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FIERCELY ON YOUR SIDE

SOLUTION BRIEF

‘Hybrid Securities’

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‘Hybrid securities’ are a broad group of securities that combine elements of both ‘debt’ and ‘equity’. They provide both businesses and investors with the ability to more accurately satisfy their funding and investment needs

Hybrid securities have the characteristics of both “debt” and “equity”. They allow the creation of financial instruments offering investors varying degrees of risk and reward. Hybrid securities offer numerous combinations of payments, rights and obligations which makes them attractive to both businesses and investors.

Hybrids provide investors with a predictable dividend or interest payment at a benchmark rate of return (often linked to the Bank Bill Swap Rate (BBSW)), plus a margin that reflects the credit risk of the issuer.

The yield on hybrid securities is nearly always higher than the standard yield offered by direct ‘equity’ securities, which makes hybrid securities more attractive than shares as an income producing asset. On the flip side, the issuer may prefer to adopt hybrid securities because the yield is often lower than comparable unsecured debt, and also provides the issuer with a significant degree of flexibility as to how the offer is structured.

Hybrid securities are not, as a general rule, “growth” assets like shares. This is because they generally have a fixed redemption value. However, they can offer equity upside to the investor that may give rise to capital gains, often linked to the performance of the underlying ordinary shares of the issuer. The convertible nature of some hybrid securities also offers investors a form of indirect access to the ordinary share equity of the issuer.

Examples of hybrid instruments include:

- Convertible Notes; and
- Preference Shares.

‘Convertible Notes’ are a debt instrument that can be converted into shares at the option of the holder or the issuer.

‘Convertible Preference Shares’ and ‘Redeemable Preference Shares’ are an example of a hybrid security that may be considered as equity when first issued but offer investors dividends that resemble interest payments and therefore debt securities.

What are the risks for investors?

Most investors see hybrid securities as high-yielding defensive assets for their portfolios and therefore a ‘flight to safety’ during difficult times. However, the higher the yield on a security of this nature, the higher the risks attached to it, which means the more likely they are to expose investors to price volatility during times of tight credit and liquidity markets.

The two main risks to investors in hybrid securities are credit or ‘default risk’, and ‘term risk’.

‘Default risk’ is the risk that the issuing entity defaults on periodic payments or repayment of the initial investment capital. Although hybrids represent a less risky investment than direct shares, the price of a hybrid security can also be affected by the performance of the issuing entity and may expose an investor to downside price risk. However, if an investor is dissatisfied with the performance of the issuer, they always have the option of trying to sell their hybrid securities prior to redemption or conversion.

‘Term risk’ involves the risk of investing in hybrid securities over long periods of time. Historically, longer maturity instruments have higher risks attached to them without the commensurate increase in expected returns. As such, the return from longer term hybrid securities is generally not worth the added risk. To avoid the price volatility attached to longer term hybrid securities, the key is to stay relatively short term (i.e. no longer than 4-5 years). The best risk adjusted returns can be delivered by investing in short-dated hybrid securities of 2-3 years.

A further but less important risk to investors of hybrid securities is ‘liquidity risk’. This is the risk that some investors may not be able to buy in or sell out of a particular hybrid security in a hurry at the price they want. Liquidity risk is, however, not a huge issue for the majority long term investors in hybrid securities because most investors purchase hybrids to access a constant and predictable income stream usually for the duration of their term (i.e. until conversion or redemption).

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Why would you invest in hybrid?

Hybrid securities can be suitable for investors both during their pre-retirement accumulation or savings phase, as well as the post-retirement pension phase, when self-funded retirees will be drawing on their life savings.

The decision to include hybrids in an investor's portfolio and to what extent is therefore dependant on a person's stage in life, time frame for investment and risk profile. Obviously, there will be greater need for high yielding income producing securities during the pension phase in order to pay for a retirement income stream than during the accumulation phase of saving for retirement when growth assets are more important. The asset allocation process both pre and post retirement therefore becomes paramount as investors rebalance their portfolios to suit market conditions and their own personal situation.

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Convertible Notes

Convertible Notes are debt instruments that may be converted to an equity holding at a future date. A Convertible Note is therefore issued with a right to convert the holding into an agreed number of ordinary shares at inception, or at a time closer to conversion. In effect, a Convertible Note is a fixed interest security with a call and/or put option to purchase shares at some later date.

Prior to conversion, the Convertible Note is debt-like, with investors receiving interest payments. At this stage the instrument generally does not convey the same benefits as equity. However, like a debenture, investors would receive their normal fixed interest payments for the duration of their ownership of the note.

Commonly there is a conversion formula which provides for a 'floor', thus guaranteeing the holder will get equity of at least the value of their investment. However, should the share price fall to a level substantially lower than the issue and conversion price, the holder is still guaranteed cash on maturity of the note.

Convertible Notes are particularly advantageous to the investor if the market value of the company's shares increases over the period they hold the note.

