Bramwell Brown Ltd

INVESTMENT ADVISERS – BROKERS

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Bramwell Brown Limited – Newsletter – May 2014

Genesis Energy

The float of Genesis Energy in April has brought to a close the Government's asset sales programme. Due to the demand for Genesis shares the offer was heavily scaled. The broker firm offer was reduced by 20 per cent, with those shares re-allocated to the general offer. A progressive scaling policy was applied to the general offer which saw larger applications scaled more significantly than smaller applications.

Application Size ($)	Application Size (Shares)	Allocation ($)	Allocation (Shares)
$999.75	645	$999.75	645
$2,001.05	1,291	$2,001.05	1,291
$3,000.80	1,936	$2,642.75	1,705
$4,000.55	2,581	$2,931.05	1,891
$5,000.30	3,226	$3,217.80	2,076
$10,000.60	6,452	$3,467.35	2,237

Close to five billion dollars will have been raised through the asset sales programme by the time the final instalments for Meridian Energy are paid next year. Whether or not the sales process has been successful is a debate that will continue throughout the months leading up to the election. It amuses me how one party can claim the process has been a roaring success while the other can claim it's been an abject failure. For those investors who took part in all the offers, the experience on average has been a good one. With the exception of Mighty River Power, all the companies floated are 20% to 25% ahead of their listing price. Here is a summary of the state asset sales.

	Listing Price	Current Price	Increase	% Increase
Mighty River Power	2.50	2.33	-0.22	-6.80%
Meridian Energy	1.00	1.22	0.20	22.00%
Air New Zealand	1.65	2.09	0.42	26.67%
Genesis Energy	1.55	1.87	0.34	20.65%

As investors we should be happy with the outcome; however as taxpayers (they're our assets) we should be disappointed. Who to blame may very much depend on your political bias.

Reserve Bank Regulations

I wrote in the March and April newsletter last year about Reserve Bank regulations designed to strengthen our banking system. With the issue of ASB's subordinated bond last month and the possibility of more on the way I thought it was worthwhile revisiting the subject. Open Bank Resolution, the Core Funding Ratio, and the revised Capital Adequacy Framework are measures that have come out of the Basel accords for regulation in the banking industry.

Open Bank Resolution's prime objective is to ensure the continuation of the core banking functions of a distressed bank – to keep it "open." A bank may be placed into statutory management on the advice of the Minister of Finance following a recommendation from the Reserve Bank. Under OBR shareholders will be the first to bear any losses, followed by holders of subordinated debt. If there are any further losses these will be allocated to the bank's unsecured creditors <u>which include its depositors</u>. In that instance a proportion of depositors' funds would be frozen based on an estimate of the potential losses of the failed bank. Those frozen funds would be available to the statutory manager to apply against the bank's losses. The unfrozen portion of depositors' funds would be available immediately, and would be supported by a Government guarantee. The guarantee should discourage depositors from rushing to withdraw their funds, but there would be no restrictions on them doing so.

The Core Funding Ratio is a tool designed to prevent banks from relying on short-term overseas borrowing to fund its activities. The rules stipulate that banks must secure a percentage of their funding from equity (shareholders), retail deposits and wholesale sources such as bonds, with durations of at least one year. In 2010 the core funding ratio was set at 65%, and has since risen to 75%.

Basel III is a global regulatory standard based around banks' capital adequacy, stress testing and liquidity risk. In a nut-shell the regulations place an expectation on banks to hold more equity capital on their balance sheets. This should strengthen our banking sector and lessen the risk of failure. The rules are designed to ensure there is a bigger pool of funds to absorb losses in the event of a bank failure. The very nature of banking means there is (or has been in the past) a low level of equity in relation to the size of the business. Depositors lend their money to the bank – the bank then on-lends that to borrowers. The assets and liabilities match but there's no equity to call on in the event of a loan default. This is fairly simplistic, but the point I'm making is that historically banks have not been able to absorb large losses. The global financial crisis saw governments bailing out banks to prevent a full-blown melt-down, and the subsequent regulations are designed to lessen the need for this to occur. Shareholders, bond-holders, and in some cases retail depositors will now be expected to carry some of the losses in the event of a bank failure. However, I don't think it will prevent governments from stepping in to shore up a bank in a worst case scenario.

