

## Preferred Shares and Perpetual Debt: Part II

### Investment Note - 06 March 2009

This Note is a follow-up to our report on Preferred Shares and Perpetual Debt published on February 11 and provides our recommendations on a further 11 securities from a diversity of issuers. In the previous Note, we identified six major risks regarding investments in preferred shares and related hybrid capital instruments: **Bankruptcy risk**, **Nationalisation risk**, **Dividend deferral/suspension risk**, **Extension risk**, **Conversion/ substitution risk**, and **Downgrade risk**.

An additional risk factor, much related to the aforementioned, is **Liquidity risk**. This risk has been highlighted by the recent Citigroup exchange offer. Holders of publicly issued straight preferred stock in Citi face the danger of holding very illiquid securities if they don't exchange and the majority of holders opt to convert into common equity. In addition, downgrade risk, in particular in the event that a hybrid security is downgraded to speculative grade, could result in higher

liquidity risk. In this scenario, the investor base for the security would shift from traditional to high yield or distressed debt investors, which could result in significant selling pressure and may have longer-term implications for the liquidity of the downgraded securities.

The past performance and future prospects for preferred shares and perpetual debt differ not just in terms of issuers but also as regards the specific characteristics of the instrument in question. Investment recommendations must hence be made on a case-by-case basis, taking into account not just the financial position of the issuer but also the precise location of the security in the issuer's capital structure. Indeed, even in the case of full nationalisation, some preferreds/hybrids could continue to be serviced if they are considered to be part of 'debt' rather than 'equity'.

### Merrill Lynch Preferred Stock and Hybrid Securities Price Index



Source: Bloomberg

Securities Covered and Investment Recommendations	
Bank of America 8% Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series K	Risk-averse investors: Sell Risk-tolerant investors: Hold
Lloyds TSB Bank 6.9% Perpetual Capital Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Lloyds 7.875% Non-Cumulative Preference Shares	Risk-averse investors: Sell Risk-tolerant investors: Hold
RBS Capital Trust B 6.8% Non-Cumulative Trust Preferred Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Natixis 9% Perpetual Non-cumulative Notes	Hold
Credit Agricole 7.375% Undated Deeply Subordinated Notes	Hold
Rabobank 7% Perpetual Non-Cumulative Capital Securities	Hold
Man Group 11% USD Perpetual Subordinated Capital Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Fortis Hybrid Financing 8.25% Perpetual Bonds (BB/Watch Developing)	Risk-averse investors: Sell Risk-tolerant investors: Hold
Prudential 6.5% Perpetual Subordinated Capital Securities (A-/Stable)	Hold
HBOS Capital Funding 6.85% Guaranteed Non-voting Non-cumulative Perpetual Securities (A-/Negative)	Risk-averse investors: Sell Risk-tolerant investors: Hold

#### **Bank of America 8% Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series K (BB-/Negative)**

Dividends on the Bank of America 8% Fixed-to-Floating Rate Preferred Stock are discretionary and non-cumulative. The Preferred Stock will not be convertible into, or exchangeable for, shares of any other class or series of stock or other securities. The securities are callable at par (100) on 30 January 2018, and on any coupon payment date thereafter.

As with Citigroup, the US government may consider converting its preferred stock holdings in Bank of America to common in order to boost tangible capital levels. If this occurs there may be increased pressure to defer on non-government non-cumulative preferred dividends.

On February 17, Bank of America announced a dividend payment of USD402mn on the fixed-rate cumulative perpetual preferred stock issued in connection with the USD45bn in government investments that the bank received in late 2008 and early 2009. Bank of America stated that total cash dividend payments to the government in 2009 will reach approximately USD2.8bn. The government preferred shares rank equal with existing Bank of America perpetual preferreds, but are cumulative whilst the existing shares are non-cumulative. This means the government could order a dividend suspension but still get

the money back for taxpayers when dividend payments are resumed, but the private holders would lose all of the deferred interest.

The recent payment indicates Bank of America's willingness and ability to meet its obligations on preferred securities, which was further underscored by remarks by CEO Lewis that it is Bank of America's intention to pay back government loans as soon as possible. Although the CEO denied that the bank may need additional capital, further governmental support cannot be ruled out. In sum, deferral of dividend payments on non-cumulative preferred stock and/or an exchange offer for preferred stock holders similar to the Citigroup offer, are significant risk factors. As a result of the increased risk of dividend deferral, S&P lowered the ratings on Bank of America's hybrid debt to BB- from BBB on March 3.

