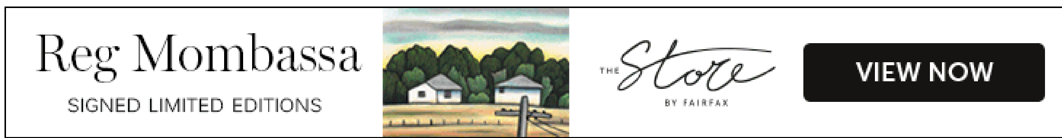
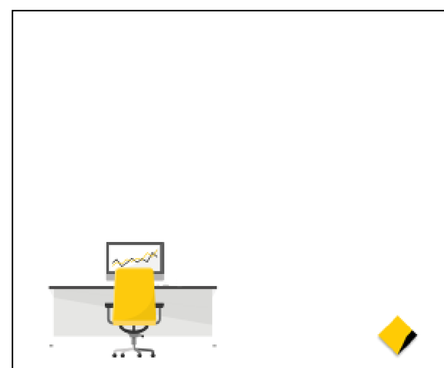


OPINION | Feb 3 2017 at 10:00 AM | Updated Feb 3 2017 at 10:11 AM

Hybrid game theory: fresh deals or rollovers?

An easy way for banks to offer investors incentives to buy a new hybrid would be to give them part of the 1 per cent sales commission they pay to distributors. **Chris Pearce**



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by **Christopher Joye**

With suggestions that CBA will issue a new "hybrid" within days, Australia's mega-banks will once again engage in game theory that determines how investors fare.

Crucial questions include: will all the majors mint fresh deals this year or will they wait to roll existing securities; have they learnt from the difficulties of days past (some clients are still underwater from CBA and Westpac's 2014 securities); should they compensate investors with concessionary returns above secondary market "spreads" as they do when raising money via shares and wholesale bonds; and is the market cheap or expensive right now?

A leading hybrid guru (who cannot be named as his firm does not allow him to be quoted) reckons "the major banks will be regular issuers into the hybrid market rather than simply waiting to roll deals on their 'call' [or expected repayment] dates". "Westpac, for example, has consistently come to market every 13 months or so," this person says.

It certainly makes sense to source this valuable form of "preferred equity" capital consistently over time rather than on dates dictated by earlier issuance. And while the

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first major bank hybrid, ANZPC, is not expected to be called until September, the banks normally announce replacement securities three to six months in advance.

The Australian Financial Review's Street Talk reports that CBA's smart treasury team is considering refinancing its Colonial Holdings' subordinated note (CNGHA), which counts as Tier 2 capital and has a March 31 call date, with a Tier 1 hybrid that would improve its all-important equity capital ratio.

When CBA launched Perls 8 (CBAPE) in February 2016, it ended up pricing the scaled $1.45 billion deal at a margin of 5.2 per cent above the quarterly bank bill swap rate.

Based on trading prices before Street Talk's news, a major bank hybrid with a five-year call date was offering an expected fully-franked annual return of 3.6 per cent above bank bills (or a total franked return of 5.4 per cent annually).

While that is 1.6 per cent less than the 5.2 per cent spread above bills captured by CBAPE investors, it is 0.8 per cent more than the 2.8 per cent margin above bills paid by CBA in its Perls 7 (CBAPD) deal in 2014. Those two hybrids make a case study in contrasts: whereas CBAPE is trading at $107, CBAPD languishes below par at $95.70.

So should banks offer investors incentives to buy a new hybrid over and above what they can get on the Australian Stock Exchange's increasingly liquid secondary market? (An easy way to do so would be by giving giving investors part of the 1 per cent sales commission they pay to distributors.)

Realm Investment House's Andrew Papageorgiou says ASX bank hybrids are currently "fair to moderately dearly priced". He argues that a new major bank hybrid with a five-year call should be priced at 4.25 per cent above bank bills, or a bit wider than current listed market levels, to compensate investors with "attractive" economics.

It is common for banks to furnish investors with similarly sized concessions when raising money via their wholesale subordinated bonds in the institutional over-the-counter market. New equity issues also tend to price at a decent discount to the volume-weighted average share price.

Papageorgiou, who runs a $235 million fixed-income portfolio that includes hybrids, believes the banks have learnt from past mistakes when they over-supplied the market with scant or no concession only to see spreads, and thus their cost of capital, inexorably widen. "The experience of 2014 is still fresh in mind and history is unlikely to repeat itself in the immediate term," he says.

The aforementioned hybrid expert thinks another factor that warrants a concession, or risk premium, is the fact that "there is normally a five-week window between an investor committing to a new hybrid and its ASX listing, during which time they have no liquidity and spreads can widen materially". In the OTC bond market, new issues start trading minutes after the bookbuild has closed.

This person also warns that one of the reasons the hybrid market has performed so well of late is because "volatility has been very low, which has contributed to spreads, or required returns, contracting". "As in in 2014, the risk is that volatility increases and spreads widen," he adds.

There is undoubtedly a tremendous amount of event risk — ranging from further Eurozone instability emanating out of Britain and Greece, geo-political conflicts and inflation surprises in the US — that could potentially undermine "animal spirits".

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While the majors do not ostensibly need to originate much hybrid capital in 2017, they may have to after the Australian Prudential Regulation Authority's releases its long-awaited definition of what an "unquestionably strong" capital ratio represents. In a November speech APRA's boss Wayne Byres surprised many banks when he said: "We'll assess capital positions against rating agency measures of capital strength."

The most respected rating agency metric is Standard & Poor's risk-adjusted capital (RAC) ratio. NAB (9.5 per cent) and Westpac (9.7 per cent) are tantalising close to the 10 per cent threshold that earns them a stand-alone credit profile upgrade from "a" to "a+". CBA (9.2 per cent) and ANZ (pro-forma for recent asset sales, 9.3 per cent), have further to go. In total, the majors only need another $13 billion of equity capital, including hybrids, to offset the impact of a sovereign credit rating downgrade on their senior, subordinated and hybrid notes.

A final wrinkle is the fact that Australian banks, and the majors particularly, have $12.4 billion of local and offshore subordinated bonds maturing in 2017, including a chunky $4.4 billion on the ASX. Deutsche Bank forecasts that our banks will issue $20 billion of subordinated bonds globally this year, which while manageable might warrant wider spreads.

The author is a portfolio manager/director of Coolabah Capital Investments and Smarter Money Investments, which invest in fixed-income securities.

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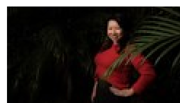

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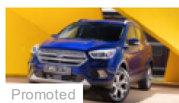

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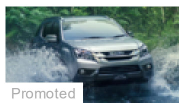

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