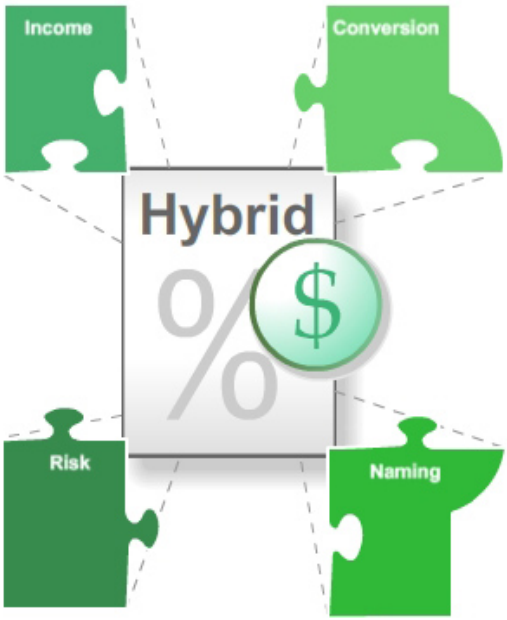
Topic 1: Hybrids

In this module we look at the key characteristics of hybrids:

- income,
- conversion into cash or shares,
- their risk profile, and
- naming conventions



Before you invest in hybrids, you may wish to become familiar with the fundamentals of bonds in our bonds course and the basics of share investing in our shares course.

Each hybrid quoted on ASX is unique. Before you invest in a hybrid, you need to understand its characteristics:

- **Income** - How is it determined and when is it paid? Is it franked or unfranked? Is it cumulative or non-cumulative?
- **Exiting your investment** - What are your exit options? When can it be redeemed or converted?
- **Ranking and risk** - If the hybrid issuer gets into financial trouble, where will you rank in the line of creditors and investors?
- **Extraordinary or Prescribed events** - Does the hybrid allow for the terms of issue to be changed under certain circumstances. What are these and how likely are they to be triggered? Can your investment be extinguished or 'written off' if the issuer suffers significant financial difficulty?

How much do I earn?	Income
Will I get my money back?	Risk
Can they change the terms?	Extraordinary events
Must I hold to maturity?	Exiting

What is a hybrid?

"Hybrid" is an umbrella term for a family of products that includes:

- Preference shares
- Capital notes
- Convertible notes and bonds
- Subordinated notes and bonds

Capital notes	✓
Convertible notes	✓
Government bonds	✗
Ordinary shares	✗
Preference shares	✓
Rights issues	✗
Subordinated notes	✓

We use the term hybrid throughout this course to cover this group of products. This is an evolving market, so there may be new products with new names not covered in this course. The final topic in this module has a more detailed look at the naming conventions for hybrids.

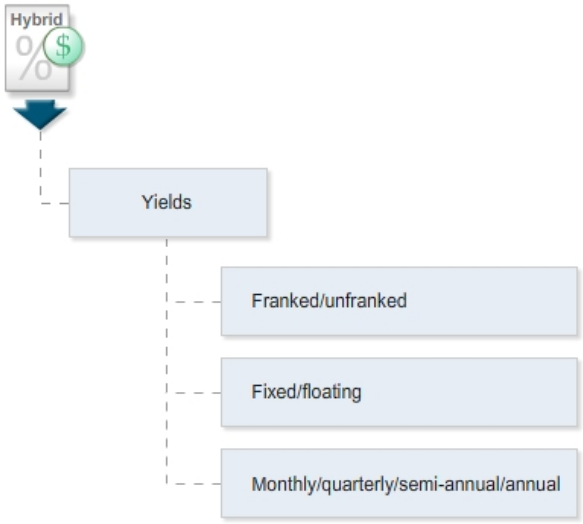
Topic 2: Income

Many hybrids are classed as a 'yield' investment - they are typically bought for their income.

It is easy to scan a list of hybrids and compare their published yields. But this figure is only part of the story though. It does not tell you if the distribution is:

- franked or unfranked,
- fixed or floating,
- paid monthly, quarterly, semi-annually or annually.

The yield figure also doesn't give you any idea of the other characteristics of the hybrid that can affect its value and its risk.



The different types of distributions

Preference shares typically pay dividends, which can be franked or unfranked.

Capital notes generally pay distributions, which also can be franked or unfranked.

