

Fixed Income

5 December 2011

Reset securities

This note covers securities issued on a perpetual or fixed term basis with one or more resets of interest rates or dividends over their expected life. These securities are mostly quoted on the NZDX on a price basis compared with vanilla fixed term senior bonds that trade on a yield. The right of repayment, except for those with a fixed term, is at the option of the issuer.

Table 1 : Recent Events

Security	Date	
ASBPA	15/11/11	Dividend reset at 4.00% pa being the one-year swap plus a margin of 1.30%.
IFTHA	15/11/11	Coupon reset at 4.22% pa being the one-year swap plus a margin of 1.50%.

Financial Conditions Update

Offshore events continue to take centre stage. This week, in a concerted effort, the US Federal Reserve, the European Central Bank, the Bank of Japan and the central banks of Britain, Canada and Switzerland coordinated an increase in USD liquidity. This was in response to European banks experiencing USD funding stresses and is the first coordinated response since the rate cut in October 2008. The immediate reaction in the markets has been positive with European bond yields falling and rises in global equities.

However, while this has definitely improved sentiment and given hope that the central banks will take action to try and avert a worst case scenario, the reality is that nothing has changed. The fundamentals of certain sovereign nations and associated banks are poor and risks remain of a recession even if the 17 countries can hold together in the European Union. Closer fiscal integration and a more aggressive European Central Bank are being proposed as potential solutions to the crisis. The European Union Leaders Summit on 9th December is the next key date for Europe. Generally, investors have been exiting the euro zone bond market and government and bank debt has been sold down. We remain a concerned observer and, given New Zealand's open economy, we remain very exposed to the global elements.

Standard & Poor's revises Bank Credit Ratings

Standard & Poor's (S&P) published its revised bank criteria in November this year and, as part of a process of "applying its new ratings criteria for banks", released adjusted ratings for 37 of the world's largest financial institutions at the end of November and then on 1st of December revised the largest Australasian banks' credit ratings.

S&P released comments noting that the new ratings are aimed at better reflecting its view of the global banking sector, including the impact of sovereign risks. "Sovereign risks impact bank ratings in many ways, directly and indirectly. They could mean reduced government support for the banks, or riskier economic operating conditions. By design, the new methodology captures these linkages".

Of the international banks, perhaps most noteworthy in the domestic market, is the downgrade of Rabobank. Under the new methodology, Rabobank has lost its coveted S&P AAA credit rating. S&P has assigned Rabobank the highest rating of the 37 banks at AA with a 'stable outlook' and the bank retains its position as the world's highest rated privately owned bank. The bank has noted that "it was inevitable that banks would lose the triple A status". Rabobank still holds the highest rating from Moody's at Aaa 'outlook negative' and Fitch rates Rabobank at AA+ 'negative outlook'. A number of other banks, mostly American and UK, were also downgraded. Credit Agricole maintained its credit rating of A+ 'stable outlook' although its subordinated instruments were downgraded.

S&P cut its issuer credit ratings on the four main Australian banks by one notch, citing its revised banking industry country risk assessment findings. S&P noted "in our view, weaknesses for the Australian banking sector are its material dependence on net external borrowings, which fund about 24% of domestic customer loans; and limited support from core customer deposits, which fund only about 38% of domestic customer loans. We consider that these weaknesses are partly offset by a domestic debt capital market that can support the banking sector and the government and central bank, whom we view as responsive and flexible to banks' funding needs."

A positive rating announcement from Fitch Ratings (Fitch) this week saw Australia upgraded to the highest possible rating of AAA from AA+ for its overseas borrowings. S&P and Moody's also have Australia at the top credit rating. The ratings upgrade reflects Australia's "high value-added economy, strong political, civil and social institutions and its flexible policy framework". The country's low government debt-to-GDP ratio of 26.3% of GDP in 2010-11 was cited as one of the standout strengths. In comparison, the median ratio in the AAA group was 55.7%. Fitch did note that Australia was relatively sensitive to external financing shocks compared with its peers and as evidence the Australian banking sector faced difficulties accessing wholesale funding in the 2008 GFC. Overall, the high credit rating of Australia as a sovereign borrower is positive for the Australasian banks. Fitch released a new report on 1 December with the comment that "Australian banks are generally well positioned to meet new regulatory requirements as set out by Basel III framework and interpreted by the Australian Prudential Regulation authority."

