Repayment and conversion

Topic 1: Getting your money back

Choosing an interest rate security

Important questions to ask are:

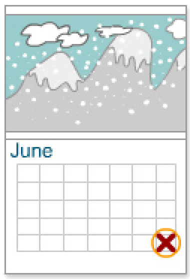
- What income will I receive?
- How do I get my money back?
- What are the risks?

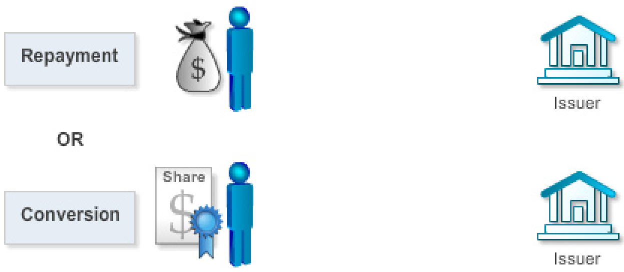
In Module 2, we looked at what income you will receive.

In this module, we look at how you get your money back, including:

- repayment of face value
- conversion into shares, or
- sale on ASX.

Repayment or conversion - cash or shares?





Generally, interest rate securities pay you cash at the end of their life (maturity).

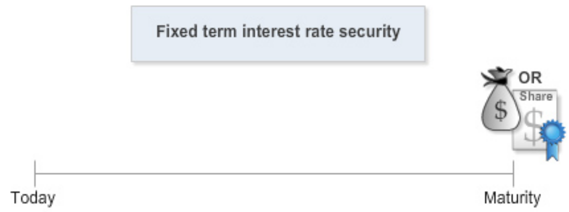
The cash amount is the face value of the security.

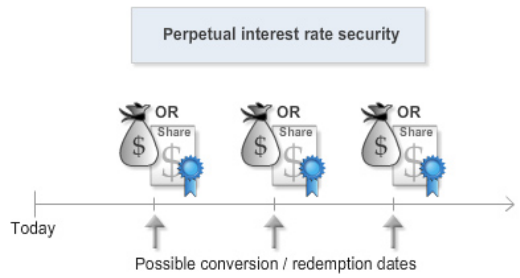
A commonly used term for paying back cash is 'redemption'.

Other securities, known as hybrids, offer the possibility of conversion into ordinary shares at some future point.

With some securities, conversion takes place automatically. With others, there may be a choice between conversion and repayment.

When do I get my cash or shares?





The terms of the interest rate security determine when repayment or conversion takes place:

1. Interest rate securities with a maturity date: the security has a fixed term and will pay cash/convert into shares on that date.

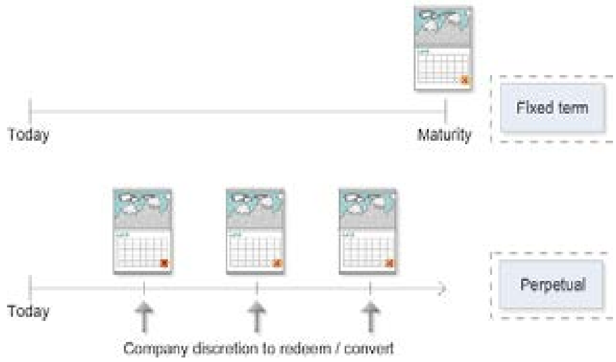
2. Perpetual interest rate securities: have no set end date, but may offer some provision for return of investment.

Perpetual securities - how do I get my cash or shares?

Perpetual securities have no maturity date.

However they will have provisions for return of capital at the company's option on specified reset dates.

These dates are usually dates that distributions are paid.



Getting your money back now

Regardless of whether your interest rate security has a maturity date or is perpetual, you can trade out by selling on ASX, just like ordinary shares.

As with shares, the availability of buyers will affect the market price.

Depending on the current market price, you may receive more or less than face value.