Other types of hybrids generally pay interest, which is not franked.

All of these different types of distributions are typically expressed as a percentage of the hybrid's face value.

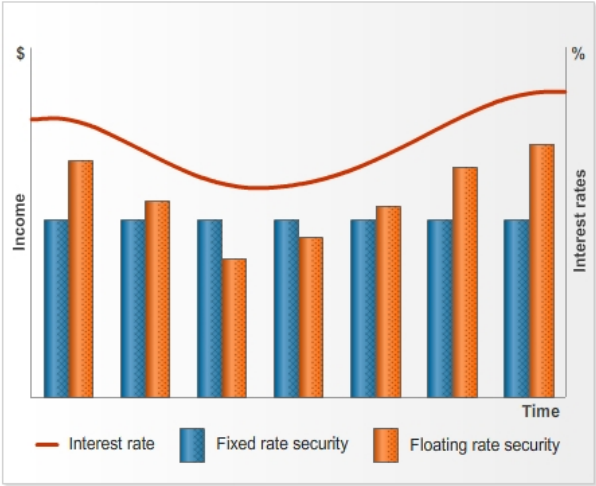
	Payments	Franking	
Capital notes	Distribution	Franked	✓
		Unfranked	✓
Other hybrids	Interest	Franked	✓
		Unfranked	✗
Preference shares	Dividend	Franked	✓
		Unfranked	✓

Fixed vs floating rate distributions

If your hybrid pays fixed rate distributions, your payments do not vary. You will receive a fixed percentage of the face value of the hybrid.

If your hybrid pays floating rate distributions, your payments will vary in line with movements in the benchmark interest rate. Floating rates are usually expressed as: *benchmark rate* + *margin* (e.g. the bank bill swap rate (BBSW) + 3.0%).

For floating rate hybrids if the benchmark interest rate rises, the income will also increase. However, if the benchmark rate falls, income will decrease.



Measuring your return

People with experience investing in shares will be familiar with using a number such as P.E. ratio or dividend yield to compare shares. When assessing bonds, yield to maturity can be used to compare the return on different instruments.

With hybrids you cannot rely on a single measure to compare the merits of different hybrids. Considerations such as their risk profile, maturity date, fixed vs floating rate returns and conversion rights make the job more complex. Stockbrokers with knowledge in this area can be a great help when considering an investment.

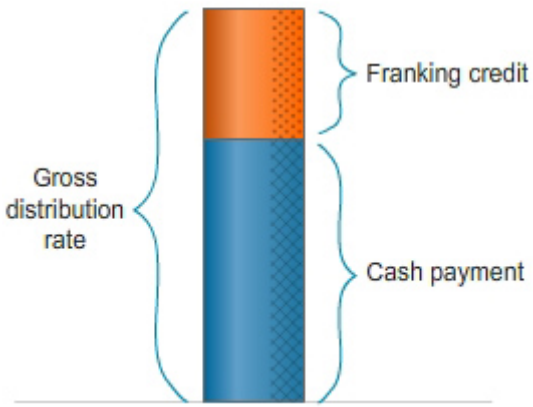
Published payment rate for franked distributions

Like dividends paid on shares, some hybrid distributions may be franked. The franking credit is added to your taxable income, but you also get credit that helps offset the tax payable on your earnings.

The gross or published distribution rate on a hybrid that pays franked distributions typically includes both the amount you receive in cash and the franking credit. The amount you receive in cash is therefore less than the published rate.

In contrast, the dividend paid on an ordinary share is usually expressed as the cash payment rate, so it does not include the value of any franking credit.

Gross distribution rate includes cash payment and franking credit.



How much cash do I get?

If you know the gross distribution on a hybrid that pays franked distributions, calculating the cash payment is simple.

If a distribution is fully franked at the company tax rate of 30%:

- cash payment = gross distribution x 70%
- franking credit = gross distribution x 30%

While the cash you receive is less than the gross distribution, the franking credit can be offset against tax payable on your earnings.

If your hybrid pays a 10% fully franked distribution you receive:
- 7% in cash, and
- 3% as a franking credit.

If your hybrid pays an **8%** fully franked distribution you receive:
- 5.6% in cash, and
- 2.4% as a franking credit.

