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Topic 1: Features of self-funding instalments

Instalments are an investment with in-built gearing. The cost of gearing is the funding cost component of the instalment which includes interest and fees.

Ideally, the income generated by the instalment is more than the funding cost, resulting in a positively geared investment. If an investment is negatively geared, the income is less than the borrowing cost.

Self-Funding Instalments (SFIs) are typically structured at the time of issue to be positively geared, with forecast dividends expected to be more than the interest charged on an annual basis.

How SFIs work

Once every 12 months (usually at the end of the financial year) the issuer calculates the interest charge for the next 12 months. This amount is added to the final payment.

When a dividend is paid, it is used by the issuer to reduce the final payment. The reduction is made on the ex-dividend date.

Over the life of the SFI, the final payment increases as pre-paid interest costs are added, and decreases as dividends are paid.

If dividends paid exceed interest charges, the final payment will fall over the instalment's life, making the investment 'self-funding'.

How do SFIs differ from ordinary instalments?

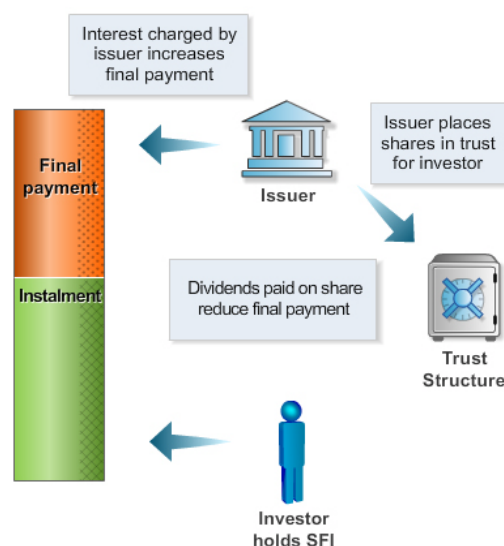
SFIs are a variation on ordinary instalments.

With a term typically of between five and ten years, they offer geared exposure, with no ongoing interest payments.

The main differences from ordinary instalments are:

- Interest is initially prepaid up to 12 months
- Interest components are added to the final payment on an annual basis
- Dividends are applied by the issuer to reduce the final payment, instead of being paid in cash to the holder.

| Scenario |
|---|
| Funding costs > income negatively geared |
| Funding costs < income positively geared |
| Funding costs = income neutrally geared |



- The final payment amount changes over time as interest increases the amount, and dividends decrease the amount.

While the issuer retains the dividend payments, franking credits are passed on to the SFI holder.

Example

XYZ shares are trading at \$20.00. You buy the following SFIs over XYZ:

- Issue date: 1 July
- Time to expiry: 5 years
- Final payment: \$10.00
- Dividends paid: \$1.00 fully franked annually
- Interest rate: 7.5% p.a.

The table opposite shows what will occur during the first two years of the SFI's life.

Assuming dividends paid are greater than the interest charged, the final payment will continue to fall during the SFI's life. (If dividends are less than the final payment will increase).

At the end of the second year, the final payment has fallen to \$9.326.

| Time | Payment | Cashflow | Final payment |
|---------------|------------|-------------|---------------|
| Issue date | | | \$10.00 |
| | Dividend 1 | \$0.50 CR | \$9.50 |
| | Dividend 2 | \$0.50 CR | \$9.00 |
| End of year 1 | Interest | \$0.675 DR* | \$9.675 |
| | Dividend 3 | \$0.50 CR | \$9.175 |
| | Dividend 4 | \$0.50 CR | \$8.675 |
| End of year 2 | Interest | \$0.651 DR | \$9.326 |

* \$9 x 7.5% = 0.675cents

Summary

- Moderately geared (around 50%) at the time of issue.
- Investment term of 5 - 10 years.
- Dividend reduces the final payment.
- Holder eligible for franking credits.
- Prepaid interest costs added to final payment once a year.
- Interest costs usually tax deductible.
- Over the life of the SFI, the final payment periodically decreases due to dividend payments and increases by the interest charged.
- The fourth letter of the warrant code is 'S'.

| Key features of self-funding instalments | |
|--|--|
| Term | 5 - 10 years |
| Dividends | Used to reduce final payment |
| Franking credits | Holder eligible |
| Gearing | <ul style="list-style-type: none"> 50% at time of issue. Designed to decline overtime. |
| Fees | Interest added to final payment in advance annually. |
| ASX Code | Fourth letter of code - "S" |

Topic 2: Selecting and monitoring SFIs

How to buy and sell SFIs

You buy SFIs in the same way you would buy ordinary instalments.

