Learn the basics

FIXED INCOME.

An investor's guide

BELL POTTER

Bell Potter Securities is a leading Australian stockbroking, investment and financial advisory firm that provides a comprehensive offering of financial services to a diversified client base that includes individuals, institutions and corporations.

Founded in 1970 by Colin Bell, Bell Potter has grown to a total staff of 600 and operates across thirteen offices in Australia and has offices in London and Hong Kong.

Bell Potter is a part of the Bell Financial Group of companies (ASX:BFG).

We provide comprehensive fixed income research and advice to investors including:

— Independent research coverage of listed debt and hybrid securities that is second to none

— Weekly and monthly fixed income publications, including regular updates describing new structural features that emerge

— A rollover and redemption service for your existing investments

— Expert advice and execution services on a full range of fixed income instruments

— Access to over-the-counter (OTC) wholesale bond market, and

— Competitive term deposits (sourced from our panel of major banks and lenders).

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1.0 OVERVIEW

A balanced portfolio

A balanced or diversified investment portfolio should contain a broad range of assets including cash, fixed income, shares and property. Within each asset class there should also be diversification to minimise the risk of capital loss.

Often referred to as the 'defensive' or conservative portion of an investment portfolio, interest rate securities generally provide predictable cash flows from scheduled coupons and repayment of face value at a call date or maturity.

The defensive characteristics of interest rate securities provide a balance to a diversified investment portfolio.

Types of interest rate products

The term "Interest Rate Security" is a broad term that can refer to a type of investment that provides a regular (or fixed) income return.

Interest rate products include:

— Bank deposits (at call / term deposits)

— Treasury notes

— Bank bills

— Treasury bonds (Australian and State)

— Corporate bonds, and

— Hybrid securities.

Key reasons for investing in interest rate products

— An attractive and relatively safe investment

— A regular and predictable income stream

— Investors can improve the return on capital over a cash account

— Capital preservation, and

— Diversification.

FIGURE 1: TYPES OF FIXED INTEREST PRODUCTS

Asset Allocation	Investing Timeframe	Type of Cash or Fixed Interest Product
	Shorter	Cash
		Bank at call deposits
		Bank bills
		Treasury notes
	12 months	Bank term deposits
		Government bonds
		— Treasury bonds
		— Exchange-traded Treasury Bonds (eTBs)
		— Exchange-traded Treasury Indexed Bonds (eTIBs)
		— State and Territory Government bonds
		Corporate bonds
		— Wholesale corporate bonds
		— ASX listed debt securities
		— Exchange Traded Bonds (XTBs)
		Hybrid securities
	Longer	— ASX listed hybrid securities

1.0 OVERVIEW

Risk and return

The relationship between risk and return is a fundamental financial relationship that impacts expected rates of return on every investment asset. If investors determine that a particular asset has a higher level of risk associated with it, they will then require a greater level of return to compensate them for the higher expected risk.

Alternatively, if an investment has relatively lower levels of expected risk then investors should generally require lower returns.

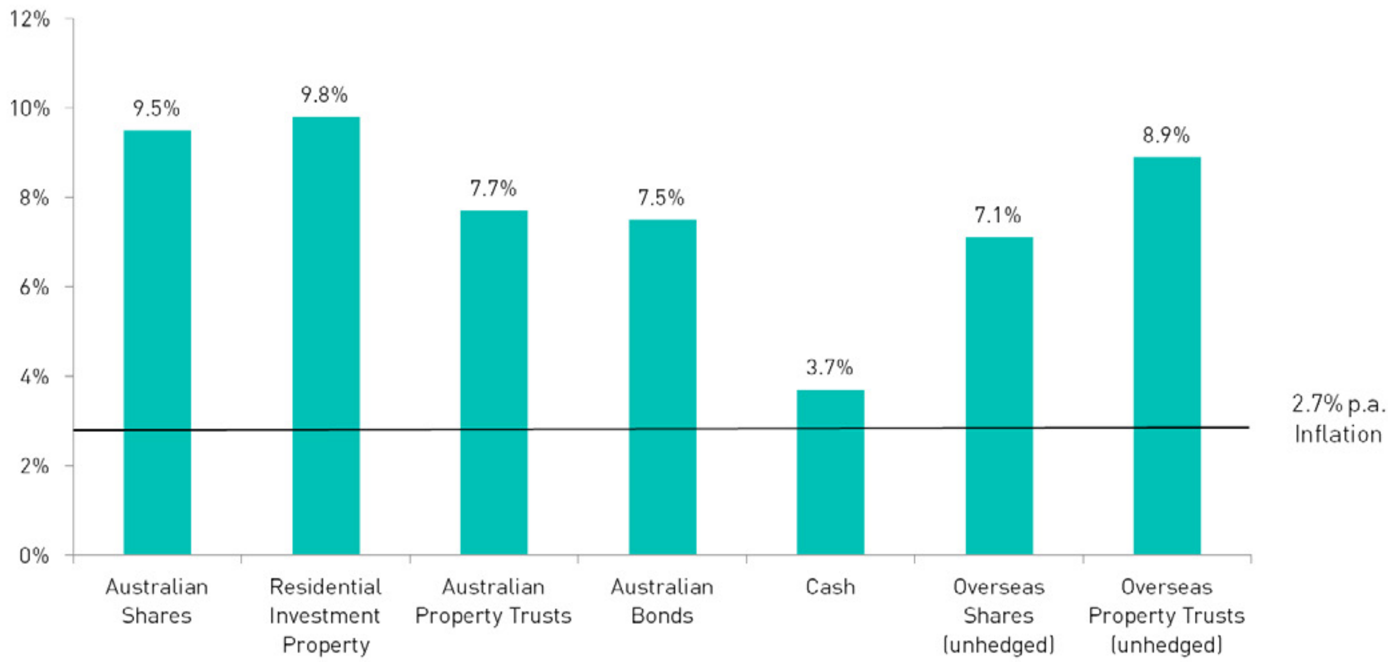
Treasury Bonds are considered as the lowest risk fixed interest investment, given the perception that Governments have a very low probability of default.