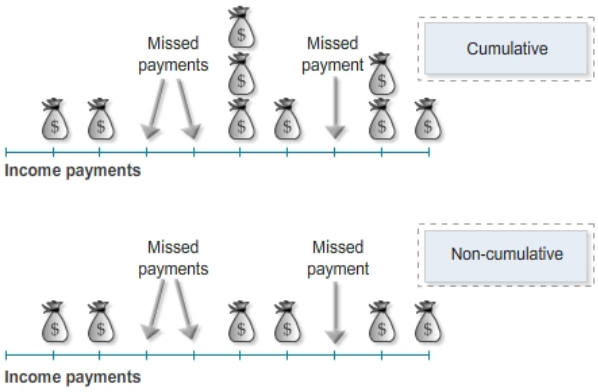
Distribution rates	Breakdown of distribution		Calculation
10%	Cash payment	7%	= 10% x 70%
	Franking credit	3%	= 10% x 30%
8%	Cash payment	5.6%	= 8% x 70%
	Franking credit	2.4%	= 8% x 30%

What happens if the issuer misses a distribution payment?

The consequences of a missed payment depend on whether payments are 'cumulative' or 'non-cumulative'. The prospectus for a hybrid will have this information.

If distributions are **cumulative**, the issuer must add the missed amount to future payments. In other words, missed payments accumulate until they are paid.

If distributions are **non-cumulative**, a missed payment is foregone forever.



Topic 3: Redemption

Exiting your investment

If you own an ASX-quoted hybrid, you usually have two options to exit your investment:

1. Sell on the exchange, or

2. Hold to maturity and receive the face value as cash (although some 'perpetual' hybrids do not have a maturity date, which means you are never required to be repaid).

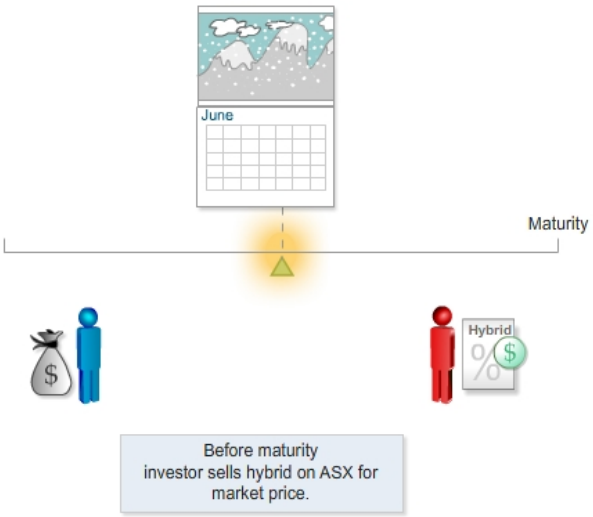
Some hybrids may be convertible into other securities such as ordinary shares. This may be:

- at the discretion of the holder,
- at the discretion of the issuer (sometime called transformable),
- automatically on the happening of certain specified events.

Conversion may be at a fixed price or calculated by reference to the market price of the underlying security.

Some hybrids can be redeemed early, before their maturity date.

As discussed later in "Prescribed events and their consequences", some hybrids must also be extinguished or written off if the issuer experiences significant financial difficulty, in which case you will lose some or all of your investment.

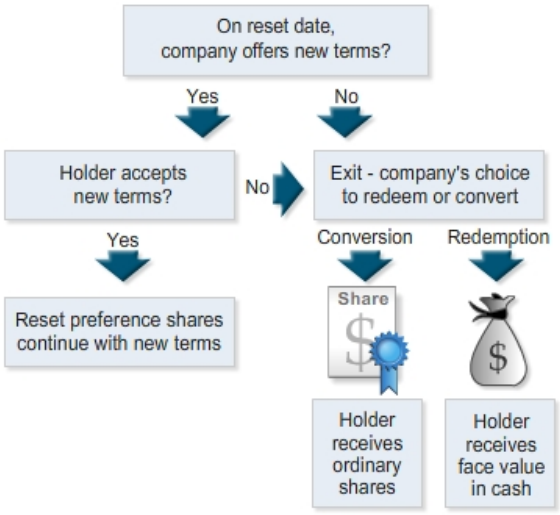


Reset hybrids - new terms for your hybrid

Some hybrids have a reset feature which gives the issuer the choice, on specified 'reset' dates, to extend the life of the hybrid on new terms.