SFIs can be bought direct from the issuer via:

- Cash application
- Shareholder application (except for SMSFs), or
- Rollover application.

You can also buy and sell SFIs on market just like shares.

At expiry, you have the usual choice of:

- making the final payment and taking ownership of the shares,
- rolling into another instalment,
- exercising the holder's put option (if one exists) or,
- do nothing and receive a cash payment (AVP) if it is in the money.

As with all instalments, you are under no obligation to make the final payment.

Choosing the right instalment

SFIs may be a suitable instalment type if you want:

- Geared exposure to the underlying shares
- Enhanced income

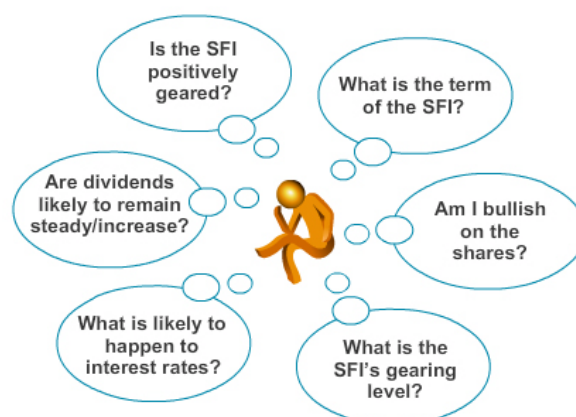
Unlike ordinary instalments, however, you must be comfortable to not receive the dividends in cash, and instead for them to reduce the final payment. If you rely on income from your investments, ordinary instalments may be more appropriate.

If SFIs are a suitable type of instalment, you need to select the appropriate SFI.

Factors to consider when comparing instalment types include:

- Desired length of exposure
- View on the underlying stock
- Projected dividend payments

| | Investor | SMSF |
|--------------------|-------------------------|------|
| Direct from issuer | Cash application | ✓ |
| | Rollover application | ✓ |
| | Shareholder application | ✗ |
| | Purchase on ASX | ✓ |



- View on interest rates
- Gearing level of the SFI.

Monitoring the performance of your SFI

SFIs typically are bought as a long term investment. Checking the price on a daily basis is therefore not usually necessary. However, it's a good idea to keep a regular eye on the performance of your investment, in particular its loan to value ratio. A rising LVR can mean the SFI is not profitable and vice-versa.

You can check the price of your SFI on the [ASX website](#), the [warrant issuer's website](#), or your broker's website.

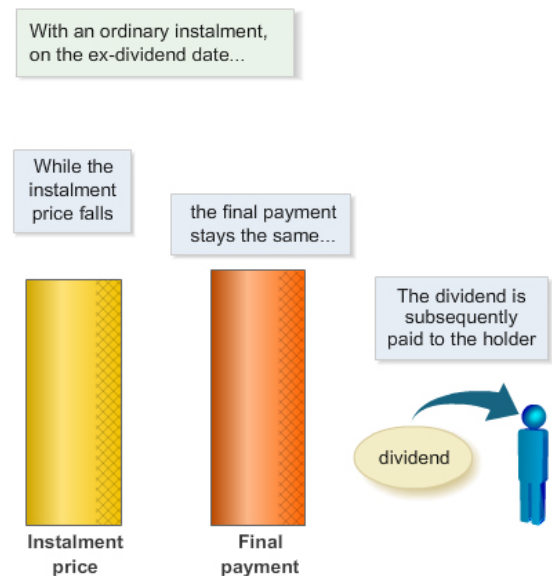
The issuer may publish an 'indicative pricing matrix'. This is a matrix that sets out the price the instalment may trade at on ASX, given various prices of the underlying stock on that day. These prices are not guaranteed, and are indicative only.

During the life of the SFI

The main influence on the price of the SFI is movements in the share price. As the SFI is regular geared, its price should move in line with changes in the stock price. (Refer to course 3 on instalment pricing details.)