When	How	Amount received
At maturity	Redeem from issuer	Face value
Before maturity	Sell on ASX	Market value

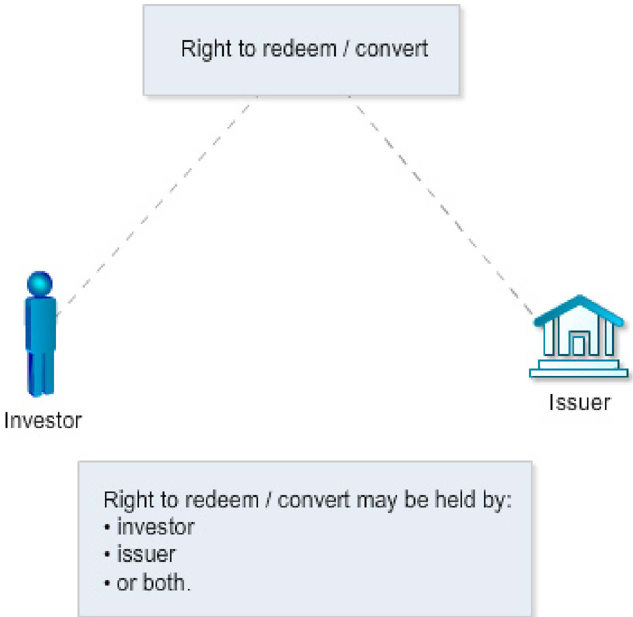
Ending the term early

Even when an interest rate security has a fixed term, it may be possible that the security can be redeemed or converted ahead of maturity.

The security may give the right to redeem or convert to either the issuer or the holder (or both). Different securities include different rights, which will be set out in the security's prospectus.

This right generally will be exerciseable only:

- on certain specified dates, or
- under certain conditions, such as when there is a change of control of the company.



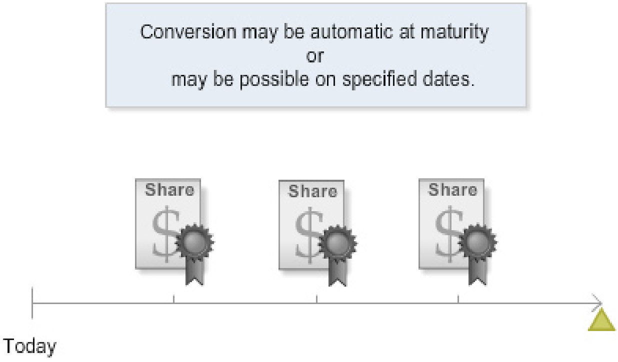
Topic 2: Conversion into shares

Instead of repaying face value, some interest rate securities convert into shares in the company.

In evaluating a convertible security, it is essential to understand how it converts into shares.

When can/will conversion take place?

Conversion may take place automatically at maturity of the security, on a specified event (such as a takeover), or there may be specified dates for conversion.

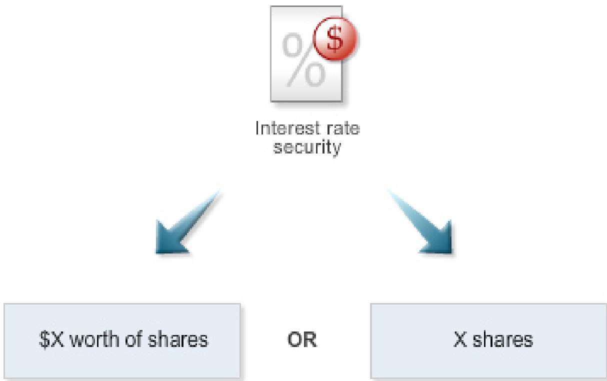


How many shares will I receive?

The number of shares you receive depends on the conversion mechanism specified in the prospectus.

Interest rate securities generally convert into either:

- a fixed number of shares, or
- a dollar value of shares.



Fixed number conversion

If an interest rate security converts into a fixed number of shares, you can calculate how many shares you will receive at the time of conversion by multiplying the number of securities you hold by the conversion rate.

For example, a security converting on a 1:1 basis gives you one share for each interest rate security you hold.

No. of interest rate securities held	Conversion rate	No. shares received
100	3:1	300
200	2:1	400
1000	1:1	1000

Dollar value conversion

If an interest rate security converts into a dollar value of shares, the number of shares you receive depends on the market price of the shares at conversion.

For example, if an interest rate security converts into $100 worth of shares, and the share price at conversion is $5.00, you would receive 20 shares per interest rate security.

