Bramwell Brown Limited – Newsletter – August 2011

Bluestar Print

Bluestar bondholders should have received offer documents amending the terms of their bonds due in September, 2012. My initial reaction to Bluestar's offer was one of disbelief, and after reading the offer documents that reaction hasn't changed. By way of disclosure I own a handful of Bluestar bonds, which I purchased last year when they were trading at 25cents in the dollar. Their offer defies all the fundamentals of risk and reward, and is excessively one-sided in favour of the owners of the company.

Bluestar issued their bonds in 2005. Private equity firm, Champ, bought the business in 2007 and made significant further investments over the next two years. In hindsight it's obvious they paid too much for the business and the level of debt was not sustainable in the post financial crisis era. In 2009 Bluestar suspended interest payments, with the bonds accruing penalty interest at a rate of 13.10%. That penalty interest has grown to a sum of over $32 million, taking the total owed to bondholders to $137 million. The main points in the offer (request for the shirt off your back?) are as follows:

- The $32 million in penalty interest will be written off (a gift from bondholders to shareholders)
- $67.5 million of bonds will have their maturity extended to September 2015. Interest at 9.10% would only be paid on these bonds from July 2013
- $37.5 million of bonds would convert to a type of equity, earning no interest, and maturing in September 2023. Repayment according to a KPMG report is highly unlikely
- In return for this unprecedented bondholder generosity the shareholders (Champ) will **loan** a further $15 million to Bluestar. This loan will incur interest of 18.50% per annum, and will rank ahead of the existing bonds
- Guarantees in favour of bondholders would be forfeited, and a requirement that any sale of Bluestar operating companies be approved by the trustee would be removed

Bluestar's proposal is insulting, and shows a total disregard for those investors who lent them money. There is no question that a restructure must occur, and part of that restructuring should include concessions from various parties. Their proposal, however, is asking for concessions from bondholders only, and none from shareholders, who should ultimately bear the most risk. Contact the office if you hold these bonds, and would like to discuss your situation.

Risk and Return

The Bluestar failure is another in a long list of failures for anyone unfortunate enough to be investing in the years leading up to global financial crisis in 2008. The finance company collapses are most obvious, as are the likes of the ill-fated ING/ANZ funds, Credit Sails, Cadmus, and Babcock & Brown among others. Less obvious, but nevertheless costly, are the handful of perpetual reset securities that were issued just before the credit crunch hit. Reset margins that appeared acceptable at the time have left some of those securities trading at large discounts to their face value, and are offering very low returns for the level of risk. When confronted with failures such as these we need to remind ourselves:

- Corporations, advisers, Governments and investors can’t predict the future and often get it wrong
- ‘Timing” markets is fraught with difficulty
- There will always be some individuals with less-than-perfect ethics trying to take your money
- Risk sometimes turns into loss.

And in these circumstances it might be timely to ask:

- How big is my exposure to individual securities, companies, industries, countries or sectors?
- What effect will a single failure have on my wealth?
- Do I have time to recoup a loss?
- Do I actually need to take the risks I’m taking?

Secondary Bond Yields

The Bluestar failure started me thinking about where our next investor loss might come from. Of course, if I had the ability to accurately predict this I wouldn’t have to work for a living. Nine times out of ten when a company gets into difficulty the market finds out at the same time investors do, and losses are instant. The secondary bond market provides a pretty good barometer of company performance, and how the market views those companies’ future prospects. Below is a table of all the bonds we have offered since I took over Bramwell Brown in 2008, with their current yields and the amount per hundred dollars you would receive today if you were to sell them.

Bond	**Interest Rate**	**Maturity**	**Yield**	**Price/$100**
PGG Wrightson Finance	8.25%	October 2011	7.00%	100.74
Telecom	8.20%	June 2013	5.08%	106.54
Marac	10.50%	July 2013	8.60%	103.86
Wellington Airport	7.50%	November 2013	6.20%	104.30
Tauranga City Council	7.05%	December 2013	4.51%	106.72