When the underlying stock goes ex-dividend, all else being equal the price of the SFI should not change, as the dividend results in an adjustment to the final payment. This is different from ordinary instalments, where the issuer passes the dividend to the holder, and the price of the instalment usually falls on the ex-dividend date.

You can keep track of the SFI's final payment by referring to the [issuer's website](#), or [checking the instalment's details on the ASX website](#).



The paperwork

If you purchase SFIs directly from the issuer, you receive a statement of your issuer-sponsored holding. The issuer will give you a breakdown of your investment into capital outlay, final payment, interest and fees.

If you buy on ASX you receive a CHESS statement verifying your holding.

The issuer provides a tax statement at the end of each financial year. This details interest, fees, distributions and other tax-related information.

Topic 3: Benefits and risks of SFIs

SFIs have features in common with ordinary instalments, including:

- Leveraged exposure to the underlying shares
- Geared income stream
- Can be used in a self managed super fund
- Tradeable on the ASX.

Unlike other instalments, however, the final payment of a SFI is not fixed, as the entire funding cost is not charged at the time of purchase, but is added to the final payment on an annual basis.

Consequently, you are exposed to movements in interest rates.

The success of an investment in SFIs depends on:

- Movements in the price of the underlying shares
- Interest rates
- Dividends paid

Like all instalments, because you are trading a leveraged product your risk is increased when compared to just trading the underlying shares.

Consider the following SFI over XYZ shares:

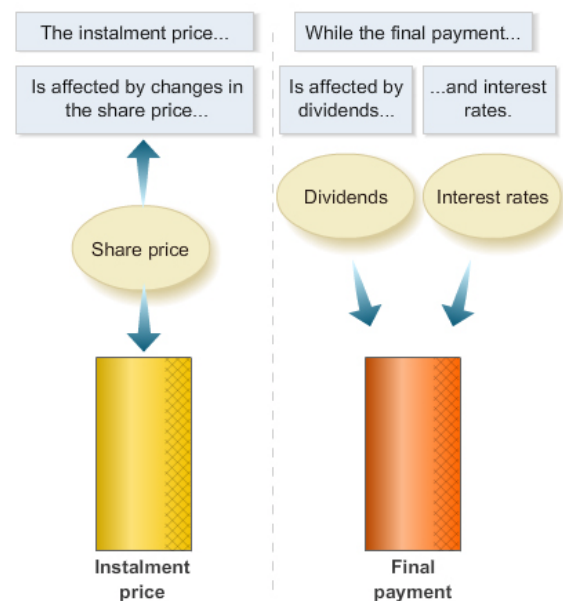
- Time to expiry: 5 years
- Final payment: \$10.00
- Dividend: \$1.00 fully franked annually
- Interest rate: 7.5% p.a.

We will now look at four dividend/interest rate scenarios and how they affect the final payment of the SFI.

Scenario 1 - dividends constant, interest rates steady

The table shows what happens to the final payment over the first three years, assuming:

- Dividends are constant at \$1.00 p.a.
- Interest rates remain at 7.5%



| Time | Payment | Cashflow | Final payment |
|------------|-----------------|------------|---------------|
| Issue date | | | \$10.00 |
| | Dividends | \$1.00 CR | \$9.00 |
| End year 1 | Interest (7.5%) | \$0.675 DR | \$9.675 |
| | Dividends | \$1.00 CR | \$8.675 |
| End year 2 | Interest (7.5%) | \$0.651 DR | \$9.326 |
| | Dividends | \$1.00 CR | \$8.326 |
| End year 3 | Interest (7.5%) | \$0.624 DR | \$8.95 |

The SFI is positively geared, and so the final payment decreases over the period. At the end of Year 3, the final payment stands at \$8.95.

Scenario 2 - dividends rising, interest rates steady

In Scenario 2, the following assumptions are made:

- Dividends rise by 10% each year
- Interest rates remain at 7.5%

The increase in dividend payments means the final payment falls at a faster rate.

As well as benefiting from higher dividends, interest charges are lower, as the interest is calculated on a lower final payment than in

Scenario 1.