$ value of shares per interest rate security	Share price used for conversion	No. shares received
$100	$10	10
$200	$25	8
$100	$4	25

The prospectus typically states that the share price used in the conversion formula is an average traded price over a specified period leading up to the conversion date. This is referred to as a volume weighted average price (VWAP).

Dollar value conversion

Discounted share price

The terms of the issue may specify that conversion is done at a discount to the share price.

Assuming the VWAP was $5.00, and a 5% discount was specified in the previous example, the share price used to calculate the conversion would be $4.75. You would receive 21 shares per security (= $100/$4.75).

The larger the discount, the more favourable the conversion terms for you.

$ value of shares per interest rate security	VWAP	Discount	Share price used for conversion	No. shares received
$100	$10	10%	$9.00	11
$100	$7	5%	$6.65	15
$100	$6	8%	$5.52	18

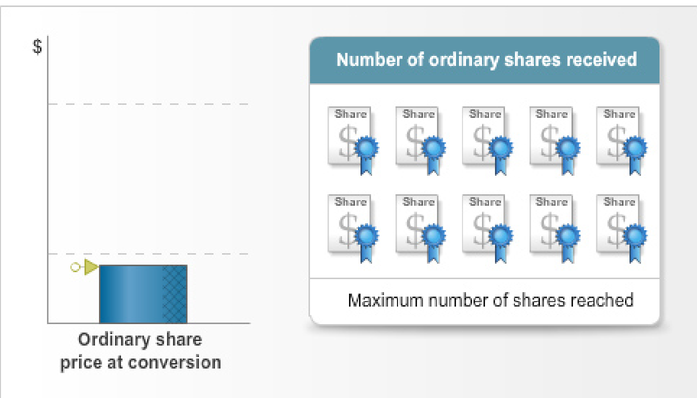
Dollar value conversion

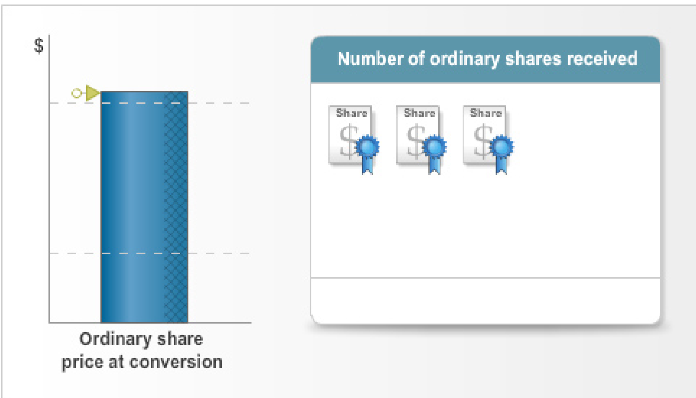
Maximum and minimum number of shares

There is often a maximum and minimum limit to the number of shares you will receive on conversion.

If the price rises above a certain point, you are guaranteed a minimum number of shares - an advantage to you.

But if the share price at conversion is below a certain point, you do not receive any extra shares - a disadvantage to you.





Topic 3: Conversion into shares (continued)

Which type of conversion should I look for?

The answer depends mainly on how much exposure you want to the company's share price.

The market price of an interest rate security with a fixed conversion ratio depends mainly on the performance of the company's ordinary shares. The price of the interest rate security tends to move in line with the price of the shares it will convert into. Depending on the shares, it can be quite volatile.

Some investors consider this type of interest rate security if they are looking for capital gain as well as income, and believe that the company's share price is very likely to go up.

The price of an interest rate security that converts into a dollar value of shares is typically much more stable, and moves independently of the share price. It is influenced more by movements in market interest rates.

You do not need to have a strong view on the share price. However you do need to have confidence that the company will do well enough to be able to pay the promised income to you.

Once conversion into ordinary shares has taken place, you become a shareholder, and must look at your investment from the perspective of a shareholder.

Taxation

Converting your interest rate securities into shares is generally not classed as a capital gains tax event, so you should not be liable for tax when conversion takes place.

Action	Possible tax consequences?
Redeem for face value	Yes
Sell on ASX	Yes
Convert into shares	No

If you redeem your securities for face value, or sell them on ASX for more than you paid for them, you may have to pay tax on your profit.