For example, on a hybrid's reset date, the issuer may want to alter the distribution rate. Typically when this occurs you can:

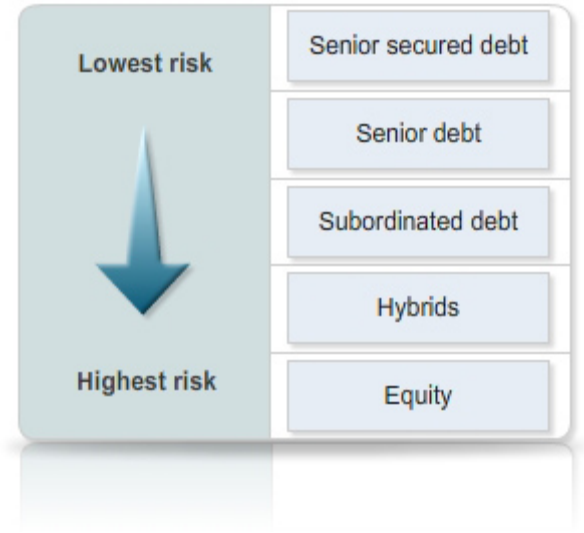
- accept the new terms, in which case your hybrid continues under the revised terms, or
- decline the new terms, in which case your hybrid may be converted into ordinary shares or redeemed for cash, depending on the terms of the issue.



Topic 4: Ranking

It is important to understand where a hybrid sits in the capital structure of a company. If you know where it ranks, you get a better picture of what risk it carries.

A good way to explain a company's capital structure is with a diagram. Looking at the image, the least risky component is at the top: 'secured' or 'senior' debt. As you move down the table, you get closer to the equity piece at the bottom - this is the highest risk part of a company's capital.

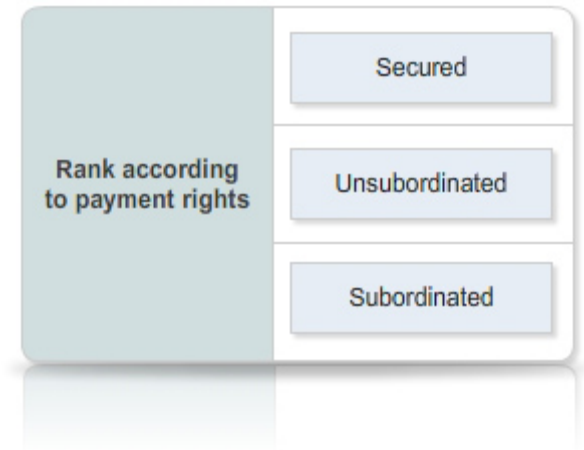


What this means that in the event of liquidation, priority of payment generally goes to secured debt first, then subordinated debt, then shareholders, with preference shareholders usually (but not always) ranking ahead of ordinary shareholders.

A hybrid typically is a security that ranks as subordinated debt or a preference share. If the hybrid converts into ordinary shares, then the ranking will change.

Subordinated debt

On the ASX corporate bond market you might often see the term "Subordinated debt". This term tells you that this debt ranks below both secured and ordinary creditors. In the event of a liquidation, secured and ordinary creditors must be repaid before subordinated creditors receive any payment.



A subordinated hybrid is therefore a riskier investment than an ordinary bond.

Topic 5: Return and risk

Higher return - higher risk

If investors think an investment has a high risk, they will generally expect a higher return than a lower risk investment.

If a hybrid offers unusually high returns, it will typically be because the market thinks there is higher risk associated with that security.

Conversely, if a hybrid is seen as low risk, the issuer may not have to offer such a high distribution to attract investors.

Assessing rates of return

How can you assess the rate of return on a hybrid?

One way is to compare its return against a low-risk reference rate such as the bank bill swap rate. Or you could look at the yields on Australian government bonds.

The greater the margin between low-risk rates and a hybrid's rate, the greater the risk the market associates with the hybrid.

A high rate of return is usually a signal that the security has higher risk associated with it.