Selective buying opportunities

We have seen a sell-off of corporate and bank securities resulting in higher yields and lower prices. This is due to a number of factors including; a number of new offers coming to the market ahead of the end of the calendar year and credit being priced more widely in this market. We have discussed in other market commentaries that, while government and highly rated vanilla bonds have seen decreasing yields and reduced or constant credit margins, many other fixed income securities are pricing at higher credit margins due to the perceived increased risk in the current market environment. As a result some securities have become cheaper to buy and look attractive.

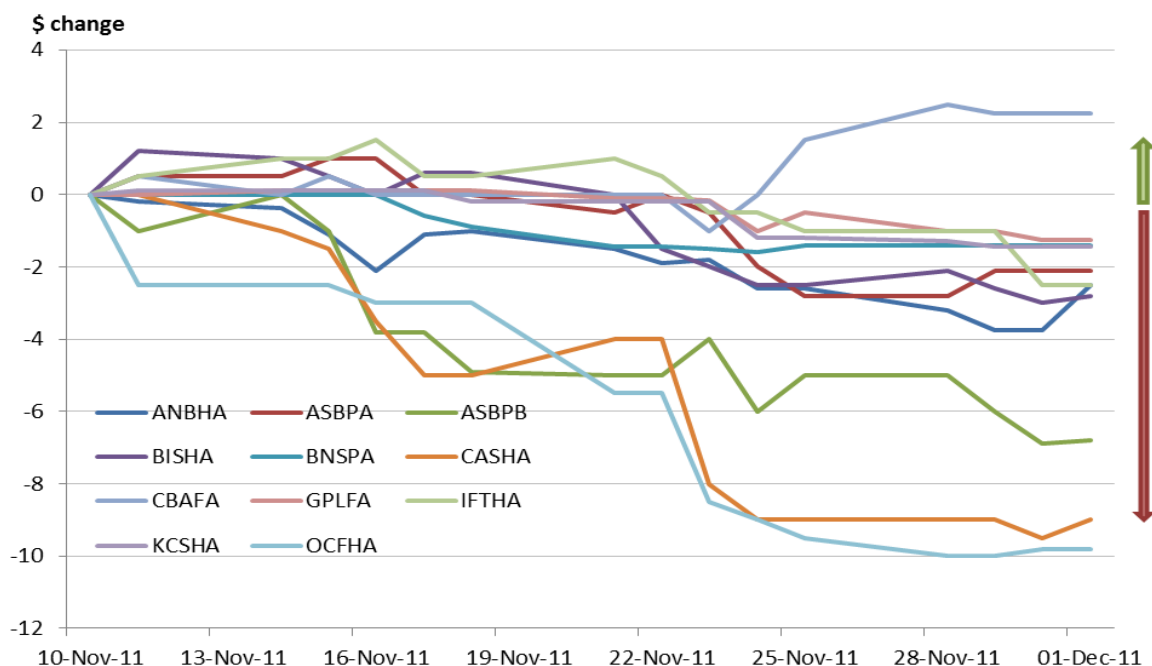
This is supported by our view that benchmark interest rates will remain lower than had been expected some months ago. The OCR is unlikely to increase until late 2012 and, furthermore, we do not expect the long end of the yield curve to rise significantly given the forecast subdued growth globally. With no resolution to the turbulent Euro zone problems, we expect to see continued volatility in the next few months although would hope that this would reduce next year.

The S&P credit downgrades to subordinated bank securities will have a small negative impact on pricing. Despite being widely expected, hybrid securities have borne the brunt of the changes to S&P's methodology and the Australasian Bank subordinated hybrids have seen ratings cut by up to four notches. This has seen a number fall from the A range into BBB. We favour specific Australasian bank securities as we believe they have a higher chance of being called at either the first or second reset or step-up date.

