

Australian Hybrid Securities: the evolution continues

Michael Saba and David Finlay
Goldman Sachs JBWere

Introduction

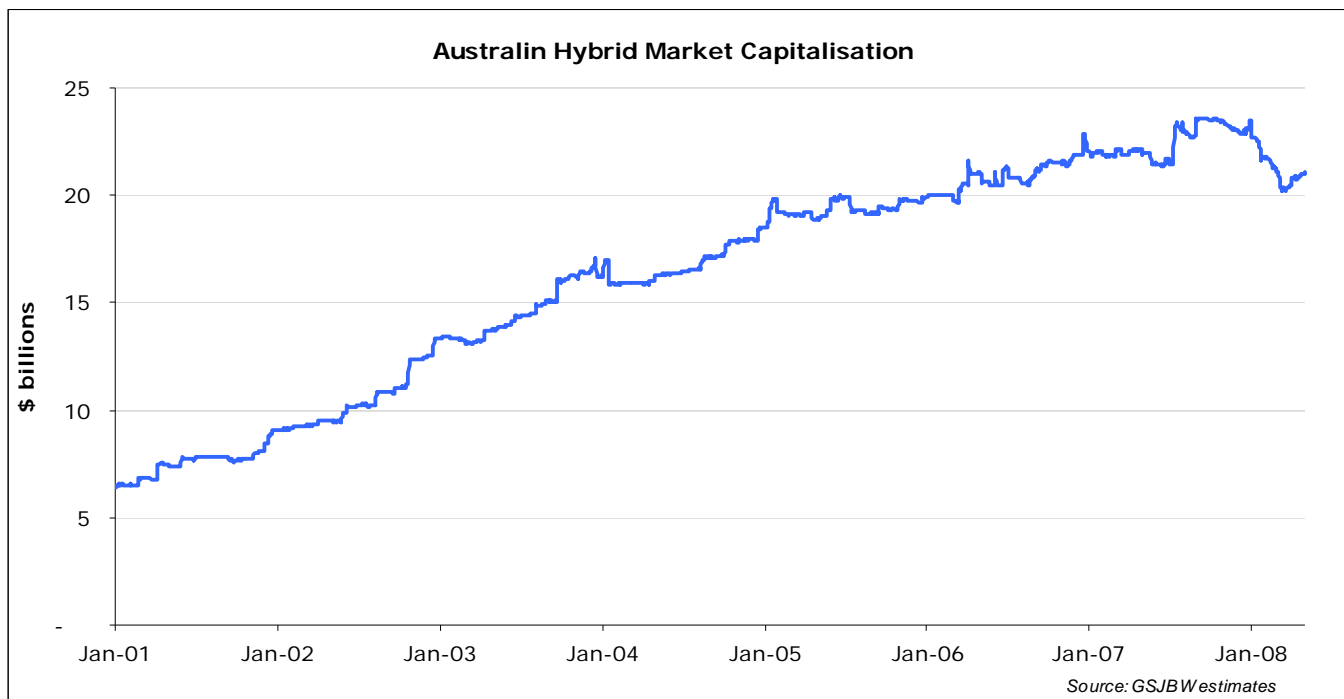
Hybrid securities have been present on the Australian financial landscape for over 20 years in various forms. Australian companies have issued hybrid securities for reasons other than just funding working capital. Hybrids have often provided capital efficiency from a regulatory or balance sheet perspective in comparison to other funding sources. Security structures have responded over time to developments in tax, accounting, ratings and regulatory treatments. Indeed a constant over the past 2 decades has been regular changes to hybrid security design. As with much in finance over this time, complexity has gradually emerged, resulting in a gathering pace of changes in security structure. The fact that the sector has survived rather than diminish in the face of regulatory and accounting changes reflects the demand from both issuers and buyers. Given the survival and indeed strong growth of the Australian Hybrid market, undoubtedly this “evolution” will continue in response to Capital structure changes and financial innovation.

There have been three categories of factors driving the evolution. Firstly in terms of security structure, changes have been instigated over time by tax treatment, APRA requirements, Basel II, IFRS changes and ASIC regulation. Secondly, investor demands have driven change in terms of yield requirement, franking demand, call option-like exposure, buyer protection under various scenarios and the need for good replacement language. Thirdly, issuing companies have found hybrids appropriate for reasons outside typical working capital requirements, such as pre IPO capital raisings, ordinary share buy back and takeover funding, capital reconstructions and private Equity buy outs. Since financial issuers have represented about 50% of the sector this decade, forced changes from relevant authorities in this area have been a major driver of change.

The term “hybrid” is used to represent a large and diverse group of securities that do not fit into the standard description of either a typical debt security or the usual representation of equity - an ordinary share. Hybrid securities can have characteristics of debt and/or equity in varying proportions from both an issuer and investor perspective. What is important however, are the structural features and how they are debt or equity like, rather than the name of the security. Despite issuing companies using many acronyms to define their hybrid, most of these securities can still be categorised. From looking for common structural features, we can identify several categories, each with more or less standard features, however because issuing companies do not have to adhere to a strict style criteria, there can be much variation within each group.