After three years, the final payment has fallen to \$8.61.

| Time | Payment | Cashflow | Final payment |
|------------|-----------------|-------------|---------------|
| Issue date | | | \$10.00 |
| | Dividends | \$1.00 CR | \$9.00 |
| End year 1 | Interest (7.5%) | \$0.675 DR | \$9.675 |
| | Dividends | \$1.10 CR | \$8.575 |
| End year 2 | Interest (7.5%) | \$ 0.643 DR | \$9.218 |
| | Dividends | \$1.21 CR | \$8.008 |
| End year 3 | Interest (7.5%) | \$0.601 DR | \$8.609 |

Scenario 3 - dividends rising, interest rates rising

In Scenario 3, the following assumptions are made:

Dividends rise by 10% each year

Interest rates rise by 1% each year

In this scenario, one variable is moving in your favour (dividends are increasing), while one variable is moving against you (interest rates are rising).

Despite the increase in interest rates, the SFI remains positively geared, with dividends exceeding interest charges.

Consequently, the final payment falls over time - but at a slower rate than in Scenario 2.

At the end of three years, the final payment has fallen to \$8.86.

| Time | Payment | Cashflow | Final payment |
|------------|-----------------|-------------|---------------|
| Issue date | | | \$10.00 |
| | Dividends | \$1.00 CR | \$9.00 |
| End year 1 | Interest (7.5%) | \$0.675 DR | \$9.675 |
| | Dividends | \$1.10 CR | \$8.575 |
| End year 2 | Interest (8.5%) | \$ 0.729 DR | \$9.304 |
| | Dividends | \$1.21 CR | \$8.094 |
| End year 3 | Interest (9.5%) | \$0.769 DR | \$8.863 |

Scenario 4 - dividends falling, interest rates rising

Scenario 4 represents the worst outcome, with dividends falling, and interest rates rising.

The following assumptions are made:

- Dividends fall by 20% each year
- Interest rates rise by 1% each year

| Time | Payment | Cashflow | Final payment |
|------------|-----------------|------------|---------------|
| Issue date | | | \$10.00 |
| | Dividends | \$1.00 CR | \$9.00 |
| End year 1 | Interest (7.5%) | \$0.675 DR | \$9.675 |
| | Dividends | \$0.80 CR | \$8.875 |
| End year 2 | Interest (8.5%) | \$0.754 DR | \$9.629 |
| | Dividends | \$0.64 CR | \$8.989 |
| End year 3 | Interest (9.5%) | \$0.854 DR | \$9.843 |

The SFI is positively geared in year 1, so the final payment falls.

At the end of year 2, the dividends received just cover the interest charge, but by the end of year 3, the reduction in dividends and the increase in interest rates mean the SFI is negatively geared. The final payment is rising.

Making things worse is that the reduction in dividends suggests the company is performing poorly, and the share price may have fallen, leading to a fall in the value of the SFI.

Your view of the performance of the underlying shares is critical.

Because the final payment varies over the life of the product, it is also important to have a view on the sustainability of the dividends paid by the underlying shares. You should also consider how you would be affected by an increase in interest rates.

Your financial adviser can assist you in determining how much room to move you have before your SFI becomes negatively geared, i.e. interest costs exceed dividend payments.

Scenario 1:

Dividends constant, interest rate steady, the SFI final payment is decreasing. The investment is positively geared



Scenario 2:

Dividends rising, interest rate steady, the SFI final payment is decreasing at a faster rate than in scenario 1.



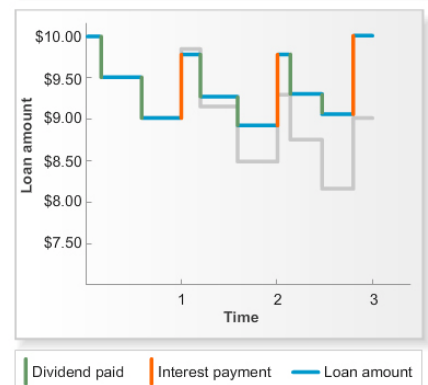
Scenario 3:

Dividends rising, interest rate rising, the SFI continues to be a positively geared investment.



Scenario 4:

Dividends falling, interest rate rising, the SFI is positively geared in year 1 but negatively geared by year 3.



Topic 4: SFIs and self managed super funds

Instalments are one of the few forms of gearing that can be used by SMSFs.