Moving lower down the capital structure increases the potential for loss, particularly for an issuer under financial pressure or distress.

FIGURE 2: SECURITY (RISK) RANKING OF INVESTMENT PRODUCTS

Ranking	Bank Basel III Classification	Product	ASX Listed Securities
Higher		Australian Treasury & State Government bonds	Exchange-traded Treasury Bonds (eTBs) Exchange-traded Treasury Indexed Bonds (eTIBs)
	Debt	Corporate bonds	Senior debt, Exchange Traded Bonds (XTBs)
	Tier 2	Corporate bonds	Subordinated notes
	Additional tier 1	Hybrid securities	Convertible preference shares, capital notes, step-up preference shares, income securities
Lower	Common equity tier 1	Ordinary shares	Ordinary shares

FIGURE 3: PRE-TAX INVESTMENT RETURNS FOR THE TWENTY YEARS TO DECEMBER 2014



Source: Russell Investments and ASX Long Term Investing Report June 2015
Please note: Past performance is no indication of future performance.

Differences between shares and interest rate securities

When companies wish to raise capital for expansion or to fund their operations, they can either raise equity capital or debt capital.

Equity capital is usually raised through the issue of shares, which can take the form of:

- Initial public offer
- Rights issue to existing shareholders
- Share purchase plan
- Institutional placement

Debt capital, on the other hand, can be raised by a number of options, including:

- Bank loan
- Wholesale (over-the-counter) debt issuance
- ASX listed debt securities

The essential differences between an interest rate security and ordinary shares can be characterised by the following criteria:

FIGURE 4: SECURITY (RISK) RANKING OF INVESTMENT PRODUCTS

	Debt	**Equity**
Income Payments	Mandatory	Discretionary
Maturity Date	Fixed	Perpetual
Ranking on Wind Up	Higher	Lower / Residual

Investment cash flows

Two key contractual obligations outlined in the issue terms of an interest rate security are:

- The interest rate / margin with which the security will pay income
- The maturity and / or call date of the security.

Failure of a debt security to make schedule interest payments and repayment of face value may result in an event of default.

By contrast, dividends paid on ordinary shares is at the issuer's discretion. In addition, shares are perpetual, where the issuer has no obligation to redeem at a future date. Company profitability and cash flow are key factors to determine the level of dividend income and share price at which investors may realise their investment.

Company wind-up / insolvency

In the event of insolvency and liquidation of an issuer, the higher ranking of debt holders than equity holders provides a greater prospect of investor returns. By contrast equity holders only have a right to the residual cash from the sale of the company's assets after all other credits have been repaid the money owed.

Equity holders are the owners of a company, which provides voting rights on various company decisions, including the appointment of directors.

2.0 SHORT TERM INVESTING

Cash/ at call deposits

Investors typically hold cash in at call deposit accounts in order to have immediate access to fund ongoing expenses.

Most Australian have a transaction savings account, where the immediate access to funds via ATMs or internet banking compensates for interest rates that are virtually zero.

Online savings accounts provide the potential for an uplift in interest rate, while some products provide bonus interest in months where a minimum deposit is made and no withdrawals.

Under the Financial Claims Scheme, the Australian government provides a guarantee on deposits of up to $250,000 per person, per eligible authorised deposit-taking institution (ADIs). ADIs include banks, building societies and credit unions.

Short-term money market

The short-term money market involves investing and trading of securities such as bank bills and treasury notes.

A bank bill (bank accepted bill of exchange) is issued by a bank (acceptor), which is liable to pay the amount of the face value to the holder of the bill at maturity. The 90 day bank bill rate is the primary benchmark rate for the Australian money market.

The federal government, through the Australian Office of Financial Management (AOFM), issues treasury notes, on maturity terms of 5, 13 and 26 weeks.

The common characteristics of these securities include:

— Securities are redeemed at par at a fixed maturity date, which may range from one day up to one year

— Only one payment is made to investors at maturity

— The discount to face value these securities are typically purchased at reflects the return investors receive, which is determined by prevailing interest rates

Reasons to invest in the short-term money market include:

— Maximising returns by employing cash in the most profitable way

— Invest funds where cyclical timing differences exist between the receipt of funds and the use of funds

— Provide liquid reserves in case of unexpected payment requirements.

Bell Potter can purchase bank bills and treasury notes on the client's behalf in the wholesale secondary market. Minimum amounts are typically in the order of $25,000.

Term deposits

Investors looking to receive a steady stream of income often consider bank term deposits. Key features of a term deposit include:

— Investment term typically ranging between one month to five years

— Provides higher interest rate than other bank deposit products to compensate for locking money away for a fixed term

— Standard interest payments made annually or at maturity. Some banks may offer more frequent interest payments (i.e. monthly or quarterly), on a slightly reduced interest rate

— Government guarantee on deposits up to $250,000

— Breaking a term deposit before maturity requires 31 days notice, combined with an interest penalty and administration fee.

3.0 LONG TERM INVESTING

Treasury bonds

Australian treasury bonds

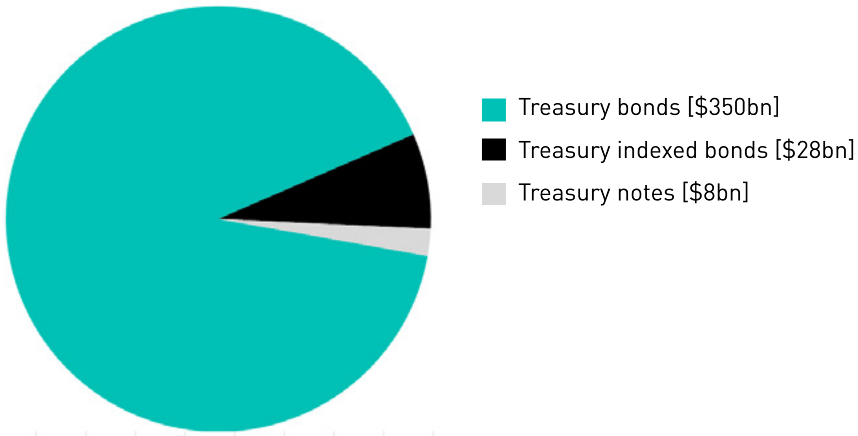
The Australian Government, through the Australian Office of Financial Management (AOFM), offers a variety of fixed interest securities, including vanilla bonds, inflation-indexed bonds and short-term treasury notes.