From the debt perspective, hybrids are used to gain fixed or floating interest rate exposure, often giving investors access to balance sheets of company's who may otherwise not have such exposure available. Many investors use hybrids for de facto cash or bond exposure to either enhance yield or to add diversity to an income portfolio. Hybrids with equity optionality typically give investors conservative share price exposure – that is, less upside than holding the ordinary share but a cushioned downside if the share price falls, this being due to their fixed interest nature. Such hybrids provide equity investors with a different risk-reward profile compared to the ordinary share. Because of a lack of a widely accessible and deep corporate bond market in Australia, the ASX listed hybrid market has become a defacto Corporate bond market. ASX listing gives transparency and easy access for all investors, resulting in this market gaining a broad public appeal. Market capitalisation of the sector has increased 4 fold over this decade to currently be over \$20 billion.

Chart 1. Capitalisation of the Australian hybrid Market since 2001



Increasingly, companies are looking at debt plus hybrid plus equity to fund their businesses rather than traditional funding methods. Hybrids provide another pool of investors without secured claims, giving funding diversity. In some cases hybrids can improve a company's average cost of capital compared to an issue of equity. Also regulatory authorities generally recognise hybrids as part of the capital base. The ability to pay franked dividends, which given many investors assign almost full value, allows a lower distribution rate to be paid than would otherwise have been necessary. All these factors legitimise hybrids as a funding instrument.

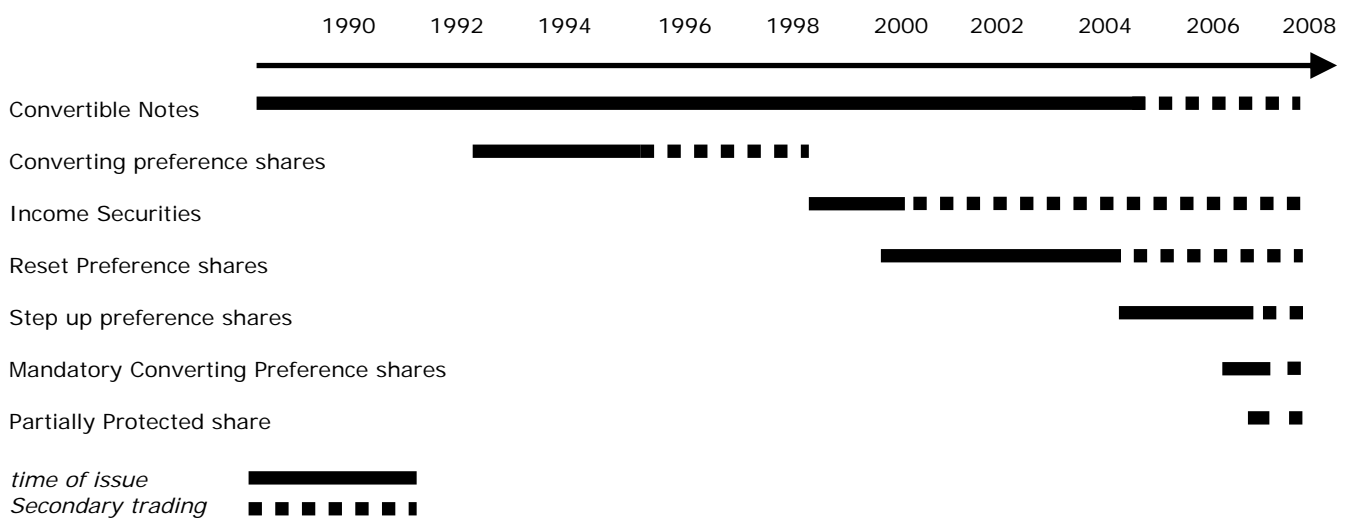
Below we firstly look at the styles of hybrids issued in Australia over the past 20 years and what has driven their emergence and then subsequent individual style demise. Secondly we concentrate on the development of the latest structures to keep companies able to issue and satisfy the large range of competing pressures as mentioned above. We will confirm discussion to hybrids issued in Australia.

Hybrid Issuance over time

One characteristic of the Australian hybrids market has been that different security types have been popular at various points in time, driven by factors that will be discussed below. Table 1 shows the major security styles and their time of issue.

The classic and initial forms of Australian hybrid securities were convertible notes (comparable to a convertible bond), a structure with debt and equity characteristics, respectively giving interest rate payments combined with direct share price exposure via fixed ratio conversion rates, and preference shares, as the name implies, preferential treatment for distributions and repayment.