The security's prospectus will include general taxation information. You should also consult your taxation adviser, who can give you advice that takes into account your own financial circumstances.

Topic 4: How safe is my money?

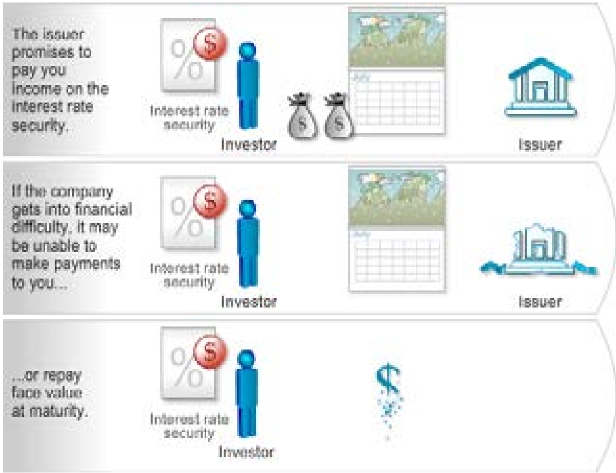
In Module 2 we looked at the risk of the company being unable to pay the income promised to you.

Just as important, you expect the issuing company to repay the face value of the interest rate security, or to be able to convert your security into shares that are worth something.

If the company goes into liquidation, you may not get all - or any - of your money back.

The risk of losing your money relates mainly to:

- creditworthiness of the issuer, and
- features of the security.

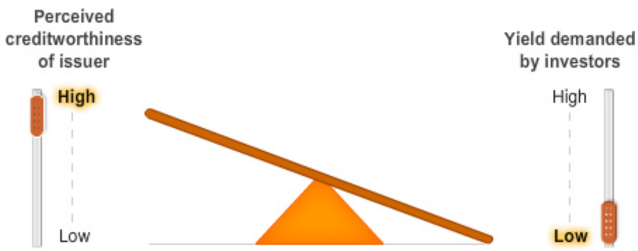


Creditworthiness of the issuer

You can form a view of a company's creditworthiness by looking at:

- the yield to maturity on the securities, and
- the company's credit rating.

The riskier that investors think a company is, the higher the yield they will demand.



An unusually high yield may indicate the market thinks the company will have trouble servicing its debt, or paying back those who have lent it money, including interest rate security holders.

Features of the security

Ranking

Interest rate securities have legal status either as debt capital or as equity capital.

Corporate bonds are debt securities.

Converting preference shares and convertible notes are 'hybrid' securities, having features of both debt and equity. Some hybrids are classed as debt, others as equity.

Class of capital	Ranking
Debt capital	Higher ranking
Equity capital	Lower ranking

The distinction is important if the company goes into liquidation. A debt holder's claim on company assets ranks above an equity holder's claim.

There is a better chance of your investment being repaid if your security is classed as debt than if it is classed as equity.

It is important to check the ranking of your interest rate security in the prospectus.

Features of the security

Secured vs. unsecured

An interest rate security may be secured or unsecured.

Most interest rate securities are unsecured i.e. they are not secured by any company assets. If the company goes into liquidation, proceeds from the sale of company assets will first of all be used to satisfy the claims of secured creditors.

Order of payment	Relationship to company
1	Secured creditors
2	Unsecured creditors
3	Ordinary shareholders

Summary

Some interest rate securities return their face value to you in cash, while others offer the possibility of conversion into ordinary shares.

If a security has a maturity date, it will pay cash or convert into shares on that date.

Perpetual securities have no maturity date, but may have provisions for return of capital on specified 'reset dates'.

You can trade out of your interest rate security by selling on ASX, just like ordinary shares. Depending on the current market price, you may receive more or less than face value. Market prices are affected by the supply of buyers and sellers.

A convertible interest rate security may convert into:

- a fixed number of shares, or
- a dollar value of shares.

The price of a security that converts into a fixed number of shares tends to move in line with the price of the shares it will convert into. In normal market conditions, the price of a security that converts into a dollar value of shares is affected less by share price movements.

You rely on the issuer to pay you the face value, or to be able to convert your security into shares.

The risk that the issuer is unable to do this is linked to:

- creditworthiness of the issuer, and
- features of the security.