Bond	Interest Rate	Maturity	Yield	Price/$100
Auckland City Council	6.42%	March 2014	4.35%	107.38
Tower	8.50%	April 2014	7.15%	103.68
Contact Energy	8.00%	May 2014	5.20%	108.91
Fletcher Building	9.00%	May 2014	6.50%	108.17
Vector	7.80%	October 2014	5.20%	109.87
Auckland Airport	7.00%	November 2014	5.50%	105.74
Kiwi Income Property Trust	8.95%	December 2014	7.25%	106.00
Trustpower	7.60%	December 2014	5.80%	106.44
Auckland City Council	6.28%	March 2015	4.90%	106.76
Fonterra	7.75%	March 2015	5.10%	109.77
Meridian Energy	7.15%	March 2015	5.06%	109.51
Goodman Property Trust	7.75%	June 2015	6.00%	106.88
Warehouse	7.37%	June 2015	6.50%	103.87
Telecom	8.35%	June 2015	5.88%	106.54
Trustpower	8.40%	December 2015	6.85%	106.88
APN News & Media	7.86%	March 2016	9.00%	96.72
Fletcher Building	9.00%	May 2016	7.00%	109.90
Goodman Fielder	7.54%	May 2016	6.85%	104.37
Infratil	8.50%	June 2016	8.01%	103.04
Greenstone Energy	7.35%	October 2016	6.80%	104.31
Auckland Airport	8.00%	November 2016	5.65%	112.29
Trustpower	8.00%	December 2016	6.44%	108.05
Meridian Energy	7.55%	March 2017	6.15%	109.39
Infratil	8.50%	June 2017	8.25%	102.23
Manukau City Council	6.52%	September 2017	5.90%	105.36
Trustpower	7.10%	December 2017	6.65%	103.22
AMP	9.80%	April 2019	5.50%	110.00
NZ Post Group Finance	7.50%	November 2039	6.80%	103.60
Genesis Energy	8.50%	July 2041	8.31%	102.49
BNZ Perpetual	9.10%	No maturity date		108.00
Kiwibank Perpetual	8.15%	No maturity date		103.80
Rabobank Perpetual	8.78%	No maturity date		108.50

As you can see from this list the only bond trading at a discount to its face value is the APN News & Media bond. That doesn’t mean there’s no risk in the other bonds – the premiums these bonds are trading at is largely a function of the decrease in interest rates since they were issued. I've listed the bonds in order of maturity in order to give a comparison of perceived risk. If, for example, you look at all the bonds maturing in 2015 it's clear to see the market perceives the Auckland City Council is carrying the least risk, while the Warehouse is carrying the most. Similarly, if you look at 2013 you will see the contrast between Marac Finance and the Tauranga City Council. If investors are at all nervous about a bond they hold, there possibly won't be a better time to sell than now – when underlying interest rates are at historic lows. Call the office if you would like to discuss the bonds you hold.

Future Interest Rates

The previous table shows the effect in the secondary market of a fall in underlying interest rates. As interest rates fall, the value of a bond issued previously should (all other things remaining equal) gain in value. Of course the opposite will occur as interest rates rise, and it's highly likely investors will be disappointed when, in two or three year's time, they look at the bonds they are buying today. We are close to the bottom of the interest rate cycle at present, and it is likely bond yields will begin to rise over the next twelve months. This means the price of those bonds will fall. Waiting for rates to rise may seem the logical thing to do, but of course you are waiting in a very low-rate environment. My advice to fixed interest investors has always been to hold a portfolio of securities with staggered maturities in order to take out the peaks and troughs in returns. Keep your fixed interest rolling over at steady intervals and you will avoid the trap of having to reinvest large sums at the bottom of the interest rate cycle.

Argosy Property Trust and Vital Healthcare Property Trust

For all those investors who may not understand the current issues around these companies, and the internalisation of their management contracts, please feel free to ring the office for clarification.

Heartland Takeover of PGG Wrightson Finance

Heartland Building Society (formerly Marac Finance, Southern Cross, and CBS Canterbury) are in the process of taking over the assets of PGG Wrightson Finance. For those investors concerned about the status of the Government Guarantee in this transaction, it is my understanding that any Government Guaranteed bond or debenture held with PGG Wrightson Finance will be similarly guaranteed by Heartland. The takeover will not proceed without the Crown's consent in this regard.

Z Energy

We still have a small amount of Z Energy bonds available. Phone the office if you would like to receive an investment statement.

Text Size

If you find the size of the text of our newsletter too small to read in your email there are a couple of options you can try. If your mouse has a wheel, place the cursor in the body of the email, hold down the Ctrl button and scroll with the wheel. This will increase or decrease the size of the text. If you don't have a wheel on your mouse try opening the email (Microsoft Outlook) in its own window (rather than the reading pane) and click on "Other Actions", "Zoom." For older versions of Outlook click on "View", "Text Size." If all else fails and you would like a hard copy sent please let me know.

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