to 5 years on a cumulative and compounding basis, investors are protected by the dividend stopper requiring non payment of ordinary dividends to CBA. In FY11, Colonial paid $580m of dividends to CBA, the equivalent of 8.5% of CBA's $6.8bn cash net profit.
- **Redemption most likely in 5 years** - although CNGHA has a 25 year maturity date, we expect redemption in 5 years. It is expected that some of the ratings agencies will treat CNGHA as equity for the first 5 years and debt thereafter with an implied follow on effect of increased cost of funding. CBA's ownership is a further reassurance since continuing beyond the initial call date has a potential negative impact on CBA also.

What we like

1. **Higher level of security** – We view CNGHA as comparably higher up the debt structure than Convertible Preference Shares and the Westpac CPS issue, but behind ANZHA. With markets in continued disarray, the greater security is reassuring.
2. **A non bank hybrid** – the majority of investors in the hybrid space will already hold bank hybrids within their portfolio. Although Colonial remains a financial and is owned by CBA, the demand for high quality non-bank issues to diversify portfolios is likely to support this Note.
3. **CBA Bank ownership –** Colonial is highly profitable with around 7 times interest cover and currently accounts for around 8% of CBA's profits and is heavily integrated into their financial planning and product distribution. We feel it unlikely that CBA would ever turn their back on Colonial should they ever enter into financial difficulties, thereby providing an implied guarantee over Colonial Group.
4. **A high level of unfranked income** – Unfranked payments pare more attractive as the full payment is received rather than having to claim the franking back at the end of each year and relative to ANZHA, CNGHA is likely to offer a further 0.5%pa yield to investors.
5. **Attractive to international investors** – Since international investors can't claim back franking credits, unfranked payments are likely to be more attractive to overseas investors.
6. **Comparison to Woolworths Notes II** – The closest comparable currently listed is Woolworths Notes II (WOWHC) issued late last year. The terms and security offered are very similar. Although in a different sector, we feel it likely that the support for high quality non-bank issues will support the price on listing.

Woolworths institutional bonds typically trade at around 0.4%pa below the major banks, indicating the lower perceived risk and we have seen the same behaviour in WOWHC on listing, currently trading at just over $104 a share.

Although Colonial is not a bank, it remains a financial and applying the same 0.4% discount to the WOWHC in making comparisons means we would expect to see this trading at around $102.

What we don't like

1. **No step up in year 5** – Although considered unlikely not to repay this debt at the first opportunity in 5 years due to the reputational risk, expected downgrade in credit rating and increased cost of funding, no step up in 5 years leaves a sour taste in the mouth. As I said to an analyst at Bell Potter recently, "if it's that unlikely why would they not put a step up in there, I don't believe that they just overlooked it".

   A significant increase in the cost of borrowing over the next few years would make this event more likely and in the event that Colonial did not repay this at the first call date, investors would be left holding a Note with a further 20 years to maturity, probably trading at below face value.

Westpac CPS - WBCPC

Key features

- **Indicative floating yield of 7.60-7.90%pa -** based on current 180 BBSW of 4.40% and bookbuild margin range of 3.20-3.50%. First payment due on 30th September 2012.
- **Option to redeem at year 6 with mandatory conversion at year 8:** Westpac has the option to convert in March 2018 or on any subsequent dividend payment date.
- **Ordinary dividend restrictions:** applies on the non payment of WBCPC dividends
- **Automatic conversion under the Capital Trigger Event**
- **Redemption highly likely in 6 years -** although WBCPC has an 8 year maturity, we think Westpac will redeem/convert at the first call date in March 2018. Major incentives for redemption/conversion include the potential for reputational damage and risk of credit rating downgrade, leading to an increased cost of funding on future debt issues.

What we like

1. **Westpac hybrids considered at the lower end of the risk spectrum** – Post GFC, the market feels there is an implied guarantee over the banks, as such bank hybrids, and in particular, the big four are considered lower risk by many than some of the lower grade issues such as Origin Energy and Tabcorp.

2. **Shorter term** – The recent trend on issues is to extend the maturity date in excess of 25 years. e.g. Origin Energy Notes (ORGHA), Woolworths Notes (WOWHC) and

Colonial Group Notes (CNGHA). This is an attempt to fit ratings house' criteria to consider the issue as equity rather than debt.

WBCPC's mandatory conversion in 8 years (subject to certain conditions being met) should provide some reassurance to investors.

3. **A higher level of income** – Relative to the other major issues (ANZHA and CNGHA), Westpac CPS offers the highest level of income. Investors ambivalent to market movements and view the risk of Australian banks failing as negligible would do well to consider this issue for its higher level of income.

What we don't like

1. **The automatic conversion clause** – APRA standards on new issues means that the bank issues such as ANZPC (issued August 2011) and WBCPC contain an automatic conversion clause to ordinary shares should their Tier 1 capital ratio fall below 5.1%. Although we feel it unlikely, in the event of a bank failing and a run on deposits, investors holding these hybrids could find themselves converted to ordinary shareholders. As a result investors are being offered historically high yields.
2. **Semi annual payments** – Income is payable twice yearly. Investors should consider that this is less attractive than quarterly payments.

Comparison to ANZPC – This issue very closely resembles ANZPC issued in August last year which was issued at 3.10% over the 180 day BBSW and has traded at close to face value since, currently at $99 a share. At 3.20% over the BBSW, this values Westpac CPS notes at below $100 per share. It therefore seems likely that Westpac will have to pay towards the upper end of its indicative range, and if so, does offer some value to investors.

A quick note on Tabcorp

We have note reviewed Tabcorp in this issue as this was quickly filled and closed early last week in response to the ANZ, Colonial and Westpac offer. Our view is that the high income offered of over 4%pa over the 90 day BBSW is likely to have been very attractive to investors and could see this listing at over $102 a share. Our view is there is currently an alternative Tabcorp offering trading at around $104, paying 4% over the BBSW and ranks higher up in the debt structure. We expect that the initial demand will see this price increase on listing but should eventually drift back to below face value as the value is arbitraged back.

Overall view

We currently favour hybrids within our client portfolios, the yield being offered is at historically high levels. The success of ANZ CPS3, Woolworths Notes Origin Energy late last year has alerted companies to the ease in which they can currently raise capital and the huge demand from retail investors. We expect to see a large number of fixed income offers to come to market this year and margins are likely to get tighter as the flood of new issues continues.

Our preference of this last week has been Colonial and ANZ followed by Westpac then Tabcorp. We like the higher security currently offered by ANZHA and CNGHA, hence our preference, and feel that the additional income on CNGHA compensates investors adequately for the lack of a step up.

The flood of hybrids launched this week should see investors benefit through higher margins as each offer competes for investor attention.

Investors looking for an allocation to these offers can contact us on 1300 559 869.