Table 1. Major types of Australian hybrid security issuance time line



Source: GSJBW estimates

The early 1990s saw the emergence of the Converting Preference share (CPS) structure. The CPS structure in its basic form resembles the payoff of a bond, paying regular defined distributions and importantly, allowing the issuance of a dollar value of shares as the repayment amount rather than cash. The “converting” reference means that at maturity/conversion the issuing company will be *converting* the preference shares into the face value worth of ordinary shares (usually at some discount). This is in contrast to the early *convertible* notes or preference shares that convert into a fixed number of ordinary shares and thus have their value tied to the underlying share price. Since

at conversion of a CPS a dollar value of ordinary shares is to be received per security, the share price level at maturity is of indirect consequence. The variable is the number of ordinary shares to be issued, the value of which adds up to the particular defined dollar value. A reference share price at the conversion date is used to determine the number of shares per unit. This mandatory conversion into shares gave the equity flavor, but in reality the economics resembled a bond. Given their equity classification, many of these hybrids had franked distributions. This increased their attractiveness to investors, and the issuing company received some payback by being able to reduce the distribution level compared to the same security with no franking. However secondary market trading at this time paid little attention to the franking value.

The CPS conversion feature allowed an easy modification to include share price exposure via placing constraints on the number of shares to be issued (minimums and maximums). Having a conversion minimum was a popular way to build in call option like exposure to give more value at issue date (and lower the distribution rate). This created an instrument akin to a convertible bond. Additionally, including a conversion maximum prevented share price dilution (but for investors represented sold put options to the company). In 1998, reclassification of CPS as debt on the balance sheet saw an end for issues, especially by banks. The problem was that CPS had a finite life, the concrete repayment feature counterintuitive to equity being permanent capital, especially when some issuers engineered buy backs to soak up the stock issued at conversion. Over 20 CPS were issued during a 6 year period in the mid 1990's, representing well over \$3 billion. What this spate of issues did, however, was to focus attention to hybrids as viable investment securities with a conservative return profile. This was in part due to the issues being large in size and issued by household name companies. They were marketed to retail and Institutional investors, with enough critical mass for some specialist funds to launch, offering premium over cash like returns, these known as "Enhanced Cash funds". Despite the CPS demise, this structure would form the backbone of many hybrid security forms to come.

In late 1999 in a short period of time over \$ 4 billion of "Income Securities" were issued, a simple structure paying investors unfranked cash distributions at a fixed rate over a short term reference rate, such as the 90 day bank bill rate. Initially popular to be issued by Banks, several high profile and well rated Corporate's also issued, such as Woolworths and PBL. They had no repayment date, with an issuer option to repay anytime after 5 years. These securities were structured to gain tax deductibility for the issuer (including via SPV or offshore entities) and classification as equity on the balance sheet due to their perpetual nature and distributions being subject to company profits. The beginning of their demise began once the investor base focused on the fact that these securities lacked a repayment date and contained no holder exit rights other than secondary market sale of the listed security. Quite clearly their form in reality being a floating rate note with at times uncertain tax deductibility (the Australian Taxation Office's successfully argued that Part IVA of the

Tax Act should apply to deny deductibility of coupons on certain income securities, and the introduction of the Debt Equity rules of Division 974 of the Tax Act altered the framework for characterising the securities), saw new issues cease almost as quickly as they began, especially once the potential perpetual nature became priced into the securities and all traded substantially below face value. Several of these securities are still on issue, with most having being repaid after the 5-7 years. Issuers will, however, continue to revisit these securities to the extent that market conditions allow. Bank of Queensland accessed a market window in November 2007 with their Perpetual Equity Preference Shares structured in franked format. The security was attractive to the issuer, eliminating any refinancing risk and providing non-innovative Tier 1 capital.

In late 2000 the basic CPS structure was modified to introduce potential longevity and overcome the debt classification problem. Rather than have a finite date for conversion into the issuing companies shares, a date was nominated where the issuing company could offer holders the option to continue under original terms or with some key terms/parameters modified (reset). Such a reset offer would presumably be driven by market forces (otherwise it would have no chance of being accepted). Companies were not compelled to offer reset terms, they could simply state repayment was to occur and the issue would be redeemed. Additionally holders did not have to accept the reset terms if offered, importantly they could opt for redemption. This gave investors certainty of exit (other than in issuer bankruptcy). In most cases the repayment mechanism was to be chosen by the company, that is, either to repay face value in cash or convert into a fixed dollar value of shares (typically at a small discount). As with the basic CPS structure, issuing companies could build in call option like exposure.

Such "Reset preference shares" (RPS) became immediately popular with over \$2 billion raised in 2001 and another \$7 billion to 2005 via some 30 plus issues. Variations on the structure were: with and without franking (Reset convertible notes); no or some embedded share price exposure via conversion minimums; and time to first reset of between 3-5 years. Banks were large issuers given the non-cumulative nature provided Tier 1 capital relief. For banks and non-banks, RPS could be treated as equity on the balance sheet, since if the reset was not offered, the issuer could redeem via issuing ordinary shares to maintain equity. Over this period with contracting credit spreads, investor demand for this return profile was strong, resulting in the emergence of specialist hybrid funds to cater for a funds management approach to this asset class. This helped fuel demand, however the direct retail appetite was growing fast, especially once legislation allowed franking credits to be fully rebatable. Issuing a hybrid security with franked payments gave companies another avenue to get value for excess franking credits. Additionally many issuing companies were indifferent to paying fixed or floating rate payments. At this time interest rates looked to be rising, resulting in issues of floating rate style payment hybrids becoming popular for retail investors, a return profile otherwise not readily available to this investor base.