The Reserve Bank capital adequacy framework talks about the various levels of capital, including share capital (ordinary shares), additional Tier 1 capital, and Tier 2 capital. The regulations dictate how much capital as a percentage of their assets a bank must hold in each category. Ordinary shares and additional Tier 1 capital carry the most risk, with Tier 2 capital ranking ahead, but still subordinated to depositors and general creditors of the bank. The recent ASB subordinated bond was an example of a fixed interest Tier 2 security that has features designed to absorb losses in the case of a bank failure. A "non-viability trigger event" would see the ASB bond converted to ordinary shares in the Commonwealth Bank of Australia. There is no guarantee that the value you receive in shares will be the same as that which you paid for the bond. Additional Tier 1 capital carries greater risk, and a non-viability trigger event would result in heavier losses. The implications of a bank failure should be well explained in the investment statement, and I would advise all investors to read and understand those implications. The chance of a bank failure is low in my opinion and the market seems to think the same with the ASB bond trading at its par value of 6.65%.

I think there is potential for these unsecured bonds to offer a better return for the risk involved. The rates will be higher than those offered on term deposits to compensate for the extra risk in case of a bank failure. The important thing is that investors are fully aware of the potential for loss in the case of a bank non-viability trigger event – in the case of Tier 1 securities that loss will be significant – it will not be too different from being a shareholder in the company. In the case of a Tier 2 security the loss may be less, however not insignificant. What investors need to ask is "is the return adequate for the extra risk I'm expected to take on?" Considering the strength of our banking system through one of the worst financial crises in some time I think these securities may have a place in a diversified portfolio.

Kiwibank Bond

Kiwibank has announced it is planning to raise up to $100 million through the issue of convertible subordinated bonds. This issue should be similar to the ASB offer in that it is designed to meet its capital adequacy requirements under the Basel III regulations. It will be interesting to see the terms of the offer as I doubt Kiwibank would issue a security that can convert to ordinary shares considering they are not listed. It's possible the terms instead will see investors lose a percentage of their investment in the case of a non-viability trigger event. We should have full details next week.

PLEASE CALL THE OFFICE IF THIS OFFER IS OF INTEREST TO YOU

Interest Rates

The Reserve Bank raised the Official Cash Rate (OCR) to 3% this month, with most commentators expecting a further increase in the next few months. We have seen some increase in the shorter-term bank deposit rates, however long-term rates remain influenced by global factors and have not moved significantly. Here are the most recent Rabobank rates we are able to offer our clients.

Term	Rate (annual interest)
Premium Saver (call account)	4.30%
1 year	4.60%
2 years	5.25%
3 years	5.50%
4 years	5.80%
5 years	5.95%

Here is a brief list of secondary market bond yields.

Bond	Coupon Rate	Maturity	Current Yield	April 2013 Yield	Current Price/$100
Fonterra	7.75%	March 2015	3.99%	3.74%	103.16
Meridian Energy	7.15%	March 2015	4.23%	3.88%	102.48
Goodman Property Trust	7.75%	June 2015	4.61%	4.60%	103.42
Warehouse	7.37%	June 2015	5.40%	5.10%	102.11
Telecom	8.35%	June 2015	4.42%	4.25%	104.25
Trustpower	8.40%	December 2015	5.40%	5.30%	104.63
Fletcher Building	9.00%	May 2016	6.00%	5.30%	105.67
Goodman Fielder	7.54%	May 2016	6.30%	5.90%	102.36
Infratil	8.50%	June 2016	5.90%	6.00%	104.94
Z Energy	7.35%	October 2016	5.50%	5.30%	104.19
Auckland Airport	8.00%	November 2016	4.64%	4.25%	107.96
Trustpower	8.00%	December 2016	5.80%	5.40%	105.31
Meridian Energy	7.55%	March 2017	5.10%	4.43%	106.47
Infratil	8.50%	June 2017	6.50%	6.50%	105.61
Trustpower	7.10%	December 2017	5.60%	5.40%	104.88
Z Energy Limited	7.25%	August 2018	5.75%	5.60%	105.66