The treasury bond market is an extremely deep and liquid market, where all issues are denominated in Australian dollars and are guaranteed by the Australian Government. The "risk-free" status attributed to Government bonds is evident in times of volatility in global equities markets, where it is common to see a rally in government bonds as investors shift funds into low risk "safe-havens".

The amount of Australian Government treasury bonds on issue is dependent upon the prevailing economic conditions, A decade of budget surpluses from the late 1990s to 2008 resulted in a fall in the nominal size of the Treasury bond market.

The fiscal stimulus spending adopted to respond to the Global Financial Crisis has required a sharp increase in bond issuance to fund the budget deficits of the Australian Government.

FIGURE 5: AUSTRALIAN GOVERNMENT SECURITIES ON ISSUE AS AT 11 SEPTEMBER 2015



State and Territory Government bonds

Securities issued by the central borrowing authorities of the State and Territory Governments are known as Semi-Government securities. These bonds trade in a highly liquid market.

If looking to trade State Government bonds, conditions and requirements of State Government bonds vary between states. Your Bell Potter adviser can discuss your requirements and make the appropriate arrangements.

Margin between Australian and State Government bonds

A state government security carries additional risk above a treasury bond, as the debt is guaranteed by the issuing State Government rather than the Australian Government.

The difference in yield is known as the trading margin, reflecting the incremental risk on factors such as relative credit rating, economic fundamentals, budget outlook, and the demand / supply of bonds.

As the Australian Government has in theory less probability of default than a State Government, the trading margin on 5 year State Government bonds is currently 20-45bp higher than 5 year treasury bonds.

3.0 LONG TERM INVESTING

Treasury bonds (cont.)

Exchange-traded Treasury Bonds and Indexed Bonds

The ASX listing of Exchange-traded Treasury Bonds (eTBs) and Exchange-traded Treasury Indexed Bonds (eTIBs) on 21 May 2013 facilitates the trading of Government bonds in units of $100 face value. At 11 September 2015, the number of ASX listings had grown to 21 eTBs and 7 eTIBs.

FIGURE 6: EXCHANGE TRADED AUSTRALIAN GOVERNMENT SECURITIES ON ISSUE AS AT 11 SEPTEMBER 2015

eTBs Maturity	ASX Code	eTBs Maturity	ASX Code	eTBs Maturity	ASX Code	eTIBs Maturity	ASX Code
21-Oct-15	GSBS15	21-Oct-19	GSBS19	21-Apr-25	GSBG25	21-Nov-18	GSIU18
15-Jun-16	GSBK16	15-Apr-20	GSBG20	21-Apr-26	GSBG26	20-Aug-20	GSIO20
15-Feb-17	GSBC17	21-Nov-20	GSBU20	21-Apr-27	GSBG27	21-Feb-22	GSIC22
21-Jul-17	GSBM17	15-May-21	GSBI21	21-Apr-29	GSBG29	20-Sep-25	GSIQ25
21-Jan-18	GSBA18	15-Jul-22	GSBM22	21-Apr-33	GSBG33	20-Sep-30	GSIQ30
21-Oct-18	GSBS18	21-Apr-23	GSBG23	21-Jun-35	GSBK35	21-Aug-35	GSIO35
15-Mar-19	GSBE19	21-Apr-24	GSBG24	21-Apr-37	GSBG37	21-Aug-40	GSIO40

The key investment metric when investing in bonds is the yield to maturity. This is a function of income payments and the capital gain / loss if the security is held to maturity.

If you are considering investing in an eTB with a 6.00% fixed coupon, what must be considered is a higher coupon than prevailing Government bond yields will equate to a bond trading at a premium to face value. After factoring in the capital loss from the bond trading at a capital price premium, the yield to maturity will be reduced below the 6.00% coupon. While the wholesale market trades and prices bonds on a yield to maturity, eTBs are traded on the ASX at a price per $100 unit. Your Bell Potter adviser can provide accurate yield to maturity pricing on eTBs.

Corporate bonds

The corporate bond market is the largest component of the wholesale Australian fixed income market, with a wide range of investment grade issuers. Corporate debt securities have historically traded in the over-the-counter wholesale market.

Moves to promote the ASX listing of corporate debt were undertaken by ASIC with its May 2010 class order. Provisions outlined in this class order were aimed at enabling ASX listed companies with a sound history of continuous disclosure to issue a shorter prospectus for vanilla bond issues above $50m.

ASX listed debt securities

Listing debt securities on the ASX enables issuers to diversify funding reliance away from bank debt, while retail investors can reduce portfolio risk profile by increasing allocation into higher ranking securities.

Debt securities listed on the ASX can be essentially broken down into the following four categories:

- Vanilla bonds: Senior debt, with a fixed maturity and no step-up or call dates.
- Subordinated debt: Classifies as regulatory Tier 2 capital for financial issuers. Securities have a call date 5 years before maturity. Failure to redeem at the call date results in a 20% p.a. reduction in the Tier 2 weighting.
- Equity credit subordinated debt: While the securities rank as subordinated debt, certain "equity like" features enable S&P to classify the security as 50% equity until the first call date.
- Convertible notes: Debt securities with an embedded call option.