Issuers of Australian hybrids have always sought certainty as to the taxation consequences. As the terms and conditions were typically drafted to meet regulatory, economic (such as rating agency or those imposed under financial covenants) and investor requirements, the taxation results are often a residual consequence of meeting these objectives. The taxation characterisation could fall on either side of the debt to equity spectrum. The Australian imputation system makes this outcome important for investors, as corporate profits should only be taxed once as tax credits flow from issuer to investor. Additionally, as funds raised from a hybrid were often used to capitalise or refinance offshore operations of the issuer, the tax outcomes in a range of jurisdictions in which those funds were deployed became relevant.

The Debt/Equity rules introduced in 2001 provide a methodology to classify financing instruments. It provides relative transparency, although questions of interpretation and discretions, together with the complexity of some commercial arrangements can still leave the result uncertain and subject to debate.

Whether an instrument has frankable distributions, like that of ordinary equity, or unfrankable payments, like a senior bond, will influence the investor base as they assess the equity like or debt like characteristics of the instrument.

Equity investors, including hybrid investors have challenged themselves as to the value of the imputation credits. The ability of investors since 2000, including individuals, life insurance companies, complying superannuation funds and tax exempt registered charities and gift deductible organisations to obtain a refund of excess franking offsets (rather than just the prior ability to only offset against other income), drove the franking credit to be valued as cash, reflecting the amount of income upon which investors were subject to tax. This was a boon for issuers, as effectively the market moved from discounting the value of the credit to some 70%, to ascribing fair value of 100%.

Several companies have been in a position to pay capital as distributions and hence have paid tax deferred distributions on their hybrids. In a structure such as a RPS, combined with concessional tax treatment if the security is held for more than 12 months, very attractive after tax returns can be earned on this bond like structure.

In 2004 there were a number of regulatory changes, including IFRS and subsequent adjustment in APRA's criteria for what could qualify as regulatory capital. These factors had major impact on not only future hybrid issues but also on existing securities. From January 2005 Australian companies had to report under revised Australian standards to the equivalent of IFRS. RPS, up to that time accounted for as equity, were reclassified as debt on the balance sheet. This was due to the potential that the security could be repaid in cash or converted under various scenarios into a

variable number of ordinary shares, that is, a fixed dollar value. Apart from balance sheet treatment, the accounting reclassification of a security from equity to debt could have other implications for issuers such as potentially breaching gearing covenants.

The biggest effect however was on financial issuers who were also impacted by the reclassification impacting on APRA treatment. Grandfathering was allowed by APRA but future issues of RPS for financials were effectively dead. Several non bank issuers were able to call their RPS as the terms contained a "change to accounting treatment" clause allowing repayment upon unfavourable accounting changes. Unless a company was indifferent to the accounting treatment, future issues of RPS were also dead. As an alternative to the "reset" feature, a "Remarketing" feature was incorporated, essentially accomplishing the same outcome, but moving the focus more to a market demand.

In 2004 changes to the Corporation Law required prospectus to be more "clear, concise and effective". This resulted in larger front parts of prospectus's attempting to describe in plain language the security structure. The use of "answers to key question" sections has also promoted the explanatory power of PDS and prospectus's. This helped expand the market further to retail investors.

In 2005 APRA proposed that residual Tier 1 (the classification that includes hybrids) could make up 25% of total Tier 1 capital. Of the 25%, 15% can be issued as innovative hybrids, and the remaining 10% as non-innovative Tier 1, initially defined as being irredeemable non-cumulative preference shares. Under the standards this allowed for mandatory or step up features with a non-call period.

Demand to use hybrids as Tier 1 capital led to the adoption of the popular European hybrid "step up" structure (SPS). This security is perpetual, paying fixed or floating rate payments, with the issuing company having the option to repay the security usually at 5-10 years, or face an interest rate penalty of an increased distribution profile. A non-call period is also included. The rate increase is meant to be such as being a disincentive for companies not to repay. Typically for bank issuers this was 100 basis points, and for a BBB+ corporate 225 basis points. If issues did step up, issuers could repay at any future distribution date. Holders have no repayment rights. One main point for the regulators and rating agencies was that the control was all in the issuer's hands, that is, holders could not impact the issuer's capital. The first of these issues to reach the step up date will be in late 2008.

Step up style hybrids began to be issued in the second half of 2004, importantly led by several financial Institutions. They were initially structured to achieve Tier 1 regulatory capital classification and included step-ups of 100bp after a 10 year non-call period. Demand was strong

signalling good investor acceptance. Investor protection was placated by inclusion of the dividend stopper clause, which prevented issuing companies from paying dividends on ordinary shares for at least 12 months if SPS distributions were not paid. Additionally at this time APRA de-coupled Tier 1 capital instruments from Australian accounting standards, removing the requirement that to qualify as Tier 1 capital, the security had to be equity for accounting purposes.