At current bid-ask prices of 30-34.5 with a YTM of 32-29%, the risk of dividend deferral is to a large extent priced in. Extension risk is less of a concern considering the first option to call falls in 2018. **We recommend that only investors with an above average risk appetite hold the Bank of America 8% Fixed-to-Floating Rate Non-Cumulative Preferred Stock. Risk-averse investors should sell.**

#### **Lloyds TSB Bank 6.9% Perpetual Capital Securities (BB+/CreditWatch Negative)**

The Lloyds TSB Bank 6.9% Perpetual Capital Securities are unsecured and have a subordinated ranking. The securities constitute tier 1 capital and coupon payments are non cumulative. The securities are callable at par (100) on any coupon payment day.

If Lloyds determines that payment of the coupon would result in it being in non-compliance with applicable capital regulations, the bank may elect to defer the coupon. Deferred coupon payments will be repaid if the capital securities are redeemed, but not in any other circumstances. If a coupon is deferred, no payment may be made on any ordinary shares, preference shares or other types of Tier 1 securities after until the bank next makes a coupon payment.

Lloyds has confirmed its intention is to treat all classes of preference shares equally. Legally it is possible for Lloyds to pay a coupon on the 12% government preference shares but not on all other classes of preference shares. However Lloyds has stated that if it pays a coupon on the government-issued 12% preference shares, then it intends to pay coupons on all other preference shares. Lloyds is talking to the Treasury about joining the asset protection plan, though the terms it negotiates may differ to the RBS settlement and no details have yet been released. On March 6, Lloyds stated that it has yet to reach a deal with the government after some newswires announced that it is close to an agreement that would leave it majority state-owned.

On February 27, Lloyds reported 2008 losses of GBP9.9bn following the emergency takeover of Halifax Bank of Scotland (HBOS) last year. Lloyds' core business made a small pre-tax profit of GBP807m but this was swamped by losses at HBOS. Lloyds stated that adjusting for the government's recapitalisation of UK banks completed in January 2009, and the estimated impact of the acquisition of HBOS, the enlarged Lloyds Banking Group's pro-forma core tier 1 capital ratio stands at 6.4% and the tier 1 ratio at 9.8%.

At the current bid-ask prices of around 13-23, the Lloyds TSB Bank 6.9% Perpetual Capital Securities have a YTM of 53-30%, reflecting substantial risks of coupon deferral, extension risk, and downgrade risk. **The risk of full nationalization of the Lloyds Banking Group has increased but still seems relatively low. We therefore recommend risk-tolerant investors to keep on holding these securities. Nevertheless, investors should be aware that any sustainable near-term price recovery seems unlikely. Risk-averse investors and/or investors who require regular income should sell.**

#### **Lloyds 7.875% Non-Cumulative Preference Shares (BB/CreditWatch Negative)**

Last month Lloyds exercised its option to exchange some Tier 1 securities for non-innovative preference shares issued by Lloyds Banking Group. The exchange was permitted in the original documentation. The UK bank addressed issues of excess innovative Tier I capital above the 15% limit by exercising an option to have the \$7.875% and €7.875% Non-Cumulative Preference Share issues treated as non-innovative.

Dividends on the securities are non-cumulative and payable at the discretion of the Board of Directors. If the company does not pay a dividend on these securities then it may not declare or pay a dividend or distribution on junior share capital or the preference shares. It appears that payment can be made on other capital including other Tier 1 securities. The securities are callable at par (100) on 29 November 2013 and on any time thereafter.

At the current bid-ask market prices of 10-14, the Lloyds 7.875% Non-Cumulative Preference Shares have a YTM of 78-56%, reflecting substantial risks of coupon deferral, extension risk, and downgrade risk. **The risk of full nationalization of the Lloyds Banking Group has increased but still seems relatively low. We therefore recommend risk-tolerant investors to keep on holding these securities. Nevertheless, investors should be aware that any sustainable near-term price recovery seems unlikely. Risk-averse investors and/or investors who require regular income should sell.**

#### **RBS Capital Trust B 6.8% Non-cumulative Trust Preferred Securities (BB/CreditWatch Negative)**

The trust preferred securities are perpetual securities that have no fixed maturity or redemption date. Coupons may be reduced or deferred if RBS does not have available sufficient distributable profits to make payments in full on the partnership preferred securities and all securities ranking equally as to rights to payments or if making a payment would breach the capital adequacy requirements of the UK Financial Services Authority.