If the attached right is exercised, the note is cancelled, and the note holder is issued with the agreed number of shares. Interest payments will accordingly cease and the (now) shareholders

become entitled to any dividends declared on the shares. They will also be able to vote at shareholders' meetings in accordance with the voting rights attached to the shares.

An advantage for a company in issuing Convertible Notes is that they will be able to avoid having to raise further funds to redeem the notes if investors convert their holdings into shares. However, it should be remembered that the issuing of shares will dilute the value of the existing share capital of the company.

A number of other advantages accrue to a company issuing Convertible Notes. Often these securities have terms of up to ten years which provides the issuing company with fixed-rate long-term debt finance. Convertible Notes therefore represent the only way that some newer and smaller companies have of obtaining long term fixed interest finance. Being a long-term security, Convertible Notes are attractive to institutions with long-term liabilities, such as superannuation funds.

Convertible Notes are also attractive to an issuing company in their own right, as they are an unsecured liability. A company that has pledged its existing assets as security for other loans can issue Convertible Notes. However, the unsecured nature of these debt-like securities does represent a risk to note holders.

Some markets will purchase a note that converts into a share in preference to purchasing an ordinary share. Large companies often feel more secure knowing that their capital is spread amongst a number of different markets rather than being dependent on one market only for their capital. Convertible Notes offer the opportunity to access these other capital markets.

In certain circumstances Convertible Note issues are released undated, giving an extended period in which to convert them into equity, thus creating a form of perpetual debt. Alternatively, convertible instruments can be callable, meaning the issuing company has the right to repurchase the instrument at a certain price in the future, thereby forcing holders of the debt instrument to convert to equity sooner than they may otherwise have chosen.

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Preference Shares

A Preference Share is a type of equity interest which has preferential rights over ordinary shares. The company's profits are distributed (through the payment of dividends) to preference shareholders before ordinary shareholders. In addition, if the company goes into liquidation, the preference shareholders are paid out before ordinary shareholders, making them slightly less risky to invest in.

Preference Shares are legally 'equity', and like equity, their dividends are paid out of after tax profits. Investors, however, generally regard Preference Shares as a form of debt security if:

- There is a contractual obligation of mandatory redemption by the company (a feature of debt rather than equity); and
- The dividend is fixed and cumulative (which is suggestive of fixed interest on a debt instrument).

However, Preference Shares are not pure debt instruments because the payment of the dividend may be dependent upon the profitability of the issuer.

There are a variety of different types of Preference Shares offered in today's financial markets with a variety of different characteristics. The most common are:

- Convertible Preference Shares; and
- Redeemable Preference Shares.

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Convertible Preference Shares

Convertible Preference Shares pay fixed dividends up until a compulsory conversion date, at which time they convert into ordinary shares at a variable price which is determined by the issuing company, and is usually at a discount to the prevailing market price. As Preference Shares, they have priority over ordinary shares in relation to both the payment of dividends and the assets of the company in the case of winding-up.

Generally, a company considering the issue of Convertible Preference Shares is in the position of needing additional equity immediately but believes that its current share price does not accurately reflect the true value of the company. This might be because the company is currently out of favour

with the equity markets. Issuing Convertible Preference Shares offers such a company the opportunity to effectively sell its shares in the future when, they hope, the shares will be worth more in the market. Therefore, from the company's perspective, the issue of a Convertible Preference Share is a form of delayed equity. The conversion into equity (i.e. ordinary shares), is just held back until the specified date.

From the investor's point of view, the receipt of fixed dividends up until the time of conversion, which is suggestive of fixed interest, gives the instrument a debt-like quality. Furthermore, the conversion of a Preference Share to ordinary shares can be thought of as payback of the principle at the end of the term in the form of ordinary shares, and in lieu of cash. The number of shares received is, however, generally determined by prevailing market prices, allowing the investor to participate in share price gains and thus giving the convertible preference share more of an equity flavour.

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Redeemable Preference Shares

Redeemable Preference Shares have a fixed redemption date on which they will usually be redeemed at a stipulated price with holders usually entitled to receive payment of the face value of their redeemable preference shares, any premiums on the Redeemable Preference Shares, and any dividends accrued (whether declared or not).

Redemption may be mandatory, at the option of the investor or the option of the issuer. Like Convertible Preference Shares, Redeemable Preference Shares have priority over ordinary shares in relation to the payment of dividends. Whilst their legal form is that of a share (therefore an equity-based instrument), most redeemable preference shares exhibit debt-like features, including:

- Fixed dividend payments;
- An option for the holder and/or issuer to redeem the share (or compulsory redemption) for a pre-determined amount; and
- Cumulative dividend payments, where any missed dividends must be made up before the company can pay dividends on its ordinary shares.

Redeemable Preference Shares may be useful in circumstances where ordinary shareholders in a company are seeking temporary use of outside capital for specific projects without risking dilution of their control of the company.



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TALK TO US

What next?

If you would like to speak to someone about using hybrid securities, call us on 1300 654 590 or email us at wehelp@adlvlaw.com.au.

Further information can also be found on our website at www.adlvlaw.com.au.

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