BRAMWELL BROWN LTD
INVESTMENT ADVISERS – BROKERS

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Kiwibank Perpetual Bonds

Kiwi Capital Funding Limited has announced an offer of up to $150 million of perpetual capital notes. Kiwi Capital Funding is a special purpose vehicle established solely for the purpose of issuing debt securities and using the proceeds to subscribe for regulatory capital instruments issued by Kiwibank. In this instance the proceeds will be used to purchase Kiwibank perpetual bonds. These bonds form part of Kiwibank's regulatory capital requirements, and as such are complex securities and riskier than a bank deposit. The notes have comparisons to the recent ANZ Bank capital notes which were explained in the March newsletter. They are Tier 1 securities, which are designed specifically to absorb losses if a bank experiences financial difficulties. They are not call deposits of the issuer and may not be suitable for many investors. It is essential potential investors read the investment statement carefully and understand the nature of these securities.

The perpetual capital notes will be repaid on May 27th 2022 provided certain conditions are met. They may also be repaid on their five-year anniversary (May 2020). The capital notes could be written off or converted to shares if certain trigger events occur. A Common Equity Trigger Event occurs if the amount of common equity capital held by the Kiwibank Group is less than 5.125% of its risk-weighted assets. Kiwibank Group's capital ratio at December 31st 2014 was approximately 13.70%. A non-viability Trigger Event will occur if the Reserve Bank or a statutory manager directs Kiwibank to convert the perpetual bonds into shares or write off the bonds. Clearly these securities are more complex than term deposits or fixed-rate, fixed-term bonds. The questions investors need to ask include "does the return compensate me for the extra risk?" and "what is the chance of a major trading bank facing financial difficulty?"

The interest rate payable on the notes will be a combination of the 5 year swap rate plus the margin. The indicative margin range is 3.65% to 3.95% per annum. If the interest rate was set today it would be between 7.29% and 7.59%. The interest rate will be reset at each five-year anniversary based on the five-year swap rate at that time, plus the margin. The notes have a BB- credit rating from Standard & Poors and will pay interest quarterly in August, November, February and May. The offer opens on May 4th and closes on May 22nd. **Call the office as soon as possible if this offer is of interest to you.**

Financial Markets Authority Guidance

The Financial Markets Authority has a number of free resources available on their website, specifically aimed at investors. Topics include KiwiSaver, investment basics, scams, and financial advisers. They have recently issued a guide to capital notes, and considering the recent ANZ and Kiwibank offers I thought it would be worthwhile including it in this month's newsletter.

Capital notes are often issued by well-known banks, but are riskier than bank deposits. They may not be suitable for many investors. A household name and high headline rate of return alone are not good reasons to invest. You also need to understand the complex and potentially risky nature of these investments, and whether they are suitable for you.

<u>What are bank capital notes?</u>

Banks must hold a certain amount of 'capital' to make them less likely to become insolvent (go out of business). Banks issue capital notes to help them raise the capital they need. You may hear different investments being described as 'Tier 1 capital' or 'Tier 2 capital' – this describes how the bank can use your money to meet its capital requirements. The important thing for investors to remember is that different capital notes have different terms and conditions, so it's always important to read the investment statement or product disclosure statement carefully. Common features of bank capital notes include:

- The bank may stop interest payments, or reduce the amount of interest they pay to investors, even if they're still in business.
- The bank can convert the notes into shares in the bank (or their parent company). The value of those shares at the time they are converted may be a lot less than the amount you paid for the capital notes.
- The notes may be cancelled so you lose some or all of your investment, even if the bank is still in business.

Where these features are included, they will be described in the offer document (investment statement or product disclosure statement). These features are usually subject to complex tests and conditions even experienced investors can find hard to evaluate.

Capital notes can also be issued by companies other than banks, and there are other financial products with similar features and risks to capital notes. These may be called 'hybrid securities', 'subordinated notes', 'preference shares' or 'convertible preference shares'. The product's investment statement or product disclosure statement will describe its features.

