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# Hybrids: A Solution to the Growing Appetite for Income

*With interest rates at record lows, and unlikely to increase any time soon, investors eyeing stable income are searching far and wide for appropriate investment opportunities.*

*Given the significant deterioration in the economy, as well as late-cycle risks for the broader market, there is heightened difficulty in finding risk-appropriate income streams. Hybrids, however, are one option for conservative investors.*

## What are hybrids?

Hybrid securities are complex assets combining the characteristics of debt securities, as well as equity securities.

In essence, an investor lends money to a company, which in turn pays a regular rate of return until a 'maturity' date, much like debt securities would. At maturity, the original 'investment' may be converted into shares, cashed out, or rolled over into a new security.

The term 'Hybrids' is used somewhat broadly to refer to different types of securities. This includes convertible debt securities, preference shares, capital notes, or a combination of these categories.

Each of these categories involves a varying level of exposure to debt-like and equity-like traits. Nonetheless, it is their equity-like traits that provide hybrids with the potential to deliver higher returns than debt securities.

## Key types of hybrids

Convertible debt securities allow the issuer or investor to convert the instrument to another security at a set date in the future. This is typically shares in the head stock of the issuer. As such, they effectively act as options that may be exercised by either party.

For holders, there is downside risk protection plus potential upside in converting to equity. For the issuer, not only do the securities avoid short-term dilution, but they are generally issued at a lower interest rate than bonds and thus more affordable to service.

Meanwhile, preference shares are equity securities that pay dividends at a special debt-like rate. As with bonds, they may be redeemed for cash at maturity. Holders usually don't have voting rights, but they have priority over common holders for dividends and capital distribution in the event of a wind up.

Capital notes may be considered primarily as debt securities, but with additional equity-like characteristics. This might include perpetual debt securities, with no fixed maturity date. Alternatively, it could be subordinated debt securities, where access to interest payments and principal repayment fall behind other classes of debt. Finally, they might be knock-out debt securities, where the issuer or a third-party has the right to treat them as capital and 'extinguish' (cancel) them in certain cases.

## Key features of hybrids

Interest payments distributed through hybrids offer a predetermined rate of return, typically on a quarterly basis or semi-annually. The rate is either floating or fixed at a regular value. Distributions may be deferrable, based on the issuer's discretion or covenant breaches. In turn, hybrids may be deemed cumulative, where interest payments accrue and must be made up for later, or non-cumulative.

The principal amount of the security is the face value of the hybrid, which is the value from which interest is calculated.

Whereas some hybrids may be convertible, even at a discount, others will have a call provision that gives the issuer the scope to buy back the security at a designated date, which may be at the issue price or the par value.

There is also variance in the timeline for conversion or the payment of the hybrid's final coupon and face value. Perpetual hybrids have no maturity date but may be sold on the ASX. On the other hand, the maturity date on some hybrids may be short-term (up to 4 years), or long-term (10+ years).

Another key feature is whether a hybrid is redeemable or non-redeemable, which provides scope for either party to redeem the securities for a specified value. In some cases, the issuer may have the right to reset terms of the hybrid after a designated period (resettable security), while holders cannot accept terms, redeem or convert hybrids before maturity.

Another defining feature of hybrids is subordination in the capital structure. This means in the event of a wind-up scenario their recovery rate is materially lower than securities above them in the capital structure.

Finally, the market price of a hybrid is derived from its underlying value (capital amount), and the accrued interest since the latter of a security's last coupon payment or original issuance. As a result, hybrids typically rise in price on a daily basis until the subsequent ex-interest date, at which time accrued interest reverts to zero.

## The hybrids market in Australia

The Australian hybrids market has grown to prominence in recent years, led by the banks. Last year, over $5bn in hybrid issues were launched through the ASX, including:

- $1.87bn via NAB (paying 4.9% interest)
- $1.65bn by CBA (3.93% interest)
- $905.5m by Macquarie (5.04% interest)
- $389m from Suncorp (3.9% interest)
- $275m by AMP (5.42% interest)

Following those listings, the total size of hybrid issues stood at $45.7bn across 45 securities.

As at the end of April, some of the offerings in the hybrid market included:

- ANZPD – semi-annual income with a floating rate of 3.07% and maturity 1/9/21
- CBAPD – quarterly income with a floating rate of 2.38% and maturity 15/12/22
- MQGPB – quarterly income with a floating rate of 5.5% and maturity 17/3/21
- SUNPH – quarterly income with a floating rate of 2.5% and maturity 17/6/26

Insurers, diversified financials firms and corporates have joined in conducting hybrid issues, including recent offers from Ramsay Health Care, Nufarm and Crown Resorts.

Companies conduct hybrids issuances in order to maintain sufficient liquidity on their balance sheets. Often this is imposed by certain regulatory requirements. For the banks, APRA has set benchmark capital targets to ensure they remain "unquestionably strong".

In effect, the funds raised from issuing hybrids provides these firms with a financial buffer in the event that market conditions deteriorate. In recent months, this has proven all the more important amid the worst economic downturn since the Great Depression.

## What are some of the advantages of hybrids?

Hybrids offer numerous potential benefits, including but not limited to:

- More stable returns by way of an income stream that is set to last for a specific period
- Typically higher yield compared with government bonds and bank rates
- Exposure to a relatively defensive asset class
- Hybrids rank above common shares in the event a company is wound up
- Portfolio diversification that assists with risk management
- An asset with a flexible structure that allows it to be redeemed or converted

## What are some of the disadvantages of hybrid securities?

Despite their upside, hybrid securities also involve numerous risks. Some of the disadvantages associated with hybrids include:

- The issuer having the freedom to terminate or convert the hybrids into equity at their discretion, which may trigger capital losses
- Underperformance relative fixed-income securities during sustained market falls
- Non-cumulative hybrids do not require the issuer to make up lost income
- Hybrids rank behind debt securities in the event a company is wound up and the issuer might default on payments
- Hybrid prices may be inversely impacted by interest rate movements, while payments may be aligned with RBA rate movements
- Some hybrids may have insufficient liquidity, high bid/ask spreads or little scope for redemption during a market downturn
- A redemption period may be extended if an issuer does not redeem the hybrid at first call, which can weigh on its trading price

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