RBS has the right to dissolve and liquidate the trust under certain circumstances. If this occurs RBS may substitute noncumulative dollar preference shares in return for the surrender and cancellation of the trust preferred securities.

On February 26, following their pre-warned 2008 results – a net loss of GBP24bn - RBS provided some details regarding the asset protection scheme and terms on the new capital from the UK Treasury. RBS will issue up to GBP19.5bn in ordinary shares with preferential rights to the UK Treasury. Although these B shares will have only limited voting rights, RBS can pay a dividend on these shares without paying one on ordinary shares. The dividend on these shares will be 7% or 2.5x the dividend on ordinary shares, whichever is the higher. These Class B shares can convert to ordinary shares if RBS stock trades

above 65p, but the government's voting rights will be capped at 75%.

Under the asset protection scheme, GBP325bn in assets will be insured by the UK government. RBS will bear the first GBP19.5bn of losses on assets transferred. Any further losses will be shared 10% by RBS and 90% by the Treasury. In addition, the Treasury required RBS to forgo certain UK tax losses and allowances, meaning that they will not be able to claim current losses against future UK taxes. Whilst this is designed to help the government deal with the biggest budget deficits since modern records began in 1970, it is also indicative of the government desire to keep RBS in private ownership.

These capital injection and asset protection measures are designed to limit future asset write-downs and avoid the need for additional capital injections, and are hence indicative of the strong desire to avoid full nationalization. This is a positive development for holders of subordinated credit securities.

Nonetheless, given the large stake owned by the government, as well as the fact that RBS pays around GBP1bn in preferred dividends/coupons, there is a risk of deferrals on non-cumulative and optional-pay securities in the coming quarters. This seems to be fully priced in with the RBS 6.8% Non-cumulative Trust Preferred Securities at bid-ask prices of 19.5-21.5, giving a YTM of 35-32%. Against this backdrop, **we recommend only investors with above-average risk appetite to hold the RBS Trust Non-Cumulative Preferred Securities. Although downside risk seems rather limited at current prices, risk-averse investors should consider selling.**

#### **Natixis 9% Perpetual Non-Cumulative Notes (BBB+/Stable)**

These are perpetual deeply subordinated notes that constitute Tier 1 Capital. Payment of interest on the notes will be compulsory if the issuer has declared or paid a dividend or more generally made a payment of any nature, on any class of share capital or on other equity securities or on any other Tier 1 Capital. Otherwise the issuer may elect not to pay interest on the Notes. Any interest not paid shall be forfeited. The Notes are callable at par (100) on 16 April 2013 and on any dividend payment date thereafter.

Natixis reported a wider-than-expected Q4 loss of €1.6bn on February 26, driven by write-downs of €1.3bn and loss provisions of €988mn. Meanwhile, Natixis has moved €31bn into a "bad bank" construction. Although this has improved visibility, additional write-downs cannot be ruled out. The bank's Tier 1 ratio declined to 8.2% from 8.6%.

On February 26, Natixis' parents Caisse Nationale des Caisse d'Epargne de Prevoyance (CNCE) and Banque Federale des Populaires (BFBP) announced their merger. The French state, which prodded the move, will inject about €5bn into the combined group, of which about half would be through buying preferred shares and the rest through the purchase of subordinated debt. The new entity

will become the second-largest French banking group and is expected to help shore up Natixis. Nevertheless, Natixis' ongoing efforts to downsizing its investment banking activities and the difficult operating environment will reduce its underlying earnings capacity.