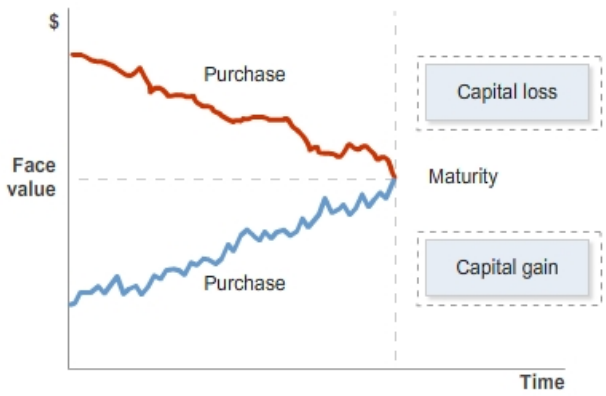
Bank Bill Swap Rate (BBSW) is 3%	
Hybrid 1 yield is 5.5%	Lower
Hybrid 2 yield is 9.3%	Higher

Risk of capital loss

If you sell your hybrid on-market you will receive the market price at the time of sale. Depending on what you paid for it, you may make a profit or a loss.

You can also make a loss if you buy a hybrid for more than its face value and then hold it to maturity, when you will only receive its face value.

Because hybrids have both debt and equity characteristics, the market price of hybrids tends to fluctuate more than simple debt securities. This may bring opportunities to make gains, but it may also lead to the increased chance of losses.



Note that in times of high market volatility, hybrid market prices can fall significantly.

Extraordinary or Prescribed events and their consequences

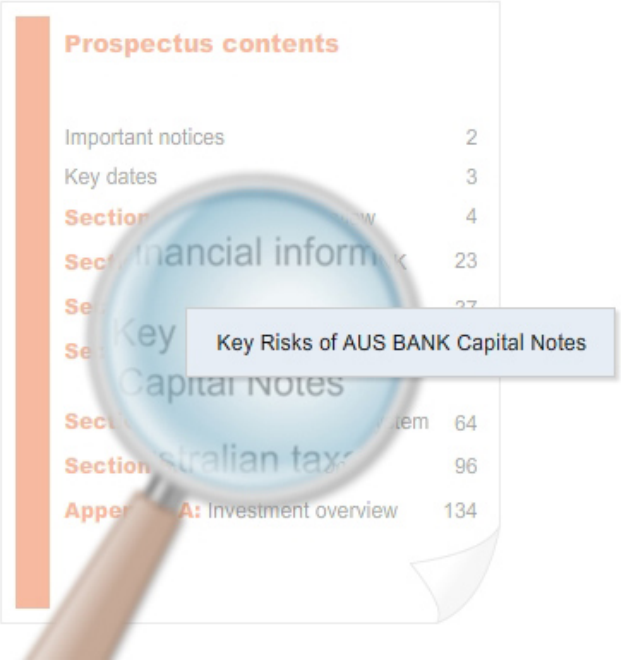
Some hybrids have terms dealing with "prescribed events" and their consequences.

These events might be related to a regulatory change, a takeover or severe financial difficulty.

These kinds of events can give the issuer the choice to redeem, convert or extinguish the hybrid, depending on the terms of issue.

When reading a hybrid's prospectus look out for terms like "loss-absorption feature" and "knock-out option". These are typically used to describe terms of issue that allow the hybrid issuer to retain full value of the hybrid's face value and not repay any money to hybrid holders - investors will therefore lose their entire investment.

Being aware of these types of events and their likelihood is an important part of being an informed hybrid investor.

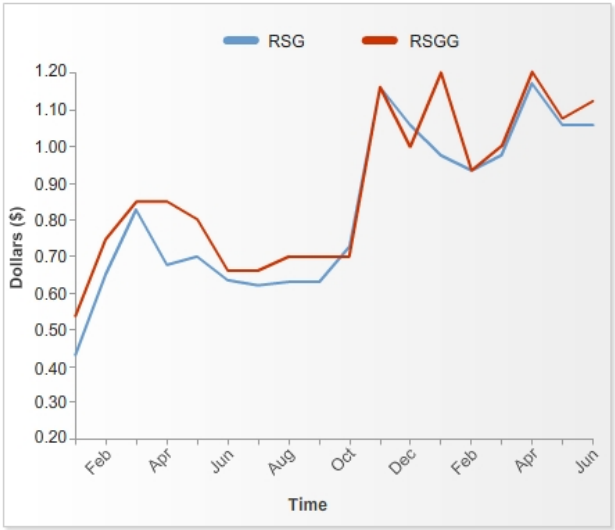


Pricing of convertible hybrids

Some hybrids carry rights of conversion to other securities (such as ordinary shares). You should understand who may exercise these conversion rights - in many cases, the issuer may have the right, but the investor will not.