We note that Kiwibank has not had its credit rating assessed under the revised banking criteria. This is expected shortly and we would not be surprised if the parent credit rating was downgraded by one notch in line with the Australasian banks. It is also reasonable to expect there could be a downgrade to the Tier 1 Kiwi Capital Securities (**KCSHA**). A foreseeable scenario could see this revised to BBB- (from BBB) although we would expect it to remain investment grade. We would be inclined to reduce holdings of this security given it is trading at a premium to par so have changed this to a Lighten recommendation. This exposure could be switched into BISHA – see comment below.

In the Chart below, all the securities shown are assumed to be priced at the same level on 10 November. The price shows the relative movement compared with each other. **CBAFA**, which we have had as a strong Hold, has been a good performer as clients like the credit rating and the known maturity of just over three years. This is despite the one-year reset.

Chart 1: Comparative Movements in Price of Selected Securities



ASBPA and more notably **ASBPB** have been sold heavily. Given the expectation that the OCR will be at these levels well into 2012, and the lower likelihood of a call for these securities, we think investors have lost patience and sought higher fixed yields. While we sympathise with the sentiment, it is hard to recommend a loss of over 30% of capital when the credit risk is a still very acceptable. Our recommendation remains a Hold based on this factor. We have revised **RBOHA** to a Hold (from a Buy) due to the ongoing depressed and turbulent conditions in Europe.

Larger issues with some liquidity, such as ANZ Subordinated Bonds (**ANBHA**) and BNZ Income Preference Shares (**BISHA**), with closer resets and uncertain call dates have also been sold heavily and the price has fallen taking out the premium (the amount the price trades above par). We envisage these securities will be called as neither will meet capital requirements under Basle III or APRA. However, ANBHA is not expected to be called until the step-up date in 2018 and as can be seen on Chart 4 (page 5), the margin to this date is much less attractive. It is possible that investors have sold to make room in portfolios for the current new offers. We have revised our recommendations to a Buy (from a Hold) on BISHA.

The volatility in the price of **CASHA** has again been evident this month. Since the September update, CASHA has risen in price from \$50 per FV\$100 to \$59 and then fallen all the way back to \$50 again. We have seen reasonable volume trade at the higher levels and a number of holders took advantage of the uplift in price to exit or lighten positions. Given the ongoing volatility and uncertainty in Europe, we continue to recommend this strategy as a means of reducing risk. The concerted action by the central banks will improve the French banks access to liquidity but does not improve the big picture.

Chart 2: Estimated Yields on Clean Prices for Annual Resets

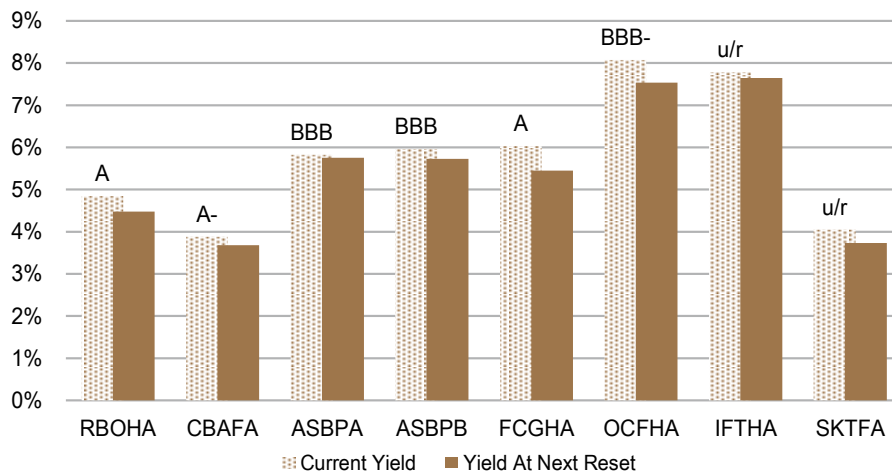


Chart 2 provides an estimate of the forecast yield for the next year. It is based on current clean prices (i.e. accrued interest /dividend is deducted) and is calculated at the existing coupon if there is no reset in the next twelve months. If there is a reset in the next 12 months, the forecast yield is adjusted for coupon / gross dividend expected to apply after the reset date (assuming no change in swap rates) divided by the current price. Our view is that FCGHA is a strong Hold and CBAFA has been reduced to a Hold.