In 2005-2006 over \$5 billion of SPS were issued, with non financials accounting for over 65% of issue size. Much of this popularity was based on favorable rating agency treatment as equity on balance sheets, however some issuance was due to this structure being flavor of the year and the temptation by some corporate to achieve flexible, covenant free and potentially perpetual funding (some issues were done without accompanying ratings). Institutional investors were weary of including SPS in interest rate portfolios due to it being too equity like. Additionally if the issue is franked, then the disincentive to the issuer from a cash perspective is the step up rate x 0.70, not the full step up rate. Nevertheless the issue size at this time showed the strength of demand for hybrids in general. Credit market conditions were tight. Bank issuance was underpinned by APRA rules confirming that financials could issue 25% of Tier 1 capital as qualified hybrid securities. Banks moved to maximize the volume issued, given the APRA tick and that franking credits were being fully valued by investors and in strong demand. This allowed the final cash rate paid by many Banks to be sub swap cash rates. Additionally when an offshore entity was used as an intermediary, and funds deployed offshore, a tax deduction could be obtained on the cash rate paid, the net result bring a very cheap cost of capital.

2006 saw a number of Australian corporate issuers raise hybrid funds with a beneficial senior ratings outcome, including Fairfax, Orica and Woolworths. The classification of a hybrid capital raising as 'high', 'intermediate' or 'minimal' under S&P criteria, or basketing under Moody's framework, can have explicit benefits for the senior ratings.

The guiding principals that S&P employs compare the hybrid with the paradigm of equity. All hybrids will have, to varying degrees, the three base equity like factors of no ongoing payments; permanence; and cushion in event of default. If, after balancing these factors, the agencies determine that the security is 'intermediate', then the hybrid will be split into 50% debt and 50% equity, for the analysis of the capital structure, as well as of cash flows and fixed charge coverage. This can be supportive of the senior capital outcomes. The absolute impact is tempered by the agencies limiting the amount of hybrids that can be used in a capital structure. Given the cost of a hybrid compared to the cost of equity, the benefit from a weighted average cost of capital perspective can be compelling. The ratings on hybrids are always lower the senior unsecured rating level of the issuer, reflecting the equity-like nature of the hybrid. The rating is typically 2 notches below the issuers senior rating.

Whilst hybrids can often have a perpetual legal form, there is often a periodic decision point for the issuer or investor. This could include a conversion, exchange or call event, or a reset in the distribution rate. One feature that the agencies are interested in is an uneconomic 'step-up' in a security creating a synthetic tenor on an otherwise permanent security as an issuer would be economically compelled to redeem or refinance a security. The Fairfax, Orica and Woolworths transactions all had step-ups in the distribution rate after approximately 5 years after issue. The step was 2.25%, 2.25% and 2.00%, and compared to the initial floating rate margin of 1.55%, 1.35% and 1.10% respectively. Whilst the margin reflected both the credit of the issuer and prevailing credit conditions at the time of issue, importantly, from an S&P perspective, the step-up was not seen to preclude the granting of 50% equity credit.

This treatment has been tightened over time, and a step-up of greater than 100 basis points for investment grade issuers would be viewed as an effective maturity date of the security for the issuer. Goodman Group issued such a security in 2007, so notwithstanding the distribution margin of 1.90%, the step-up was limited to 100bps.

Effective the second half of 2006 APRA revised the rules as to what constitutes Tier 1 and upper and lower Tier 2 capital. Non-innovative instruments could no longer have a synthetic maturity such as a step up feature. Mandatory conversion into ordinary shares in certain circumstances was however an allowable feature and presentation of the security under IFRS was decoupled from the regulatory treatment.