FIGURE 7: ASX LISTED DEBT SECURITIES

	Senior debt	Financial subordinated notes	Subordinated notes	Convertible notes
Securities	CBA (CBAHA) Heritage (HBSHB) IMF (IMFHA) Tatts (TTSHA)	AMP (AMPHA) ANZ (ANZHA) Australian Unity (AYUHA) NAB (NABHB) Suncorp (SUNPD) Westpac (WBCHA, WBCHB)	AGL (AGLHA) APA (AQHHA) Colonial (CNGHA) Caltex (CTXHA) Crown (CWNHA, CWNHB) Goodman (GMPPA) Origin (ORGHA) Tabcorp (TAHHB) Woolworths (WOWHC)	AFIC (AFIG) Contango (CTNG) Peet (PPCG)
Pros	Fixed maturity Mandatory interest payments Interest (no franking)	Incentive to call 5 years from maturity with 20% Tier 2 step- down p.a. over final 5 years. Interest payments not deferrable if issuer is solvent	Yield uplift relative to senior debt Loss of equity credit at call date provides incentive to redeem	Potential for equity upside with embedded call option
Cons	Liquidity may vary	Ranks below senior debt Non-viability trigger event on issues post January 2013.	Complex structure Interest payment may be deferred. Long maturity if not called.	Liquidity may vary

3.0 LONG TERM INVESTING

Corporate bonds (cont.)

Equity credit subordinated notes

In order to obtain equity credit, the security must have equity like features such as deferral of interest payments and the provision for the issuer to extend redemption to the maturity date. This equity credit structure satisfies the requirements of S&P to allow 50% classification as equity in calculation of its financial ratios until the call date, therefore providing ratings support to the issuer.

While the structure satisfies the ratings agencies equity requirements, the ATO classifies this as debt, allowing tax deductions on interest payments. The securities are also reported as debt on the issuer's balance sheet.

FIGURE 8: ASX LISTED DEBT SECURITIES

	Crown Subordinated Notes II (CWNHB)	Goodman PLUS II (GMPPA)	Crown Subordinated Notes (CWNHA)	APA Group Subordinated Notes (AQHHA)	Caltex Subordinated Notes (CTXHA)
Issue size	$630m	$327m	$532m	$515m	$550m
ASX Listing	24 Apr 2015	26 Sep 2012 (EGM)	17 Sep 2012	19 Sep 2012	6 Sep 2012
Margin: 3 month BBSW +	4.00%	3.90%	5.00%	4.50%	4.50%
Maturity	Apr 2075 (Year 60)	Dec 2073 (Year 61)	Sep 2072 (Year 60)	Sep 2072 (Year 60)	Sep 2037 (Year 25)
First call date	Jul 2021 (Year 6)	Sep 2017 (Year 5)	Sep 2018 (Year 6)	Mar 2018 (Year 5.5)	Sep 2017 (Year 5)
Step-up date	Jul 2041 (Year 26)	Sep 2022 & Dec 2038	Sep 2038 (Year 26)	Mar 2038 (Year 25)	Sep 2017 (Year 5)
Step-up margin	1.00%	0.25% and 0.75%	1.00%	1.00%	0.25%
Optional interest deferral	Yes, subject to dividend stopper	Yes, subject to dividend stopper	Yes, subject to dividend stopper	Yes, subject to dividend stopper	Yes, subject to dividend stopper
Mandatory interest deferral	Yes, if Crown's Leverage Ratio is above 5.0x, or Interest Cover Ratio is below 2.5x	No	Yes, if Crown's Leverage Ratio is above 5.0x, or Interest Cover Ratio is below 2.5x	No	No
Interest deferral	Interest can be deferred on a cumulative and compounding basis	Interest can be deferred on a cumulative and compounding basis	Interest can be deferred on a cumulative and compounding basis	Interest can be deferred on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis
Assessed equity credit	50% first 6 years	50% first 6 years	50% first 6 years	50% first 5.5 years	50% first 5 years
Ranking	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity

FIGURE 8: ASX LISTED DEBT SECURITIES

	AGL Energy Subordinated Notes (AGKHA)	Colonial Group Subordinated Notes (CNGHA)	Tabcorp Subordinated Notes (TAHHB)	Origin Energy Notes (ORGHA)	Woolworths Notes II (WOWHC)
Issue size	$650m	$1,000m	$250m	$900m	$700m
ASX Listing	5 Apr 2012	29 Mar 2012	23 Mar 2012	23 Dec 2011	25 Nov 2011
Margin: 3 month BBSW +	3.80%	3.25%	4.00%	4.00%	3.25%
Maturity	Jun 2039 (Year 27)	Mar 2037 (Year 5)	Mar 2037 (Year 25)	Dec 2071 (Year 60)	Nov 2036 (Year 25)
First call date	Jun 2019 (Year 7)	Mar 2017 (Year 5)	Mar 2017 (Year 5)	Dec 2016 (Year 5)	Nov 2016 (Year 5)
Step-up date	Jun 2019 (Year 7)	n/a	Mar 2017 (Year 5)	Dec 2036 (Year 25)	Nov 2016 (Year 5)
Step-up margin	0.25%	0.00%	0.25%	1.00%	1.00%
Optional interest deferral	No	Yes, subject to dividend stopper	No	Yes, subject to dividend stopper	Yes, subject to dividend stopper
Mandatory interest deferral	Yes, if AGL's Leverage Ratio is above 4.0x, or Interest Cover Ratio is below 3.0x	No	Yes, if Tabcorp's Leverage Ratio is above 3.5x, or Interest Cover Ratio is below 3.0x	Yes, if Origin's Interest Cover Ratio is below 3.5x. Leverage Ratio (above 4.0x) will next be tested Dec 2016	No
Interest deferral	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis
Assessed equity credit	50% first 7 years	50% first 5 years	50% first 5 years	50% first 5 years	50% first 5 years
Ranking	Subordinated, ranks above ordinary equity	Subordinated, ranks above prefs and ordinary shares held by Commonwealth Bank	Subordinated, ranks above ordinary equity	Subordinated, ranks equal with Euro Capital Securities and above ordinary equity	Subordinated, ranks above ordinary equity

3.0 LONG TERM INVESTING

Corporate bonds (cont.)

Advantages and disadvantages of ASX listed debt securities

Advantages

— Regular income payments. Interest payments must be paid ahead of dividends.

— Fixed maturity - failure to redeem at face value at maturity is typically an event of default.

— Liquidity and valuation via ASX listing. Settlement on T+3 days. Selling before maturity may result in capital gains or losses, dependent on prevailing market conditions

— Potential for capital gain if sold prior to maturity - dependent on improvement in prevailing market conditions

Disadvantages

— Liquidity may be limited

— Potential for capital loss if sold prior to maturity - may result from adverse credit conditions or deteriorating financial metrics and performance of the issuer

Wholesale corporate bonds

This wholesale corporate bond market consists of a wide range of investment grade issuers, include bank and financial companies, non-financial corporates, non-resident corporates, as well as the issuance of asset-backed securities.