We have also included a term reset estimated yield chart as well (Chart 3). A number of these securities with five-year resets have been trading at significant premiums but these have come in sharply with the recent sell-off, particularly those with closer reset dates.

Chart 3: Estimated Yields on Clean Prices for Term Resets (assuming no change in interest rates)

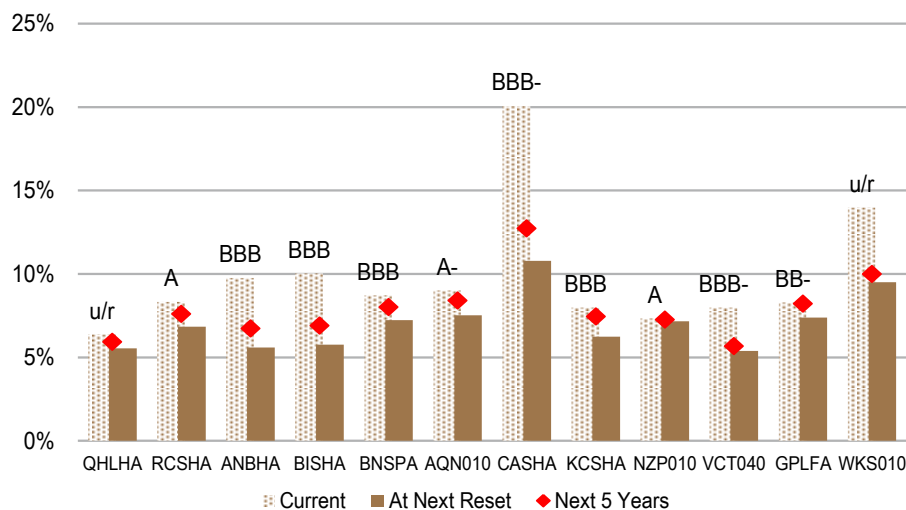
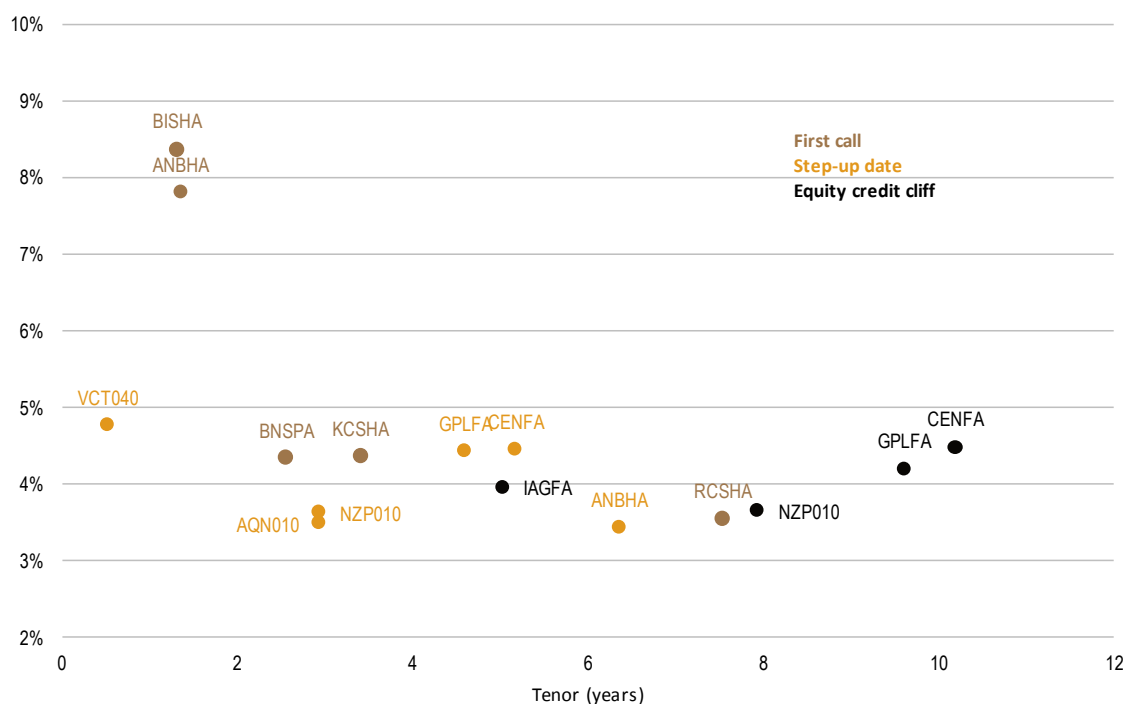