Another feature of instalments in SMSFs is the enhanced income and franking credit stream they offer.

Because of the lower tax rate environment of the SMSF, franked dividends often result in excess franking credits that can offset additional income or contributions from tax.

When in the accumulation phase, SMSFs may attract:

- 15% tax on earnings generated by the SMSF
- 15% tax on contributions paid into the SMSF

In the allocated pension phase, earnings on investments supporting a superannuation pension may be tax free. It is important to check your situation with a tax adviser.

The following case study compares an investment in XYZ shares with an investment in SFIs.

Case study

Your SMSF has \$30,000 to invest. You consider buying 1,333 XYZ shares, currently trading at \$22.50.

Alternatively, you consider investing the \$30,000 in the following SFIs over XYZ:

- Final payment: \$13.50
- Instalment price: \$11.13
- Prepaid interest: \$1.00

\$30,000 buys you 2,695 SFIs.

XYZ is forecast to pay fully franked dividends of \$1.17 over the next 12 months. The table opposite compares the dividend yield from the instalments with the yield from the shares. The investment in SFIs gives you higher net income and a higher dividend yield. Remember that you do not receive this dividend as cash because it goes towards paying off your loan.

(This example does not represent any capital appreciation/depreciation in the shares or instalments.)

...resulting in higher net income.

| | XYZ Shares | XYZ SFIs |
|---|------------|------------|
| Capital invested | \$30,000 | \$30,000 |
| Unit price | \$22.50 | \$11.13 |
| Number of shares / instalments | 1,333 | 2,695 |
| Dividends | \$1,559.61 | \$3,153.15 |
| Dividend yield (%) | 5.20% | 10.51% |
| Franking credits | \$668.40 | \$1,351.35 |
| Net income (dividends + franking credits) | \$2,228.01 | \$4,504.50 |

On the annual reset date, 12 months of prepaid interest is added to the final payment. Assuming your SMSF holds the SFIs for the next 12 months, the fund might be able to claim a tax deduction for this amount.

The interest cost equals the number of SFIs multiplied by the interest cost per instalment = $2,695 \times \$1.00 = \$2,695$.

Claiming the interest as a deduction reduces taxable income from \$4,504.50 to \$1,809.50.

Assuming you are in the accumulation phase, tax payable on the net income from the instalments is \$271.43. This compares to tax of \$334.20 if the fund had invested in XYZ shares.

Your SMSF has franking credits of \$1,351.35 to offset against the tax bill. After paying tax of \$271.43, there are excess credits of \$1,079.93.

The excess credits have created an earnings offset. The value of this offset is the amount of additional income that could be generated by the fund without needing to pay more tax - the additional income that, if taxed at 15%, would result in a tax liability of \$1,079.93.

The excess franking credits of \$1,079.93 may allow you to earn or contribute \$7,199.50 to your SMSF without paying tax.

This compares with an offset of \$2,228.01 if the fund had invested in XYZ shares.

It is important to seek professional tax advice on your own tax situation.

Summary

The difference between the 15% tax on earnings of super funds, and the company tax rate of 30%, may make fully franked income especially valuable to super funds.

Imputation credits attached to fully franked dividends usually exceed tax payable on those dividends. If so, the credits can potentially be used to offset the tax on the fund's other income, or on contributions into the fund.

Tax deductibility of the prepaid interest of the SFI may reduce the net taxable income, further increasing the excess franking credits.

Deducting the prepaid interest cost reduces the taxable net income, and therefore the tax payable.

| | XYZ Shares | XYZ SFIs |
|-------------------------|------------|------------|
| Number of shares / SFIs | 1,333 | 2,695 |
| Net income | \$2,228.01 | \$4,504.50 |
| Prepaid interest | - | (\$2,695) |
| Taxable net income | \$2,228.01 | \$1,809.50 |
| Tax payable @ 15% | \$334.20 | \$271.43 |

\$7,199.50 of extra income could be earned before the tax liability would exceed the available excess franking credits.

| | XYZ Shares | XYZ SFIs |
|----------------------------|------------|------------|
| Tax payable @ 15% | \$334.20 | \$271.43 |
| Franking credits available | \$668.40 | \$1,351.35 |
| Excess franking credits | \$334.20 | \$1,079.93 |
| Earnings shelter | \$2,228.01 | \$7,199.50 |