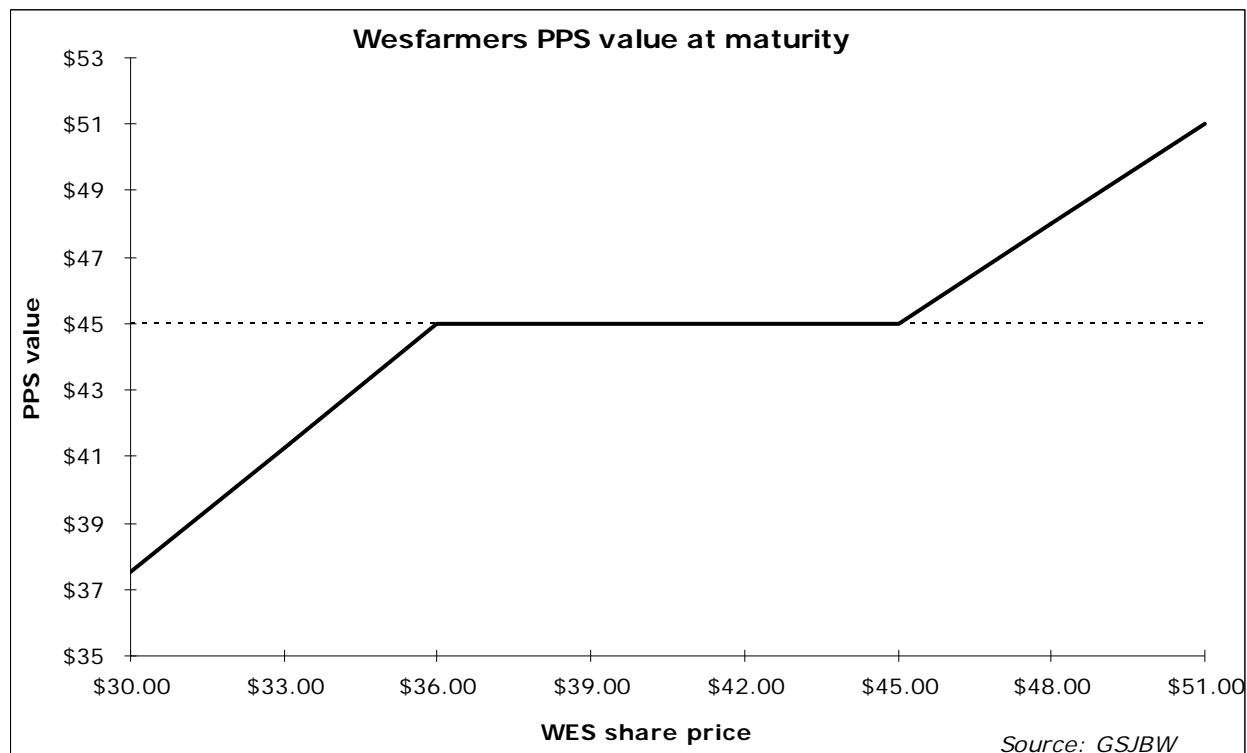
SPS continued to be issued by non financials in 2006-7 but with the advent of the credit crisis, investor demand quickly waned due to the increasing potential of perpetuity and lack of a hard repayment profile. The popularity of the hybrid market saw private equity buyouts in 2006 use the sector for funding, issuing bond like structures with attached rights for the potential of an IPO during the bond life.

In 2006 with the Banks still looking to have issues classified as non innovative Tier 2 capital, combined with still strong investor demand for franking credits and tight credit margins, the basic CPS structure was modified to include a mandatory conversion feature, where face value is returned to holders via cash repayment or in the form of a dollar value of ordinary shares at a defined date (usually 5 years). The conversion is subject to a share price test in accordance with APRA requirements. If the share price is below a certain level (50% of the price at the initial issue date), conversion is deferred until the share price recovers (test applied each 3 months, if positive, mandatory conversion). Hence the security may not be converted and may remain in place under original cash flow terms. Given the share price test was well out of the money, this "extension risk" was largely ignored, with the market keen to have a replacement for the step up structure.

The first Mandatory CPS (MCPS) issue was true mandatory deferral, in that if the conversion test was to fail, then repayment via stock conversion was actually deferred. However in subsequent issues APRA relaxed this test to allow potential for cash repayment by the company even if the conversion test failed. These later MCPS are then in effect bond like structures issuer having to repay at a fixed date with the option to continue the issue if the share price fails the redemption condition. Mandatory convertibles that can provide a 'high' level of equity credit support because of their short dated conversion, may find support as issuers look to lower the cost of issuing equity. Three banks subsequently have raised over \$2.8 billion in the four issues to date. A fourth bank used the structure in a non-Australian dollar format and sold into offshore markets.

Despite there having being only one issue of this type so far, the issue of a Partially Protected Share (PPS) in 2007 by Wesfarmers to provide extra incremental value in the Coles takeover is worth attention, especially given its \$6 billion size. The structure was new to the market and more closely related to ordinary equity than other recent issues as described above. The PPS are effectively an ordinary WES share (to pay the same dividends) with some additional stipulations in relation to the level of the underlying company share price at maturity. The protected price of the security was set at about a 15% premium to the share price at the time. This protected level is the value returned to holders via a top up mechanism at maturity. This mechanism is similar to fixed dollar conversions for CPS, a reference price prior to maturity (based on a VWAP) is divided into the protection price, in the case for WES this being \$45, and if the WES share price is less than \$45, then extra WES shares are issued to the holder to "top up" to \$45 of total value. A maximum conversion ratio is also present, in this case 1.25, which results in exposure to the share price below \$36. Additionally holders can convert at any time at a ratio of 1:1. Hence \$45 of value is returned between WES share prices of \$36 and \$45, above \$45 upside to the WES share price is obtained on a 1:1 basis and below \$36 the holder is exposed to 1.25 x the falling WES share price (meaning for each \$1 below \$36, the holder receives \$45 minus \$1.25). The payoff from holding this PPS is shown in chart 2. It is important to note that the PPS holder gets a larger return than the ordinary share holders at all prices under \$45. The net result in economics is that the Wesfarmers PPS holder is long one ordinary share plus a \$45 put and short 1.25x \$36 puts.