Chart 4: Estimated Margins on the First Call, Step-up Date and Equity Credit Cliff



Step-up Perpetual Term Resets

Nufarm has stepped up its coupon on **NFFHA** (**NFNG** on ASX) by 2% to 8.61% on 24 November. The company advised a week ago that it has completed the refinancing of its existing syndicated bank facility with a number of Australian and foreign financial institutions. The new syndicate will provide a three-year A\$625 million facility and this provides Nufarm with a comfortable level of funding headroom and flexibility. The price of the Australian ASX security has strengthened and, given there is more liquidity in the ASX market and NFFHA is fungible with NFNG, we continue to recommend any remaining holders exit.

This month there has been a lot of retail investors selling Vector capital bonds (**VCT040**). At the current yield of 7.50%, we believe they offer good value with a credit spread of around 3% over bank deposits out to June 2012. There is also a strong likelihood the holders will have the opportunity to invest in a new Vector issue mid next year. The security has just gone ex-interest and is trading at \$100.09 per FV\$100.

Last month we noted the reset terms at the election date in June 2012. To restate, our expectation is that Vector will offer new terms to holders (as they did in December 2006). Under this arrangement, any holders who do not want to accept the new terms can offer their capital bonds for sale under the resale facility. If bonds are not resold then we expect Vector will redeem therefore providing an exit for holders at par. If Vector fails to give an election notice then the company is deemed to have postponed the election date by a period of one year and for that one year period the interest accrues at the one-year swap rate plus the step-up margin of 1.90%. The next election date in this instance is in one year's time.

The Works Finance securities **WKS010** have traded at very high apparent yields on low volume. The direction is all one-way with the most recent sell at 87%. The price at this level is \$69.76. The reset date of June 2012 is looming fast, although we do not expect any advice from the company until early next year. As noted in the last review the market would appear to be pricing in Downer EDI choosing not to redeem or remarket a new offer to holders of WKS010. This would be an unfortunate and unpopular option with holders but at least there is a substantial step-up of 2% in the coupon so the credit margin becomes 4.05% over the one-year swap if this is the outcome.

In Appendix 1 we have listed all the securities individually with relevant terms and the implied margin and IRR where appropriate. The content of this paper should be used as a guide only.

Some points to assist with the use of this update:

1. Each security pays an incremental spread over a base rate or benchmark. This spread, called the credit margin, is particular to each Issuer and the terms of the instrument. It is expressed here as bps or as a percentage. The credit margin is the proxy for risk so an understanding of the current implied margin, independent of actual yields, is important to be able to compare these securities with new offers or secondary market trading of other fixed income securities.
2. We have also shown the estimated yield for the next 12 months based on two scenarios: firstly; the assumption the security is bought at current prices; and secondly; the assumption they are purchased at par.
3. We have included, where appropriate, internal rates of return (IRR). The IRR can loosely be described as being equivalent to a yield on a fixed rate bond. We note that for reset securities when the swap rate benchmark rises from current levels for future resets then the actual IRR outcome will be higher. Clearly the IRR will be lower in the instance that swap rates fall below current levels for future resets.
4. The basis for calculating the "implied margin" usually assumes the security will continue in perpetuity (we use 50 years as a proxy). However, some of the bank perpetual securities have been issued on the expectation of a call from the issuer occurring at a certain time – usually after five years for the domestic issuers and ten years for the overseas issuers. Therefore, we have provided an indication of the implied margin on a specified call date, although we note there is no certainty around a call being made.

Appendix One: Security Details

We have highlighted the S&P downgrades to credit ratings of subordinated bank securities in this update.