...which can be used as a potential offset for additional income or contributions to the fund.

| | XYZ Shares | XYZ SFIs |
|-------------------------|------------|--------------|
| Amount invested | \$30,000 | \$30,000 |
| Net income | \$2,228.01 | \$4,504.50 |
| Prepaid interest | - | (\$2,695.00) |
| Taxable net income | \$2,228.01 | \$1,809.50 |
| Tax payable @ 15% | \$334.20 | \$271.43 |
| Excess franking credits | \$334.20 | \$1,079.93 |
| Earnings shelter | \$2,228.01 | \$7,199.50 |

As is the case with ordinary instalments, the acquisition by super funds of SFIs by shareholder application (the 'cash extraction strategy') is not allowed.

Notwithstanding the potential tax features of SFIs, investors need to carefully consider the future value of the underlying share. The leveraged nature of a SFI means downward stock price movements can negate potential tax benefits - seek advice for tax planning strategies.

Topic 5: Stop Loss and Rolling SFIs

Stop Loss Self Funding Instalments

Stop Loss SFIs and Rolling SFIs present variations on the ordinary SFI structure. The following screens will outline the details of these variations.

Stop Loss SFIs have four key differences to regular SFIs:

- A stop loss level which prevents the value of the stop loss SFI becoming negative.
- No protection costs.
- Interest is calculated and added to the loan amount on a daily basis rather than yearly.
- Generally always trade one for one (delta = 1) with the value of the underlying security.

With regular SFIs, the protection cost for the term of the product is built into the initial payment. The stop loss SFI removes the protection cost by setting a stop loss level for the underlying share price.

A stop loss level is a predetermined underlying share price which, if reached, will result in a halt in trading of the SFI. The stop loss level is set above the SFI's loan amount (second payment).

In the chart opposite, the stop loss level was set at \$28. When the underlying share price reached \$28, trading in the SFI stopped. At this point the issuer will calculate if there is any remaining value in the SFI. If there is, you are generally able to sell the instalment back to the issuer and receive a cash payment for that remaining value.

Risk of a stop loss

If the share price recovers and rises back above the stop level, you can miss out on the potential upside. (This may be mitigated by rolling into a new more moderately geared instalment to avoid triggering the stop loss.)

Adjusting the stop loss level

The stop loss level of the instalment may be adjusted at certain periods. It may also be adjusted due to certain events such as the payment of dividends and corporate actions that affect the underlying. The PDS provides detail on this.

Interest on loan amount

Like ordinary SFIs, the stop loss SFI attracts interest on its loan amount. Regular SFIs generally calculate and add this interest payment to the loan amount once every 12 months. With stop loss SFIs, the interest amount is added to the loan amount daily. Details on the adjustment of the interest rate are detailed in the PDS.

Rolling Self Funding Instalments

Rolling SFIs have two key differences from regular SFIs;

- The initial Rolling SFI price includes protection costs only for up to a maximum of 12 months in advance as opposed to the entire investment period
- The Rolling SFI will have an annual review every 12 months with a range of flexible options available.

Lower initial payment

Like regular SFIs, the loan amount for a Rolling SFI will be increased every 12 months as interest costs are added to the loan amount. The key difference between Rolling SFIs and the ordinary SFI is that the initial instalment price only includes protection costs for a maximum of 12 months in advance as opposed to the entire investment term of the SFI. This will therefore reduce the upfront cost (initial payment) of the instalment.

Twelve month review

Every 12 months the Rolling SFI will have an annual review that gives you the opportunity to elect from a variety of options:

- Pay the remaining loan amount and take delivery of the underlying security.
- Continue the SFI for another 12 month period (at the issuer's discretion).
- Roll into another series of SFIs.

- Sell the instalment back to the issuer.
- You can do nothing. If the instalment is continued for another 12 month period the interest (including protection costs) will be automatically added to the loan amount.

Possible termination

The issuer may terminate the Rolling SFI in certain circumstances as outlined in the PDS. In general this may occur if the share price of the instalment is less than the loan amount, if the LVR of the SFI rises to a level where the interest rate (including protection) is too expensive, or in the case of an extraordinary event, such as a takeover or delisting.