If the hybrid converts into a fixed number of other securities (or at a significant discount to the current market price of the other securities), the market price of a convertible hybrid tends to move in line with the price of the underlying security offering the holder an 'equity-like' exposure.

If the price of the underlying security fluctuates significantly, then the price of the convertible hybrid is also likely to be volatile. Again, this may bring opportunities to make gains, but it may also lead to the occurrence of losses.



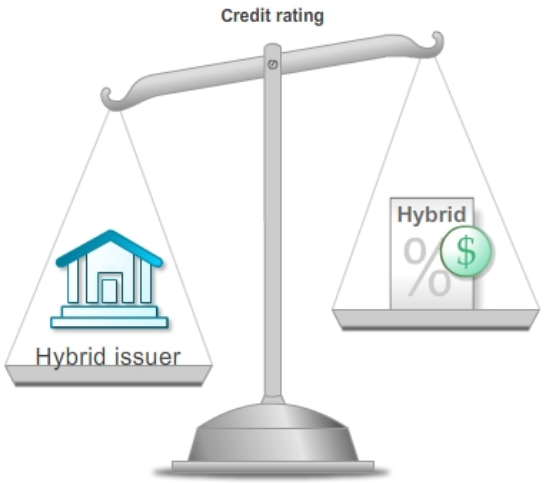
Credit ratings

A credit rating is a credit rating agency's assessment of the credit worthiness of a borrower - its ability to repay its debt and the likelihood of default.

A credit rating may provide an investor with one indicator as to the relative risk of investing in a hybrid. An investor should look both at the credit rating of the issuer and at the credit rating of the hybrid these two things are not always the same.

If a company is unrated, it does not necessarily mean that its securities are high risk, but it does mean that investors will have to turn to other means to evaluate its financial strength. An investment adviser or broker may be able to assist in doing this.

Some credit rating data is available on the ASX website.

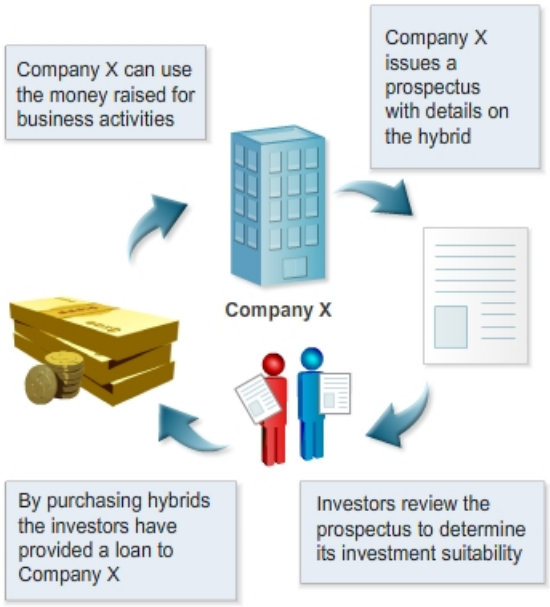


Topic 6: How to buy and sell

Buying at the time of issue

Before they are traded on the sharemarket, you can usually subscribe for hybrids directly from the issuer. This is called buying on the primary market.

You subscribe using the application form in the prospectus for the hybrids. This is a similar process to applying for shares in a float.



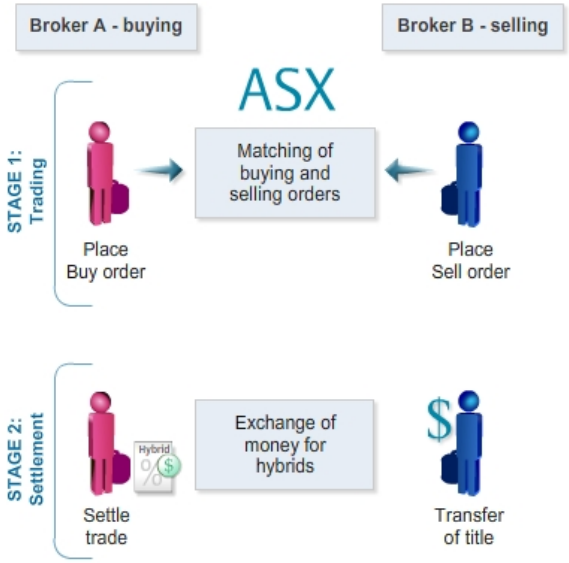
Trading on market

For hybrids quoted on ASX, you can also buy them on market after they have been issued. This is called buying on the secondary market.