1. Perpetual Securities: 1-year and 3-year reset periods

Security	ASBPA	Recommendation	HOLD
Issuer	ASB Capital Limited	Current price	\$0.6890
Instrument	Perpetual Preference Shares	Current Dividend	4.00%
Ranking	Subordinated	Implied Margin	3.78%
Credit Ratings	BBB (was A+) (S&P)/A3 (Moody's)	Yield next 12 months	5.82%
Issue Yield	One year swap plus 1.30%	Constant Rate IRR	5.92%
Step-up Margin	0.00%	Next Reset Date	15 November 2012
PIE Status	Confirmed	Call Date	Any dividend paymt date at par

Security	ASBPB	Recommendation	HOLD
Issuer	ASB Capital No. 2 Limited	Current price	\$0.64
Instrument	Perpetual Preference Shares	Current Dividend	3.8%
Ranking	Subordinated	Implied Margin	3.98%
S& Credit Rating	BBB (was A+)	Yield next 12 months	5.83%
Issue Yield	One year swap plus 1.00%	Constant Rate IRR	5.94%
Step-up Margin	0.00%	Next Reset Date	15 May 2012
PIE Status	Confirmed	Call Date	Anytime at par plus accrued div

Security	FCGHA	Recommendation	Strong HOLD
Issuer	Fonterra Co-operative Group Ltd	Current price	\$0.78
Instrument	Capital Notes	Current Coupon	4.66%
Ranking	Unsecured and Subordinated	Implied Margin	3.26%
S&P Credit Rating	A	Yield next 12 months	5.80%
Issue Yield	One year NZGS plus 1.80%	Constant Rate IRR	5.60%
Margin	Credit rating dependent	Next Reset Date	10 July 2012
PIE Status	No – pays interest coupon	Call Date	10 July at higher VWAP or par

Security	IFTHA	Recommendation	HOLD
Issuer	Infratil Limited	Current price	\$0.50
Instrument	Perpetual Convertible Debt	Current Coupon	4.22%
Ranking	Unsecured and Unsubordinated	Implied Margin	6.14%
Credit Rating	No credit rating	Yield next 12 months	7.77%
Issue Yield	One year swap plus 1.50%	Constant Rate IRR	7.81%
Step-up Margin	Increases if gearing above 60%	Next Reset Date	15 November 2012
PIE Status	No – pays interest coupon	Call Date	Anytime at higher VWAP or par

Security	OCFHA	Recommendation	HOLD
Issuer	Origin Energy Contact Finance	Current price	\$0.56
Instrument	Perpetual Preference Shares	Current Dividend	4.47%
Ranking	Subordinated	Implied Margin	6.01%
S&P Credit Rating	BBB- (Negative Watch)	Yield next 12 months	8.00%
Issue Yield	One year swap plus 1.50%	Constant Rate IRR	7.69%
Step-up Margin	0.00%	Next Reset Date	15 October 2012
PIE Status	No	Call Date	After 9 October 2012 at par

Security	RBOHA	Recommendation	HOLD (previously a BUY)
Issuer	Rabobank Nederland	Current price	\$0.7690
Instrument	Perpetual Capital Securities	Current Coupon	3.70%
Ranking	Unsecured and Subordinated	Implied Margin	2.37% (6.10% if called in 2017)
S&P Credit Rating	A (was AA-)	Yield next 12 months	4.79%
Issue Yield	One year swap plus 0.76%	IRR to Call in 2017	8.68%
Step-up Margin	0.00%	Next Reset Date	8 October 2012
Floating Rate	After Call Date if not called	Call Date	8 October 2017
PIE Status	No – pays interest coupon		
Security	QHLHA	Recommendation	HOLD
Issuer	Quayside Holdings Ltd	Current price	\$0.85
Instrument	Perpetual Preference Shares	Current Dividend	5.42%
Ranking	Benefit of Put option to BOPRC	Implied Margin	2.85%
Credit Rating	No credit rating	Yield next 12 months	6.38%
Issue Yield	Three year swap plus 1.70%	Constant Rate IRR	5.72%
Step-up Margin	0.00%	Next Reset Date	12 March 2014
PIE Status	No	Call Date	Anytime at higher VWAP or par