Payments can be unpredictable

Bank capital notes will usually offer a good headline interest rate, but investors should think about whether this is enough to make the higher risks worthwhile, and whether those risks fit their investment needs. Some features of bank capital notes can be difficult to predict, including:

Interest payments may be reduced or stopped

Capital notes often allow the bank to stop paying interest, or reduce the amount of interest they pay, under certain circumstances. Sometimes interest payments are completely the bank's decision, even if their business is profitable. It might be difficult to predict the circumstances in which a well-known bank chooses to stop paying interest on its capital notes, but you shouldn't assume this would never happen.

Buy-back is usually the bank's decision. Although capital notes are long term investments, sometimes of 'perpetual' duration, they often contain provisions that lead investors to expect the bank will buy the notes back (called buy-back) after an initial period, often five years. Any buy-back is usually the bank's decision. You shouldn't assume that because the bank is a household name they will buy-back the notes after this initial period. Capital notes are deliberately designed with features that give banks flexibility over payments. Although it can be difficult to predict when a bank might use these features, you should be aware that they can be used when it's in the bank's interests to do so.

The market price can change quickly

Bank capital notes are usually listed on NZX, but this doesn't necessarily mean you will be able to sell your notes quickly, or at all. The market price for capital notes can change quickly. For example, the value of the note may suddenly fall if the bank suspends or defers interest payments, or if they don't buy-back the notes when the market expected them to.

Bank capital notes are designed to protect the bank

Bank capital notes are designed to make banks less likely to become insolvent. Their terms are often controlled by the requirements of 'prudential regulation', which is regulation to protect the stability of the financial system, rather than your specific investment. The risk of loss to the bank is reduced by passing this risk on to investors who purchase their capital notes.

The same features that give banks flexibility to cancel or postpone their obligations create complex risks for investors.

Source: http://www.fma.govt.nz/consumers/free-resources/ Your Guide to Capital Notes - FMA

Energy Shares

Holders of the partially-floated energy companies should be aware of the various entitlements or obligations attached to those shares. If you have continued to hold any of the state-owned energy companies since issue you may be entitled to bonus shares and/or required to pay a second instalment for your shares. Here is a summary:

<u>Mighty River Power</u>

Mighty River was listed on May 14th 2013. Those investors who participated in the Initial Public Offering, and continue to hold their shares in the same registered name until May 14th 2015, will be entitled to one bonus share for every twenty-five held (up to a maximum of two hundred shares). The bonus shares will be allotted on May 21st as fully paid shares. No action is required by investors, and you should receive a statement from the share registry showing your updated holding. Anyone holding more than five thousand shares will only receive the maximum allocation of two hundred bonus shares.

<u>Meridian Energy</u>

Meridian's instalment receipts were listed on October 30th 2013 with the first of two instalments being paid at issue. Any investors who hold Meridian Energy instalment receipts on May 4th 2015 will be required to pay the second and final instalment by May 15th. The first instalment was $1.00 and the second instalment is 0.50cents. The share registry will send a final payment notice on May 6th, which will confirm how much you need to pay. You cannot pay the final instalment before May 6th, and you must have paid it by no later than May 15th. You will have three options for payment; cheque, on-line banking or direct debit, and these options will be explained fully in the final payment notice.

<u>Genesis Energy</u>

Genesis was listed on April 16th 2014. Those investors who participated in the Initial Public Offering, and continued to hold their shares in the same registered name until April 16th 2015, will be entitled to one bonus share for every fifteen held (up to a maximum of two thousand shares). The shares should have been issued on April 23rd and eligible investors would have received an updated holding statement by now.

Official Cash Rate

The OCR has again been left unchanged at 3.50%. Judging by the Reserve Bank's commentary I wouldn't expect an interest rate rise anytime soon, and given the dairy industry woes and very low inflation the next move could be down rather than up.