The current bid-ask prices of the Natixis 9% Non-Cumulative Notes are around 24-27, with a YTM of 37-33%, reflects significant risk of dividend deferral. **Given the ongoing uncertainties Natixis is facing, we recommend only investors with a long-term investment horizon and an above average risk tolerance to consider keep on holding the Notes. Less risk tolerant investors should sell.**

#### **Credit Agricole 7.375% Undated Deeply Subordinated Notes (A/Stable)**

Payment of interest on the notes is compulsory if the issuer pays dividends on its ordinary shares. However the issuer may elect, and in certain circumstances shall be required, not to pay interest falling due on the notes. The notes are not cumulative: any interest not paid shall be forfeited and no longer be due and payable. Credit Agricole are allowed to call the Notes on 19 October 2012 and on any dividend payment date thereafter.

On March 4, Credit Agricole reported a higher-than-expected Q4 net loss of €309mn, driven by significant losses of €527mn at its Greek bank Emporiki. The bank reported Tier 1 ratio as of end-2008 of 9.1%. Credit Agricole does not intend to make use of a second round of funds provided by the government. The bank's total write-downs of €6.8bn have been relatively small compared to its peers. The bank has received €8.9bn of additional capital, including €3bn of governmental support through subordinated bonds.

**We recommend investors to keep on holding the Credit Agricole 7.375% Undated Deeply Subordinated Notes.** The Notes trade at a bid-ask of around 52-55, yielding 14-13.5%.

#### **Rabobank 7% Perpetual Non-Cumulative Capital Securities (AA/Stable)**

Payment of interest on the Capital Securities is required if the issuer, or any member of the Rabobank Group, declares or pays a dividend or distribution on any equal or junior ranked security. Interest is not payable if the applicable Solvency Laws prohibit the issuer from doing so. Interest payments are not cumulative and interest which is not paid will not accumulate or compound. The Securities are callable on 22 October 2012 and any date thereafter.

Rabobank is one of the stronger global financial entities, benefiting from a low-risk banking franchise, its strong domestic market shares and a solid financial condition. Rabobank's Tier 1 ratio was 10.1% as of end-June 2008 and the bank is one of the few global financial institutions benefiting from a triple- A rating.

The current bid-ask prices of the Rabobank 7% Perpetual Non-Cumulative Capital Securities are 74-76, giving a YTM of 9.5-9.3%. **We recommend investors to keep on holding these Securities.**

#### **Man Group 11% USD Perpetual Subordinated Capital Securities (Baa3/Negative)**

The notes are unsecured and rank pari passu in right of repayment with preference shares. Man Group has the option to defer interest payments, but any deferred payments will become due and payable on the earliest of a) redemption, b) substitution or c) liquidation.

The outlook on Man Group's credit rating was revised to negative from stable by Moody's on 12 December 2008. This primarily reflects the growing pressure on sales and redemptions that the hedge fund and asset management industries are experiencing, which may negatively affect Man Group's profitability. These negative factors are to some extent mitigated by Man Group's relatively low financial leverage and its reduced reliance on short-term funding, following the issuance of USD300mn in subordinated debt. In addition, the group benefits from a strong position in the global hedge fund industry with good geographic diversification.

The Man Group 11% Capital Securities trade at a bid-ask of 58-60, yielding 19-18%. **We recommend that conservative investors sell the Man Group 11% Junior Subordinated Perpetual Bonds, owing to the above-average sector risk of the hedge fund industry. In addition, downgrade risk and the junior subordinated ranking are reasons why conservative investors should sell.**

#### **Fortis Hybrid Financing 8.25% Perpetual Bonds (BB/Watch Developing)**

Fortis announced after its split-up last October that the Fortis Hybrid Financing 8¼% perpetual securities should continue to be served by its owners Fortis Bank (FBB) and Fortis Insurance Bank (FIB). Meanwhile, it was announced that the Belgium government acquired a 25% stake in Fortis Bank while the remainder would be bought by BNP Paribas. However, in December 2008, the Brussels Court of Appeals ruled that the sale of Fortis assets must be put to shareholders for a vote. Subsequently, shareholders voted on February 11 against the sale of FBB and FIB to BNP Paribas. On February 27, Fortis, the Belgian state and BNP Paribas agreed to extend the takeover and it is expected that a statement about a revised deal will be made on March 6.