2. Fixed Term Floating Rate Notes: 1-year reset

Security	CBAFA	Recommendation	HOLD (previously strong Buy)
Issuer	CBA Capital Australia Ltd	Current price	\$0.93
Instrument	Redeemable Preference Shares	Current Dividend	3.59%
Ranking	Subordinated	Implied Margin	3.26%
S&P Credit Rating	A- (was AA-)	Yield next 12 months	3.76%
Issue Yield	One year swap plus 0.75%	IRR to 2015	5.91%
Step-up Margin	0.00%	Next Reset Date	15 April 2012
PIE Status	No	Call Date	Annually on 15 April
		Redemption Date	15 April 2015
Security	SKTFA	Recommendation	HOLD /LIGHTEN
Issuer	SKY Network Television Ltd	Current price	\$0.8945
Instrument	Bonds	Current Coupon	3.60%
Ranking	Unsecured and Unsubordinated	Implied Margin	3.26%
Credit Rating	No credit rating	Yield next 12 months	3.76%
Issue Yield	One year swap plus 0.65%	IRR to 2016	5.91%
Step-up Margin	0.00%	Next Reset Date	16 October 2012
PIE Status	No – pays interest coupon	Call Date	From 16 October 2010 at par
		Redemption Date	16 October 2016

3. Perpetual Securities: 5-year reset

Security	ANBHA	Recommendation	HOLD
Issuer	ANZ National Bank Ltd	Current price	\$1.003 (\$0.9898 capital price)
Instrument	Perpetual Callable Bonds	Current Coupon	9.66%
Ranking	Unsecured and Subordinated	Implied Margin	2.99%(Perpetual) 3.42%(2018)
Credit Ratings	BBB (was A+)(S&P)/A1(Moody's)	Yield next 12 months	9.76%
Issue Yield	Five year swap plus 2.00%	Next Reset Date	18 April 2013
Step-up Margin	1.00% (from 2018 if not called)	Call Date	18 April 2013
PIE Status	No – pays interest coupon	IRR to Call in 2018	6.76%

Security	BISHA	Recommendation	BUY (previously Hold)
Issuer	BNZ Income Securities Ltd	Current price	\$1.005 (\$0.9865 capital price)
Instrument	Perpetual Non-cumulative Shares	Current Dividend	9.89%
Ranking	Subordinated	Implied Margin	2.61% (Perpetual) 8.29%(2013)
Credit Ratings	BBB (was A+)(S&P)/A3 (Moody's)	Yield next 12 months	10.03%
Issue Yield	Five year swap plus 2.20%	IRR to Call in 2013	8.29%
Step-up Margin	0.00%	Next Reset Date	28 March 2013
PIE Status	Yes	Call Date	28 March 2013
Security	BNSPA	Recommendation	HOLD / LIGHTEN
Issuer	BNZ Income Securities 2 Ltd	Current price	\$1.06 (\$1.043 capital price)
Instrument	Perpetual Non-cumulative Share	Current Dividend	9.10%
Ranking	Subordinated	Implied Margin	3.90% (Perpetual) 4.31% (2014)
Credit Ratings	BBB (was A+)(S&P)/A3poss downgr	Yield next 12 months	8.72%
Issue Yield	Five year swap plus 4.09%	IRR to Call in 2014	7.24%
Step-up Margin	0.00%	Next Reset Date	28 June 2014
PIE Status	Yes	Call Date	28 June 2014
Security	CASHA	Recommendation	HOLD / LIGHTEN
Issuer	Credit Agricole S.A.	Current price	\$0.50 (\$0.4788 capital price)
Instrument	Perpetual Non-cumulative Notes	Current Coupon	10.035%
Ranking	Subordinated	Implied Margin	9.72% (Perpetual)19.61% (2017)
Credit Ratings	BBB- (was BBB)(S&P) / A3 (Moody's)	Yield next 12 months	20.96%
Issue Yield	Five year swap plus 1.90%	IRR to Call in 2017	22.8%
Step-up Margin	0.00%	Next Reset Date	19 December 2012
PIE Status	No – pays interest coupon	Call Date	19 December 2017
Security	KCSHA	Recommendation	LIGHTEN (previously Hold)
Issuer	Kiwi Capital Securities	Current price	\$1.0275 (\$1.0206 capital price)
Instrument	Perpetual Non-cumulative Shares	Current Dividend	8.15%
Ranking	Subordinated	Implied Margin	3.08%(Perpetual) 4.33%(2015)
S&P Credit Rating	BBB (to be revised)	Yield next 12 months	7.99%
Issue Yield	Five year swap plus 2.90%	IRR to Call in 2015	7.46%
Step-up Margin	0.00%	Next Reset Date	4 May 2015
PIE Status	Yes	Call Date	4 May 2015
Security	RCSHA	Recommendation	HOLD / LIGHTEN
Issuer	Rabobank Nederland	Current price	\$1.0550 (\$1.0550 capital price)
Instrument	Perpetual Non-cumulative Shares	Current Dividend	8.7864%
Ranking	Subordinated	Implied Margin	3.47%(Perpetual) 3.54%(2019)
S&P Credit Rating	A (was AA-)	Yield next 12 months	8.33%
Issue Yield	Five year swap plus 3.75%	IRR to Call in 2019	6.87%
Step-up Margin	0.00%	Next Reset Date	18 June 2014
PIE Status	Yes	Call Date	18 June 2019