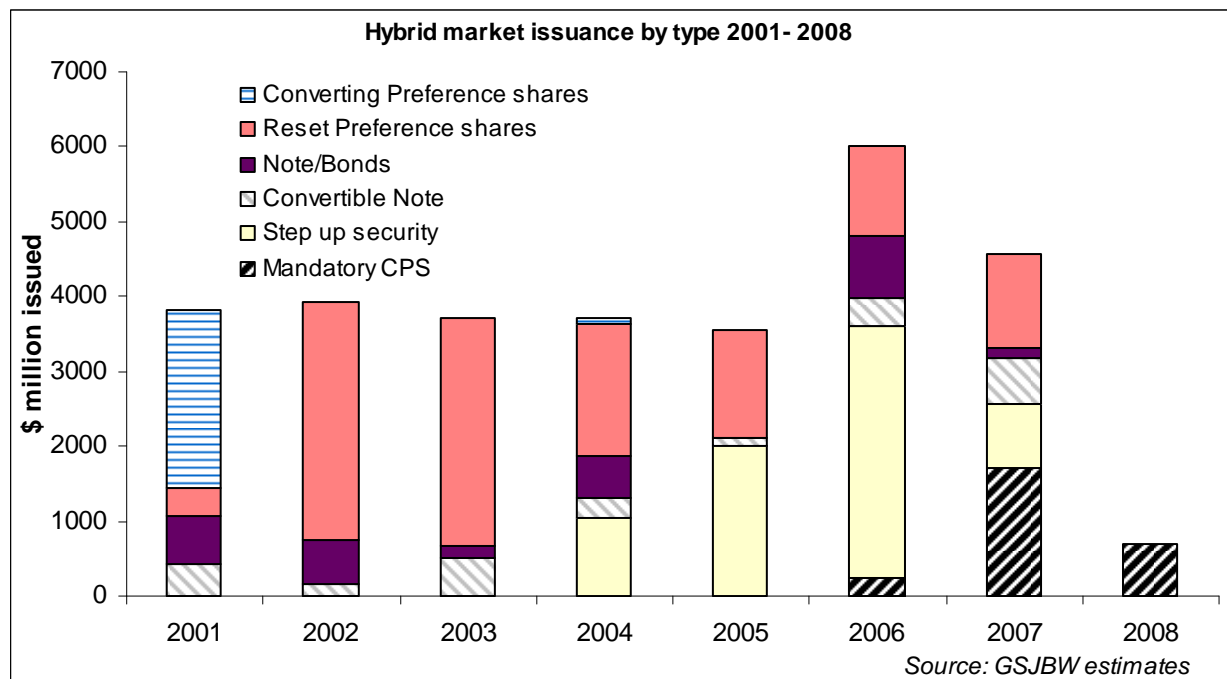
Chart 2. Wesfarmers Partially protected share payoff



The PPS had an additional interesting stipulation. If the ordinary 20 day VWAP is above \$45 for more than 20 consecutive days prior to maturity, the PPS is reclassified as an ordinary share and the \$45 top mechanism is cancelled, or "knocked out". As a result the valuation description mentioned above needs to use a modified option pricing model, classifying the puts as "Up and out" knockout barrier options.

At initial look, this appears to be a good structure, however there is no natural home for such a security, except for long term ordinary share holders. Hence future issues must be targeted at those seeking equity exposure. Typical hybrid buyers are yield based and are looking for a hard exit value, rather than share price exposure. In the case of the PPS, a bond can be constructed by buying back the short puts. The value of a PPS can be determined, but in practice Investors apply a significant discount to theoretical value because of the knock out feature, given this can cut short the protection. However, for the knock out to be reached, it implies a significant share price improvement, hence an improved return. Secondly, the knock out structure is difficult to hedge properly, resulting in little arbitrage activity. Nevertheless the Wesfarmers PPS trades with good liquidity, albeit well below theoretical value.

Chart 3. Issuance of Australian hybrids by security type



Investors

The hybrid market growth has seen a diverse range of investors use this asset class. As well as retail investors adopting this market to gain bond like returns and hybrid funds emerging to cater for such, other users of interest rate markets looked to hybrids in this period for defacto bond and floating rate note exposure. These included general Institutional interest rate investors seeking alpha in their portfolios and especially small to medium size fund managers looking to park cash. Additionally general equity fund managers used RPS with embedded equity exposures as did hedge fund style investors arbitraging the share price volatility component. Growth in investor types and styles is also a hallmark of the Australian hybrid market.

We have outlined above many hybrid security designs which have allowed variations in return characteristics such as; including direct equity exposure; paying franked distributions or not; paying fixed or floating rate distributions; and importantly, category of issuers (given financials are popular). This results in many sub-categories of investment exposure. These are outlined in table 2 which shows how these sub-sectors have performed over recent years.