The secondary market for corporate bonds encompasses all of the exchanges, trading rooms, and electronic networks known as the over-the-counter (OTC) market. Bell Potter participates in the OTC market, along with a number of securities firms, banks and brokers.

Given the minimum parcel size of $500,000, client participation is limited to sophisticated / professional investors. The thresholds under the corporations law to qualify as a "professional investor" is to have an accountant certify that the investors has:

— A gross income of $250,000 or more per annum in each of the previous two years; or

— Net assets of at least $2.5m.

Exchange-traded bonds (XTBs)

Retail investors now have access to exchange-traded bond units (XTBs), following the regulatory process undertaken by the Australian Corporate Bond Company (ACBC). Initially 17 bonds were listed on the ASX on 14 May 2015, allowing trading in $100 units versus minimum parcel sizes of $500,000 in the wholesale market.

The initial 17 bonds are all top 50 ASX listed companies, with underlying issue sizes of the bonds typically $150m-$525m. Maturities range from July 2017 - November 2020. Future issuance of XTBs is expected to align with investor demand.

Key investment considerations for the XTBs include:

- Fixed / floating rate bonds: Higher ranking than most existing ASX listed debt and hybrid securities, which are predominately floating rate.
- Liquidity: XTBs are traded on the ASX where liquidity is provided via a market maker mechanism, similar to the Exchange-traded treasury bonds. Indicative bid/ask spread ~6-10bp.
- Diversification: Given most investors have an overweight exposure to banks, XTBs offer senior debt of non-bank top 50 ASX listed corporates.
- Fees: ACBC charges a fee of 0.40% p.a. which is incorporated into the unit price of the ASX listed units. This allows investors to receive the full interest coupons.
- Pricing: Bell Potter can provide live yield to maturity pricing.
- Margin lending: Bell Potter margin lending will provide the same LVR as the issuer.

FIGURE 9: EXCHANGE TRADED BOND UNTIS (XTBs)

ASX Code	Issuer	Maturity	Issue Size ($m)	Pay Dates
YTMAZJ	Aurizon	20 Oct 2020	$525	28 Apr / 28 Oct
YTMBHP	BHP	18 Oct 2017	$1,000	18 Apr / 18 Oct
YTMCWN	Crown	18 Jul 2017	$300	18 Jan / 18 Jul
YTMDXS	Dexus	10 Sep 2018	$205	10 Mar / 10 Sep
YTMGPT	GPT	24 Jan 2019	$250	24 Jan / 24 Jul
YTMIPL	Incitec Pivot	21 Feb 2019	$200	21 Feb / 21 Aug
YTMLLC	Lend Lease	13 Nov 2018	$250	13 May / 13 Nov
YTMLL1	Lend Lease	13 May 2020	$225	13 May / 13 Nov
YTMMGR	Mirvac	18 Sep 2020	$200	18 Mar / 18 Sep
YTMNVN	Novion	19 Dec 2019	$250	19 Jun / 19 Dec
YTMSCG	Scentre	23 Oct 2019	$150	23 Apr / 23 Oct
YTMSGP	Stockland	6 Sep 2019	$150	6 Mar / 6 Sep
YTMSG1	Stockland	25 Nov 2020	$160	25 May / 25 Nov
YTMTLS	Telstra	15 Jul 2020	$500	15 Jan / 15 Jul
YTMWES	Wesfarmers	28 Mar 2019	$500	28 Mar / 28 Sep
YTMWE1	Wesfarmers	12 Mar 2020	$350	12 Mar / 12 Sep
YTMWOW	Woolworths	21 Mar 2019	$500	21 Mar / 21 Sep

Corporate bonds (cont.)

Exchange-traded Bonds (XTBs)

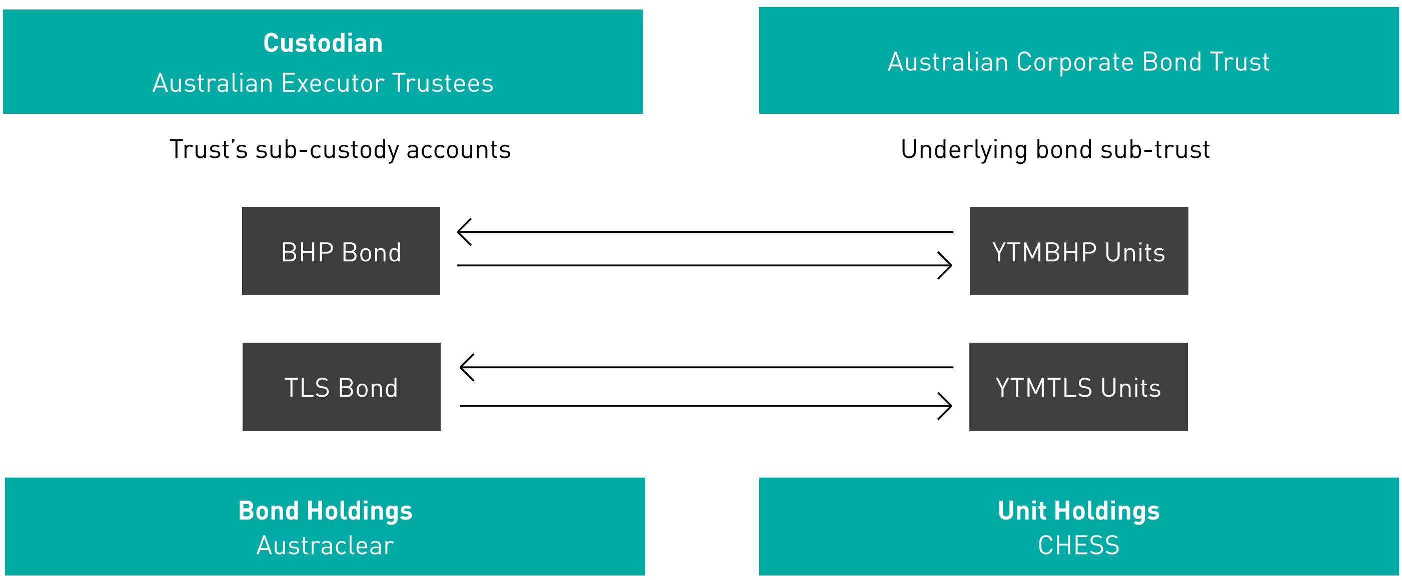
Risks of Investing in XTBs

A key risk to consider when investing in XTB bonds versus direct bond investment is the counterparty risk in relation to the responsible entity, securities manager and indirectly the bond issuer. In each case, XTB holders may lose their entire investment amount. In addition, a default by a counterparty could lead to increase in fees and expenses as other counterparties may seek to recover their fees and expenses from the Trust.

