Beyond the head-line yield

The art of picking Capital Notes

by Mark Story

After the recent bath most investors have taken over managed funds, and with term deposits or government bonds struggling to pay 5% – it's hardly surprising the retail market is gravitating towards fixed interest offerings like Capital Notes. But instead of understanding the inherent risks associated with this asset class, many are simply bedazzled by the promise of high yields? So what do they need to know to avoid getting burned, and how can extra risk – taken to earn additional yield – be properly managed?

If the popularity Capital Notes and secured bonds are receiving right now reveals anything meaningful, it's a reminder that retail investors still struggle with the truism that higher returns and lower security go hand in glove. As they neither compromise the balance sheet, nor dilute an equity position, Capital Notes are a painless way for companies to raise funds.

With financial institutions largely focused on investment grade opportunities, Capital Notes have been the domain of retail investors looking for higher rates of fixed income. But the grief Capital Notes can inflict on unsuspecting "mum and pop" investors usually isn't obvious until the damage is done.

Dig beyond the well promoted head-line yield, and it becomes manifestly clear why many Capital Notes are also referred to as junk bonds — a metaphor for low grade investments. The ease with which junk bonds can be window-dressed as respectable Capital Notes means retail investors can unwittingly exceed their risk appetite. What they forget is that if things turn to custard (and the company folds) - they may not even get their money back.

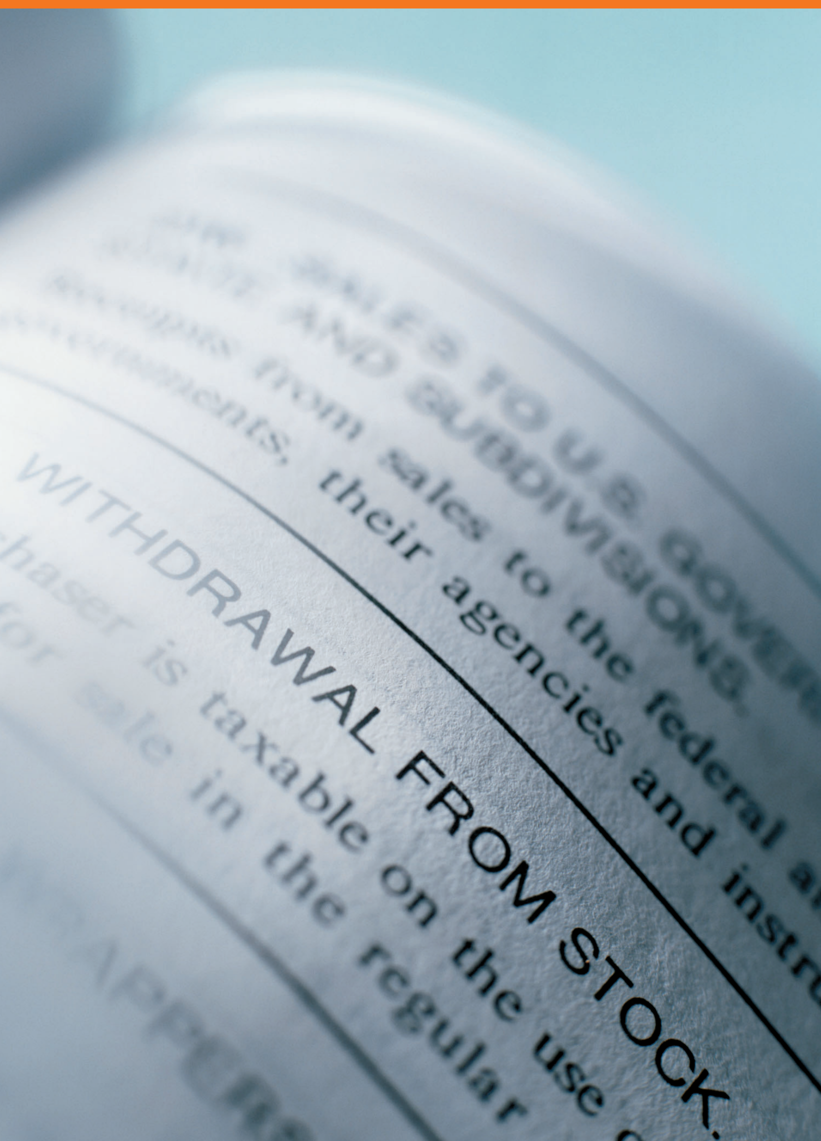
HOW CAN EXTRA RISK – TAKEN TO EARN ADDITIONAL YIELD – BE PROPERLY MANAGED?

Assessing risk

The level of risk associated with debt offerings (like Capital Notes) depends on: The credit rating of the company issuing the notes, how each note is ranked, and where it would stand compared with other securities if the company was wound up. In that event, the ranking becomes all important because it identifies where unit-holders would fit in the pecking order queuing up to be paid after such an event.

Serving to illustrate these risks (a few years ago now) were the high-profile failures of two well-known companies - Skellerup and meat processor, Fortex.

Adding insult to injury, some Capital Notes, sometimes offering only a relatively small interest-rate premium over government bonds, are without any credit rating. In fairness, recent Capital Note issuers, like Infratil or Capital Properties – that typically don't look to the capital market for funding - have less reason to seek a rating. Nevertheless, one of the hallmarks of quality Capital Notes is an international-rating agency's grading. Based on the credit rating of the company offering the notes, this grading is typically two notches below the senior debt rating of the company.



Many investors have been attracted to a wave of recent debt issues - including, Mighty River Power ($200m), Feltex Carpets $60m) and Goodman Finance ($175m to $250m). But few realise that they might be trading significant credit risk for the possibility of relatively attractive returns (typically around 9%).

Underlying security

Capital Notes work in a similar way to bonds, but unlike government stock, the underlying security isn't something investors can just take for granted. In fact, Capital Notes are usually unsecured and rank lower than other types of company debt - in the event of a company wind-up. It's highly questionable then whether companies with severe cash liquidity problems should really be issuing Capital Notes.

THE TRICK FOR INVESTORS IS ACCURATELY JUDGING HOW SECURE A PARTICULAR BOND IS

The recent issue by 'cash-burn' battler, Provenco (formerly Advantage) serves to illustrate this point. But to be fair, it happens on the equity market too. Revelations as to the sorry state of Air New Zealand's balance sheet (pre recapitalisation) only came after its Rights Issue came in fully subscribed.

Without a doubt, corporations with strong financial performance offer a secure proposition, which can even lead to profit if sold in the year or two after issue and before maturity. But the trick for investors is accurately judging how secure a particular bond is, and the possible downside (capital loss) if sold before maturity. Equally important, says Chris Lambert director with Direct Broking is what the company's underlying performance will do to Capital Note demand.

Liquidity driver

As long as the company is doing well, liquidity is usually good. Conversely, bad press can make Capital Notes harder to off-load. For example, owing to its recent bad run, Capital Note-holders (issued at 8.75%) of Tower – which at time of issue had a triple B- senior debt rating - could find it tricky to sell at 10%. Those with Tranz Rail and BIL Capital Notes are in a similar boat. While all these Capital Notes were fully subscribed, these stocks are now out of favour with brokers. 'But bad press doesn't necessarily alter the price on the bond unless a company's rating is under threat. But as most local Capital Note issues are unrated, bad news will be reflected in the price a lot sooner' says Lambert.

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