Step-Up Securities

Security	NFNG on ASX NFFHA on NZDX	Recommendation	SELL
Issuer	Nufarm Finance (NZ)	Current price	A\$0.7925 per FVA\$1.00(NZ\$1.04)
Instrument	Step-up Securities	Current Interest Rate	8.61% (AU\$) (Step-up 24 Nov)
Ranking	Subordinated	Implied Margin	7.93%
S&P Credit Rating	B	Yield next 12 months	10.78%
Moody's Credit Rating	N/A	IRR in Perpetuity	10.65%
Issue Yield	A\$ SA / NZ Five year swap plus 1.90	Next Reset Date	15 April 2012
Step-up Margin	2%	Step-Up Date	24 November 2011

Security	NZP010	Recommendation	HOLD
Issuer	NZ Post Group Finance	Current price	\$1.0265 (Yield of 6.65%)
Instrument	Subordinated Notes	Current Dividend	7.50%
Ranking	Subordinated	Implied Margin	3.49% (Maturity) 3.62% (2014)
Legal maturity	15 November 2039	Yield next 12 months	7.34%
S&P Credit Rating	A	IRR to Step-Up Date	6.64%
Issue Yield	Five year swap plus 2.80%	Next Reset Date	15 November 2014
Step-up Margin	1.00%	Step-up Date	15 November 2014

Security	WKS010	Recommendation	HOLD
Issuer	Works Finance NZ	Current price	\$0.6982 (Yield of 87%)
Instrument	Perpetual Preference Shares	Current Dividend	9.80%
Ranking	Subordinated	Implied Margin	7.39% (Perpetuity)
Fitch Credit Rating	Parent only BBB-	Yield next 12 months	10.73%
Moody's Credit Rating	N/A	IRR in Perpetuity	8.76%
Issue Yield	Three year swap plus 2.05%	Next Reset Date	15 June 2012
Step-up Margin	2.00%	Call Date	15 June 2012

Security	GPLFA	Recommendation	HOLD
Issuer	Genesis Energy	Current price	\$1.0375
Instrument	Capital Bonds	Current Dividend	8.50%
Ranking	Subordinated	Implied Margin	3.9% (Maturity) 4.41% (2016)
Legal maturity	15 July 2041	Yield next 12 months	8.29%
S&P Credit Rating	BB-	IRR to Step-Up Date	7.82%
Issue Yield	Five year swap plus 3.87%	Next Reset Date	15 July 2016
Step-up Margin	0.25%	Step-up Date	15 July 2016

Security	VCT040	Recommendation	HOLD / SPECULATIVE BUY
Issuer	Vector	Current price	\$1.009 (Yield of 7.5%)
Instrument	Capital Bonds	Current Dividend	8.00%
Ranking	Subordinated	Implied Margin	1.85% (Perpetuity) 4.60% (2012)
S&P Credit Rating	BBB-	Yield next 12 months	6.80%
Issue Yield	Five year swap plus 0.90%	IRR to Step-Up Date	7.14%
Step-up Margin	1.00%	Election Date	15 June 2012
		Step-up Date	15 June 2012