

SUBORDINATED DEBT SECURITIES WITH 'EQUITY CREDIT' FACT SHEET.

BELL POTTER

Overview

Investors are currently being rewarded with historically high issue margins as companies structure new subordinated debt securities to qualify for 'Equity Credit' from credit rating agencies.

Investors are being offered attractive issue margins of approximately 3.0% to 4.0% above the Bank Bill SWAP rate for taking on relatively low levels of incremental risk corresponding to the new subordinated debt securities with equity credit features.

What is Equity Credit?

Equity Credit is a classification of a security that provides an indication of the extent to which a credit rating agency treats the security as equity rather than debt when evaluating the quantitative aspects of an issuer's corporate credit rating.

The 'Equity Credit' structure allows companies to raise debt securities in the market yet have this debt assessed as 'equity' by the credit rating agencies for an initial period, generally, the first 5 years. After 5 years the credit rating agencies then assess the issue as 100% debt therefore the issuer has an incentive to redeem the securities.

Benefits of Equity Credit for the Issuer

Subordinated debt funding that qualifies for equity credit will improve the financial ratios that credit rating agencies use when evaluating the corporate credit rating. The structure provides the benefit of obtaining an equity credit for the credit ratings agencies when evaluating the corporate credit rating of the issuer, while still having the issue assessed as 'debt' by the Australian Taxation Office.

Features of ASX Listed Subordinated Debt Securities with Equity Credit features

- Corporate bonds are debt securities, interest payments must be paid ahead of dividend distributions.
- Generally, equity credit will apply for the first five years of the issue. After 5 years, the credit agencies will assess this issue as 100% debt. As a result there is an incentive for the issuer to redeem at the year 5 call date.
- The Australian Taxation Office treats the issue as debt, interest payments are tax deductible.
- To qualify for 'equity credit' the issuer has the ability to defer interest payments and adhere to specific Leverage and Interest Cover Ratios.
- Ultimately any investment decision needs to factor in an assessment of the ability of an issuer to protect the interests of its investor base. This generally revolves around the ability to make scheduled quarterly interest payments and redeem at year 5.

Benefits of ASX listed debt instruments

- ASX listing offers holders the ability to trade bonds providing liquidity. This may result in capital gains or potential capital losses dependent on market conditions at the time.
- The ASX market allows holders to assess the value of their investment at any given time.
- Potential capital gains if sold prior to maturity. Capital gains may result from positive interest rate movements, credit margins contracting and improved financial health of the issuer.
- Access to funds is quick-settlement of trades T+3 days.

Understanding Risk

Corporate bonds can either be secured, unsecured or subordinated. Issues with 'equity credit' features are a form of subordinated debt.

Subordinated debt ranks behind senior debt, and generally behind senior unsecured debt as well, but above hybrid equity and ordinary equity. In essence, the creditor ranks ahead of ordinary shareholders but is subordinated to other higher debt obligations that have a higher claim on an asset.

| Ranking | Classification | Type of Instrument |
|---------|----------------------------|-----------------------------------|
| Higher | Senior Obligations | Secured Debt |
| | | Unsubordinated and unsecured debt |
| | Equal Ranking Obligations | Subordinated and unsecured debt |
| | Junior Ranking Obligations | Preference shares |
| | | Ordinary shares |
| Lower | | |

Disadvantages of ASX Listed Debt Securities

- Varying liquidity.
- Potential capital losses if sold prior to maturity resulting from adverse credit conditions or interest rate movements.
- Structure of the issue needs to be assessed.

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If you have any questions, please call your Adviser, Barry Ziegler on 03 9235 1848
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