Table 2. Performance of various hybrid subsectors 2003-2007

	2003	2004	2005	2006	2007
All hybrids	10.05%	9.97%	5.54%	9.26%	3.50%
All hybrids NO delta	10.35%	8.04%	5.50%	7.71%	3.67%
All hybrids WITH delta	9.51%	14.68%	5.44%	19.37%	-0.70%
All Floating rate	12.32%	7.78%	5.62%	8.03%	3.98%
All Fixed rate	8.11%	12.39%	5.50%	12.01%	1.68%
All Fixed NO Delta	4.96%	8.77%	5.43%	6.27%	2.02%
All Fixed with Delta	9.37%	14.68%	5.46%	20.99%	-1.30%
All Franked	5.75%	9.09%	5.46%	6.94%	4.66%
All Franked incl gross up	8.33%	11.61%	7.87%	9.39%	7.03%
All Unfranked	11.98%	10.55%	5.60%	10.87%	2.68%
All Rated (Inv G)	9.78%	7.91%	6.11%	7.02%	5.49%
All Unrated	10.55%	13.44%	4.58%	13.34%	0.21%
All Unrated NO Delta	13.32%	11.45%	3.23%	11.28%	-0.20%
All Unrated with Delta	9.55%	14.44%	6.24%	18.38%	0.22%
All Banks & Insurance	9.20%	7.58%	5.81%	5.62%	5.73%
All Non Banks & Ins	11.13%	12.13%	5.26%	12.20%	1.44%
All Non B&I NO Delta	11.71%	8.85%	5.12%	10.05%	1.49%
All Non B&I with Delta	10.68%	14.84%	5.44%	19.37%	-0.70%

Source: GSJBW estimates

The next evolutionary step....

Issuers and investors will continue to respond changes in the capital markets framework. Responses to changes such as these will be pragmatic. On 23 April 2008, for instance, draft legislation was released in New Zealand that impacted the NZ tax treatment of stapled stock arrangements. These changes were foreshadowed in February 2008, and seek to deny deductibility of interest payments on debt securities in New Zealand, where that debt security is stapled to a share in a company. Whilst those measures were intended to capture specific corporate restructures, they may capture some hybrid arrangements where funds are invested in NZ by an Australian parent company. We have seen both corporates and financials issue securities of this type to fund their New Zealand operations.

These amendments will only affect these types of securities issued on a prospective basis. Existing securities will be grandfathered. Taxation laws are not typically applied retrospectively, or at a minimum without a sunset transition. Tax calls are, however, standard where a change in taxation law or administration would lead to an adverse result for the issuer. For issuers that may have sought to use this type of security for trans-tasman investing, new structural mechanics will undoubtedly develop. Rather than stapled securities for instance, directly issued arrangements may be contracted between the issuer and investor.

We will continue to see incremental changes in the regulatory and legislative framework impacting issuers and investor behaviour. There is currently some uncertainty, for instance, as to the taxation outcomes for Banks and other APRA regulated entities issuing Upper Tier II capital. It is important for these issuers to have the ability to issue such securities with regulatory and taxation certainty as they look to maximise the efficiency of their capital base. Clarifying the debt treatment was a matter that was identified under the previous government, but regulations never emerged. The May 2008 Federal Budget flagged that regulations would be forthcoming to clarify the treatment.

Capital markets in recent times have shown greater uncertainty. In credit markets, liquidity is being rationed, and the cost of credit has widened. Equity markets have shown increased volatility. Issuers will continue to explore the use of hybrid securities in these times, looking to access cost effective pools of capital.

Hybrids that incorporate the ability for investors to participate in the equity performance of the issuer may gain greater traction. In an environment where the ability to access certain capital markets at any point in time may be restricted, hybrids can be viewed as a funding instrument notwithstanding their often subordinated features and an important part of an issuer's balance sheet.

From a fundamentals perspective, the convertibles market allows historically high stock volatility to be monetised via including optionality resulting in a reduced distribution rate. Whilst convertible bonds typically price at a volatility discount, the recent increase means that such securities may be able to be offered closer to historic volatility. A convertible can be viewed as a smart financing solution, raising funds cheaply, reduce near term refinancing risk, diversifying the investor base, whilst sending a strong signalling effect to the market about managements view as to the direction of the ordinary stock price. For investors, it can provide attractive participation in the equity upside, with certainty of a regular distribution and the protection of a bond floor, rather than being exposed to downside risk.

This volatility may also be able to be valued in securities that provide a cheaper way for issuers of issuing equity such as a mandatory convertible format. Whilst such issues have been common in offshore market, they have not had the same attraction in the Australian market, in part because of the relatively higher Australian dividend yields. Like the Wesfarmers PPS, these securities would provide only partial equity participation for investors, compensated by a higher return for investors. In a short dated convertible format, they can provide a high degree of strength to an issuer's ratings balance sheet.

We also anticipate that Issuers will look to structure securities to accommodate preferences of investors so as to be able to access pockets of liquidity. A higher rate environment, both in basis and credit, may see investors attracted to fixed rate issuance at this point in the credit and interest

rate cycle. Whilst investors look to lock rates in, issuers could be encouraged to assess appetite in fixing the cost of their hybrid capital requirements.

The hybrid market is a great example in Australian Finance of innovation to meet a changing issuance landscape. It has been characterised by many changes in security design, especially this decade. Despite many changes being driven by regulatory and accounting bodies, the main propulsion for changes have been investor appetite and attraction of issuers to this viable funding alternative, as without these factors, financial engineers would have had to turn their skills to other areas.