Buying and selling hybrids on market is no different to trading shares. You instruct your broker to place an order, either by phone or online. Brokerage will be payable on the transaction.

If you are broker-sponsored, you receive a CHESS statement recording your holding, just as when you buy shares on-market.

If you choose to be issuer-sponsored, you will receive a holding statement from the issuer.



Prices and distribution information

You can get market prices from your broker or the ASX website.

The price table on the ASX website also lists the ex-date information for upcoming distributions.

If your hybrid pays dividends, you can enter its code into the dividend search function to find out information about past and upcoming dividends, including:

- payment amount
- ex-dividend date
- payment date, and
- franking level.

Note that if your security pays interest rather than dividends, you will not be able to use the dividend search function to find information about your payments. In this situation information about interest payments can be found by searching the market announcements for the issuing company.

Code	Div Amount	Ex Div Date	Record Date	Date Payable	% Franked	Type
ANZPB	143.15c	24/11/2008	28/11/2008	15/12/08	100%	Final
ANZPB	122.34c	20/02/2009	26/02/2009	16/03/09	100%	Interim
ANZPB	96.57c	22/05/2009	28/05/2009	15/06/09	100%	Interim
ANZPB	102.25c	25/08/2009	31/08/2009	15/09/09	100%	Interim
ANZPB	103.93c	24/11/2009	30/11/2009	15/12/09	100%	Final
ANZPB	116.51c	19/02/2010	25/02/2010	15/03/10	100%	Interim

Topic 7: Naming convention

A hybrid's name may help you understand its characteristics. In 2015 ASX commenced using a standardised security naming conventions and descriptions for ASX quoted debt and hybrid securities. Each debt and hybrid security has a unique code and three different security descriptions:

1. Long form description - a maximum of 50 characters;

2. Abbreviated description - a maximum of 18 characters; and

3. Short description - a maximum of 8 characters.

You will find one or more of these descriptions on your CHESS statement, trading screen, broker advice, financial newspaper report such as in the Australian Financial Review, and other places where ASX debt and hybrid securities are referred to.

To understand what each description or letter means, refer to the Guide to the naming conventions and security descriptions for ASX quoted debt and hybrid securities. The Guide also includes a glossary of terms.

	Long form	Abbreviated	Short
Capital note	Cap note	CN	N
Preference share	Pref	PRE	P
Hybrid security	Hybrid	HY	H

Example of a long form description for hybrid ANZPE

ANZPE has the following 'Long form description': **CAP NOTE 6-BBSW+3.25% PERP NON-CUM RED T-03-24**

Using the Guide (PDF), you can determine what the security description means.

Note: Due to character constraints, some features may not be able to be included in a security's description. For example, the ANZPE capital notes are subordinated securities, but their short description does not include 'SUB' because of space constraints.

You can review the full list of securities and their descriptions and get more information on ASX's security descriptions for debt and hybrid securities.

CAP NOTE	A capital note, meaning the instrument is a debt security but it has equity like features (in this case because it is subordinated and APRA has a right to extinguish the security under certain circumstance).
6-BBSW+3.25%	The security pays a semi-annual floating distribution based on the 6 month BBSW rate +3.25%.
PERP	The security has no maturity date (e.g. it is perpetual).
NON-CUM	The distributions are non-cumulative.
RED	The security is redeemable.
T-03-24	The security has a trigger date for possible conversion in March 2024.

Summary

Next steps

- Before you invest in a hybrid, carefully review its terms of issue (these will be in the prospectus). This will help you understand the risks specific to that investment.
- Consult an adviser if you need help to understand the terms of the security you are researching.
- Review any available credit ratings or broker research you can obtain on the hybrid.
- Check the market depth for the target security. The hybrid market has a 'long tail' meaning the majority of the trading activity occurs in the top dozen securities and then tails off very quickly. This can mean low levels of liquidity in many securities quoted in the hybrid market. This can be a risk consideration when selecting an investment.