The BB rating on the Fortis Hybrid Financing 8¼% perpetual debt, which is 6 notches lower than that of its owner Fortis Bank, reflects the view of S&P that there is a high risk of coupon deferral. The outlook is watch developing, with the rating direction depending on the future ownership structure of Fortis Bank. Despite the "no-

vote" of shareholders, the October 2008 agreement, which outlines the terms of the Belgian government's transfer of a 75% stake in FBB to BNP Paribas, remains binding for the Fortis Group. Under this agreement, however, a portfolio of structured products with fair value of EUR10.4bn is transferred by FBB to a special purpose vehicle (SPV) which is majority owned by Fortis Group (66%), while under the amended agreements the Belgian government would have accepted to fund most of the SPV. Also, it remains uncertain if FIB will be sold by Fortis Group to BNP Paribas.

The ratings on FBB and FIB may be affirmed or could be raised by one or two notches depending on, among other factors, the review of FIB's stand-alone credit profile, the scope of the legal risk to Fortis Group, and how much the impaired securities portfolio could alter the group's financial profile.

The current liquidity seems very limited for Fortis hybrid debt with the Perpetual Bonds showing a bid-ask of 18.25-20.25, yielding 45-41%. **We recommend that risk-averse investors sell. Only investors with an above-average risk tolerance should consider holding these bonds.**

#### **Prudential 6.5% Perpetual Subordinated Capital Securities (A-/Stable)**

Interest payments on the Prudential Capital Securities may be deferred at the discretion of the issuer. Deferred interest payments will be made only upon redemption of the Capital Securities and may only be funded by the issuance of ordinary shares. Interest payments on the Capital Securities will be mandatory if Prudential meets the Solvency Conditions which dictate that assets exceed total liabilities, other than liabilities that are not senior creditors, by at least 4% or such other percentage specified by the FSA. The Securities are redeemable at par (100) at the discretion of the issuer on any interest payment date falling on or after 23 December 2008.

On February 19, Prudential reported a strong capital position of GBP1.7bn as of end-2008, up from GBP1.2bn in Q3, resulting in a solvency ratio of 160%. Meanwhile, the UK insurer announced the sale of its Taiwanese business to China Life which it estimates will release an additional GBP800mn of capital to further increase the buffer to GBP2.5bn.

The Capital Securities are priced at a bid-ask of 27-30 with a YTM of 24-21%. Current market prices reflect risk of extension as the issuer has foregone early redemption in December 2008. As Prudential's capital levels have shown significant improvement, near-term coupon deferral seems remote. **We recommend investors to keep on holding these securities. Nevertheless, investors should be aware that any near-term sustainable price recovery seems unlikely.**

**HBOS Capital Funding 6.85% Guaranteed Non-voting Non-cumulative Perpetual Securities (BB+/CreditWatch Negative)**

The Capital Funding Securities are issued by HBOS Capital Funding, a fully-owned subsidiary of HBOS incorporated in Jersey with limited liability. All obligations of the issuer to make payments are guaranteed on a limited and subordinated basis by HBOS. The securities are perpetual and not subject to any mandatory redemption provisions. They are, however, callable at par (100) at the discretion of the issuer on any dividend payment date.

S&P lowered its ratings on hybrid debt to BB+ from A and placed the outlook on CreditWatch with negative implications. The rating agency stated that although they still expect Lloyds to maintain coupon payments, risk of deferral has risen materially owing to the potential government intervention and the bank's weak earnings results.

Uncertainties over the future capital structure of Lloyds Banking Group, the new entity which was formed after completion of the HBOS acquisition by Lloyds in January, is weighing on the market prices of hybrid securities issued by Lloyds and HBOS. Lloyds has confirmed that it is in talks with the UK government to participate in the asset protection plan, though the terms it negotiates may differ to the RBS settlement and no details have yet been released. On March 6, Lloyds stated that it has yet to reach a deal with the government after some newswires announced that it is close to an agreement that would leave it state-controlled.

The HBOS Capital Funding Securities currently trade bid-ask prices of around 10-20, giving a YTM of 68-34%. Extension risk is fully priced in, underscored by the fact that the issuer has foregone to call the Securities on the next call date on March 23. **The risk of full nationalization of the Lloyds Banking Group has increased but still seems relatively low. We therefore recommend risk-tolerant investors to keep on holding these securities. Nevertheless, investors should be aware that any sustainable near-term price recovery seems unlikely. Risk-averse investors and/or investors who require regular income should sell.**

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