Another key risk is segregation and pooling risk, where the underlying bonds for each class of XTB are held in separate underlying bond sub-trusts. Each XTB provides a beneficial interest in the relevant underlying bond sub-trust, but not an entitlement to, or interest in, any particular underlying bond, or part thereof, held in the relevant underlying bond sub-trust. This means that underlying bonds are only pooled together in the relevant underlying bond sub-trust.

If the responsible entity defaults on its obligations under this PDS to a particular class of XTB holders, individual XTB holders can only claim against the assets in the relevant underlying bond Sub-trust (i.e. the underlying bonds and any coupon payments or other distribution amounts held in the underlying bond sub-trust).

FIGURE 10: SEGREGATION OF UNIT CLASSES



Other risks of investing in XTBs include:

- Exposure to the creditworthiness of the bond Issuer (i.e. default risk);
- Liquidity risk - the ability of investors to trade XTBs prior to maturity.
- Quotation risk - that securities remain quoted on the ASX
- Market risk - value of the underlying bonds may be impacted by factors such as changes in interest rates, economic, political and legal conditions, investor perceptions, Australian and worldwide economic conditions, debt market conditions and the financial performance of the bond issuer.

Hybrid securities

Hybrid securities constitute the preferred equity component of the capital structure, having features of both debt and equity.

— The debt features include a schedule of distributions payable at a predetermined rate or margin above bank bill.

— The equity features provides for payment of franked dividends at the issuer's discretion. Hybrids are also perpetual in nature, with potential for the issuer to elect to convert into ordinary equity (or redeem) at a specified call / step-up / reset date. Conversion into ordinary shares on a mandatory conversion date requires certainty share price thresholds to be satisfied.

FIGURE 11: ASX LISTED HYBRID SECURITIES

	Major bank hybrids	Financial hybrids	Perpetual income securities	Perpetual step-up hybrids
Securities	ANZ (ANZPA, ANZPC, ANZPD ANZPE, ANZPF) CBA (CBAPC, CBAPD) NAB (NABPA, NABPB, NABPC) WBC (WBCPC, WBCPD, WBCPE, WBCPF)	BEN (BENPD, BENPE, BENPF) BOQ (BOQPD) Challenger (CGFPA) IAG (IAGPC, IANG) Macquarie (MBLPA, MQGPA) Suncorp (SUNPC, SUNPE)	BEN (BENHB) Macquarie (MBLHB) NAB (NABHA) Suncorp (SBKHB)	Elders (ELDPA) Multiplex (MXUPA) Nufarm (NFNG) PaperlinX (PXUPA) Ramsay (RHCPA) Seven Group (SVWPA)
Rationale	Additional Tier 1 Capital	Additional Tier 1 Capital	Additional Tier 1 Capital (partial)	Retaining hybrid funding
Pros	Incremental yield uplift Liquidity	Incremental yield uplift Liquidity	Cash - margin does not represent gross up value of franking credits	Issuer exposure with potentially higher yield than ordinary shares
Cons	Trigger Events	Trigger Events	Redemption uncertainty Low issue margins	Redemption uncertainty Potential to suspect dividends

Financial hybrid securities

Financial companies are the largest issuers of hybrid securities, particularly given qualifying convertible preference shares / capital notes form the Additional Tier 1 capital layer of bank regulatory capital.

In the $46bn ASX listed debt and hybrid market, there are 27 financial hybrid securities currently listed, with a combined face value of over $28bn. The 4 major banks have 16 listed hybrids, with the remaining 11 securities split between Bendigo and Adelaide Bank, Bank of Queensland, Challenger, IAG, Macquarie and Suncorp.

3.0 LONG TERM INVESTING

Hybrid securities (cont.)

Financial hybrid securities

Basel III requirements for stronger capital ratios

The fallout from the Global Financial Crisis has seen the Basel Committee on Banking Supervision establish new capital reforms. Hybrid securities compliant under the Basel III prudential reforms adopted by APRA now include two Trigger Events:

— Common Equity Tier 1 (CET1) Capital falls below 5.125%; and/or

— APRA deems the financial institution as non viable.

The trigger events require conversion of the hybrid security into ordinary equity, providing an immediate injection of Common Equity Tier 1 Capital.

While investors may view these trigger events unfavourably on account of the additional risk and complexity of investing in hybrid securities, what must be considered is these have been introduced in conjunction with the banks holding stronger capital levels. From 1 January 2016, APRA's prudential standards will require the major Australian banks to hold 8.00% CET1, consisting of:

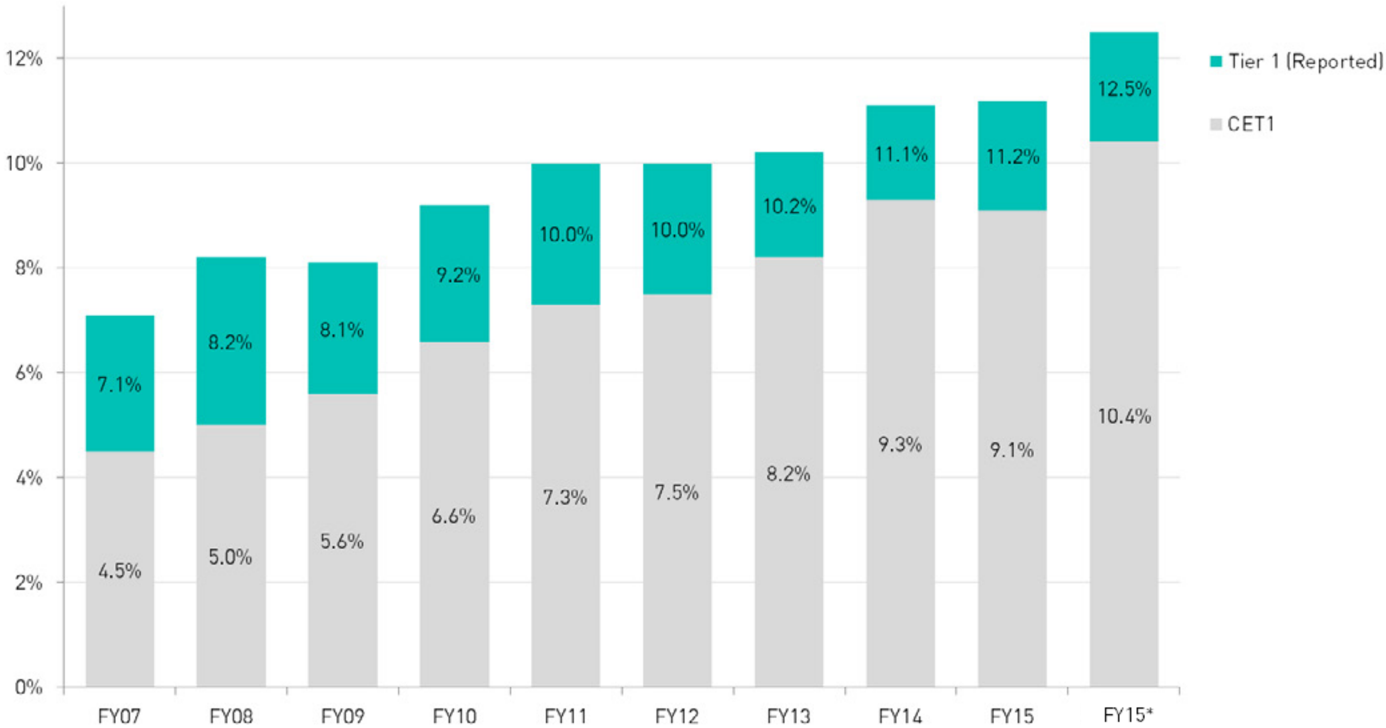
— 4.50% regulatory minimum

— 2.50% capital conservation buffer

— 1.00% D-SIB (Domestically Systemically Important Banks) capital buffer

In addition, APRA's adoption of the Financial System Inquiry (Murray Report) for the strengthening of bank capital levels such that they are "unquestionably strong" by being in the top quartile of international banks will see the major Australian banks target CET1 ratios of ~10%.

FIGURE 12: COMMONWEALTH BANK TIER 1 CAPITAL FY07-FY15



* Pro Forma FY15 including CBA $5bn Entitlement Offer

Source: Company data

Action required to restore deteriorating capital levels

If CET1 ratios start drifting towards 8.00%, banks will prudently look at measures at improving capital levels such as raising equity, divesting assets and cutting dividends. If the CET1 ratio falls between 7.125% and 8.00%, the percentage of earnings able to be used for discretionary payments such as dividends on ordinary shares and hybrids as well as bonuses reduces to 60%. These restrictions provide for an organic regeneration of capital. Given the Australian banks currently have a 70-80% payout ratio, a reduction in CET1 below 8.00% will result in ordinary dividend cuts.

FIGURE 13: CAPITAL CONSERVATION BUFFER

CET1	% of earnings for discretionary payments
>8.000%	100%
7.125-8.000%	60%
6.250-7.125%	40%
5.375-6.250%	20%
4.500-5.375%	0%

Enhanced yield versus incremental risk

Investors considering investing in bank hybrids need to be aware of the risks involved in moving from a bank deposit protected by the Government guarantee scheme, to a security that ranks behind deposits, senior debt and subordinated debt.

While the uplift in margin from hybrids may appear attractive if the issuer's current financial position is strong, incremental risks from moving lower on the capital structure can quickly escalate if there is a material deterioration in the issuer's financials.

A fall in the capital price of a hybrid reflects the additional margin required by investors to compensate for risks such as the issuer may not be able to redeem or convert the hybrid at the first call date. In more extreme cases, hybrid distributions may be suspended (subject to the issuer not paying ordinary dividends).

Determining income payments

Income on floating rate securities is determined by adding a margin to a bank bill rate.

- Floating: Bank bill swap rate (BBSW) - the prevailing 3 month bank bill (quarterly coupons) or 6 month bank bill (half yearly coupons) at the issue date or payment date of the previous coupon. This tends to be correlated to the Reserve Bank Official Cash Rate.
- Fixed: Margin - usually determined in the bookbuild held for broker firm and bookbuild bids. This margin reflects the grossed up value of franking credits.

Assuming a current 3 month bank bill of 2.20% + 3.80% margin equates to a grossed up income of $6.00 ($4.20 fully franked). If the dividend period is 91 days, then the gross dividend payment amount will be $1.4959 ($1.0471 fully franked). Issue terms typically allow for a cash top up if the issuer has insufficient franking credit to pay fully franked dividends.

Hybrid securities (cont.)

Financial hybrid securities

Hybrid dividends at issuer's discretion versus dividend stopper

The equity characteristics of hybrids allows the issuer discretion to pay a scheduled hybrid dividend. Hybrid dividends are also typically non-cumulative, where the issuer has no obligation to pay missed dividend payments at a future date. Non payment of hybrid dividends prevents payment of ordinary dividends under the dividend stopper. This highlights the priority ranking of a hybrid over ordinary shares in terms of income. Hybrid dividend payments of financial issuers are also subject to three key payment conditions:

— Complying with APRA's capital adequacy requirements post dividend payments
— The payment of the dividend does not result in the issuer becoming insolvent
— APRA does not object to the payment of the dividend.

Conversion / Redemption

Issue terms typically allow for conversion at a Mandatory Conversion Date (MCD). All new financial preference shares since 2011 also have an optional exchange date two years before the MCD, where the issuer may decide to convert or redeem the security, subject to APRA's approval. There has been a trend for issuers to fund redemption by undertaking a replacement issue incorporating a reinvestment offer.

In order for bank convertible preference shares (CPS) and capital notes to qualify as Additional Tier 1 capital, APRA has imposed a maximum conversion number in order to limit the dilution of ordinary shares upon conversion. This maximum conversion number represents the face value of the preference share divided by 50% of the volume weighted average price (VWAP) of the issuer on the 20 business days preceding the issue date (issue date VWAP). Using an Issue Date VWAP of $25.00 would equate to a maximum conversion number of 8.00 shares per pref (i.e. $100.00 / (50% x $25.00)).

The following Mandatory Conversion Conditions (MCC) exist to prevent preference share holders from receiving less that face value at mandatory conversion:

— First: VWAP of ordinary shares on the 25th business day before a possible MCD must be above 56% of the Issue Date VWAP (i.e. $25 x 56% = $14.00)
— Second: VWAP of ordinary shares during the 20 business days preceding the possible MCD exceeds 50.5% of the issue date VWAP (i.e. $25 x 50.5% = $12.63).

Most preference shares also have a requirement of Continuous Trading (i.e. no delisting event) prior to a possible MCD.

The perpetual nature of preference shares relates to the MCC not being satisfied and the issuer not seeking APRA's approval to redeem. Under this scenario, conversion at the MCD will not occur, and the security will remain on issue and continue to pay dividends at the same margin. The MCC will be tested on each future dividend date.

Financial perpetual income securities

The following four ASX listed income securities were issued over 1998-1999 as perpetual floating rate notes:

— Bendigo and Adelaide Bank (BENHB)
— Macquarie (MBLHB)
— NAB (NABHA)
— Suncorp (SBKHB)

The combination of a very low issue margin and no set redemption date has resulted in these securities trading at a material discount to face value since the onset of the Global Financial Crisis.

APRA's transitional arrangements under Basel III for Tier 1 and Tier 2 capital instruments issued before 17 December 2009 will result in the Additional Tier 1 Capital weighting reducing from 10% per annum between January 2013 until 1 January 2022 (0% weighting).

Given these income securities offer a very cheap source of perpetual funding, this appears to currently outweigh the gradual loss of Additional Tier 1 status. To redeem these securities at face value would likely require a material recovery in prevailing hybrid margins to ensure it is cost effective. In the interim, off-market buy-backs at $80 have been undertaken on BENHB and SBKHB.

Industrial perpetual stepped up preference shares

Post the onset of the Global Financial Crisis, a number of issuers with step-up preference shares took the decision to pay an additional step-up margin on the hybrid (typically 2.00-2.50%), rather than redeem or convert at the step-up date. The following six issuers who took this decision typically had balance sheet constraints and preferred to pay the additional margin to retain the funding:

- Elders (ELDPA)
- Multiplex (MXUPA)
- Nufarm (NFNG)
- PaperlinX (PXUPA)
- Ramsay (RHCPA)
- Seven Group (SVWPA)

The combination of a deterioration in the issuer's financial metrics and uncertainty over when the security may be redeemed or converted has seen some of these securities trade at a substantial discount to face value.

While these securities have the option of redeeming or converting these securities at future dividend payment dates, Transpacific has been the only issuer to redeem its TPAPA security as a result of improved financial metrics from asset sales. Australand's AAZPB was redeemed as a result of a takeover bid, while Elders has conducted an on market buy-back for 25% of ELDPA on issue at $80.

Hybrid risks

Key hybrid risks include:

- Bank hybrids are not deposits protected by the government guarantee scheme
- Preferred equity ranks behind deposits, senior debt and subordinated debt
- Hybrid dividends are at the issuer's discretion and are non-cumulative.
- Bank hybrid dividends payments are subject to three key payment conditions:
    - The issuer complying with APRA's capital adequacy requirements post the hybrid dividend payments;
    - The hybrid dividend payment does not result in the issuer becoming insolvent;
    - APRA does not object to the payment of the hybrid dividend.
- Adverse movement in credit spreads as a result of a tightening in the availability and cost of credit.
- Downward pressure on hybrid prices as a result of new issues offering more attractive issue terms and margins. Selling existing hybrids to participate in new raisings may also cause price weakness.
- Adverse changes in the issuer's financial performance which combined with a major bad debt event could lead to the Common Equity Tier 1 Capital Ratio falling below 5.125%, resulting in automatic conversion under the Capital Trigger Event. Automatic conversion may also be required under a Non-Viability Trigger Event.

3.0 LONG TERM INVESTING

Hybrid securities (cont.)

Hybrid risks (cont.)

- Under an Inability Event, the hybrid may lose its value and investors will not receive any compensation if the issuer is not able to issue ordinary shares within 5 business days from conversion under a Capital Trigger Event or Non-Viability Trigger. Scenarios under which this may occur include the issuer being prevented from issuing ordinary shares by circumstances outside of its control, including an applicable law or order of any court, or action of any government authority from issuing shares.
- Conversion at the Mandatory Conversion Date requires the issuer's share price at the time of mandatory conversion to be above certain thresholds. If these thresholds are not met at the mandatory conversion or at future dividend payment dates, the hybrid may remain on issue indefinitely.

ASIC "Complex Investments" warning: Money Smart website

ASIC's Money Smart website provides information for retail investors who are considering investing in "Complex Investments" such as hybrid securities:

www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes

Basically, hybrid securities (including subordinated notes and convertible preference shares) may be from well-known companies but they are very different from 'normal' corporate bonds.

Some hybrid securities make investors take on 'equity-like' risks. Some also have terms and conditions that allow the issuer to exit the deal or suspend interest payments when they choose. Some are very long-term investments (for example, more than 20 years).

Hybrid securities may be unsuitable for you if you need steady returns or capital security typically from a bank term deposit style of investment.

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