Elstree

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Franking credit refunds: part 2 What does our envelope tell us?

- We don't think that the removal of the excess franking credit rebate has much of an effect on the hybrid demand/supply equation.
- It looks to us that we'll see somewhere between $1.4b and $4.5b of forced selling.

How much forced selling?

Clearly hybrids and franked shares are popular with SMSF's and as such we're interested in trying to estimate how the demand/supply picture will change if the ALP's proposal is implemented. It will result in some investors selling franked hybrid securities because without the benefit of franking they are less attractive investments. Despite the sheer political stupidity and the low probability of it getting through the parliament unscathed, while the ALP remains at $1.60 favourite to win the next election (Lib/NP $2.70) the issue will remain "live". As per our note of last week, the situation for SMSF in the accumulation phase (where they pay 15% tax) is unchanged: the tax they pay is broadly offset by the franking credits. It becomes more problematic for Super Funds in either Full Pension mode (paying 0%) or Partial Pension mode (paying somewhere between 0% and 15%).

The data: messy

So our task was to estimate what proportion of the SMSF market is in Full Pension/Part Pension mode and then estimate their asset allocation to hybrids. We expect that segment will sell all their hybrids and they will need to be absorbed by the rest of the market; at higher yields. The higher the forced selling, the more we expect to see yields rise (producing capital losses). It's complicated by the recent move to reduce the 0% tax paying segment to $1.6m per member. Anecdotally, there are a number of very large super funds in 0% tax paying mode. One of the comments made (by Bill Shorten?) was that one super fund received a franking credit rebate of $2.5m. By our calculations, that means that the amount of franked investments was larger than $150m, and presumably the fund was even larger than that. Unfortunately, the estimation process is not easy. The ATO data is messy, but we've done our best 'mosaic thingy' to come up with a market map.

Size of Super segments

For the purposes of the analysis, we've split the total SMSF market into the various segments. As at June 2016, the SMSF market was $621b (it has grown to $672b as of September 2017), and we think it is split up as below. We've split the market into the various phases/tax rates:15%, 0% - 15% and 15%. We have then had to split the market into those funds that have less than $1.6m per member and more than $1.6m per member. This is important as those 0% and 0%-15% funds which currently have more than $1.6m per member (as per the $150m fund above) will need to split the fund into a $1.6m per member portion paying 0% tax and the rest will pay 15% tax. The $150m fund will soon have $1.6m per member paying 0% tax and $146.8m paying 15% tax. The colours give a rough indication of the size of the market, but the numbers are our estimate of each segment. If we are wrong, we have have probably underestimated the size of the large funds, which means that the pro forma number of 0% tax payer funds in 2020 will be smaller than these estimates.

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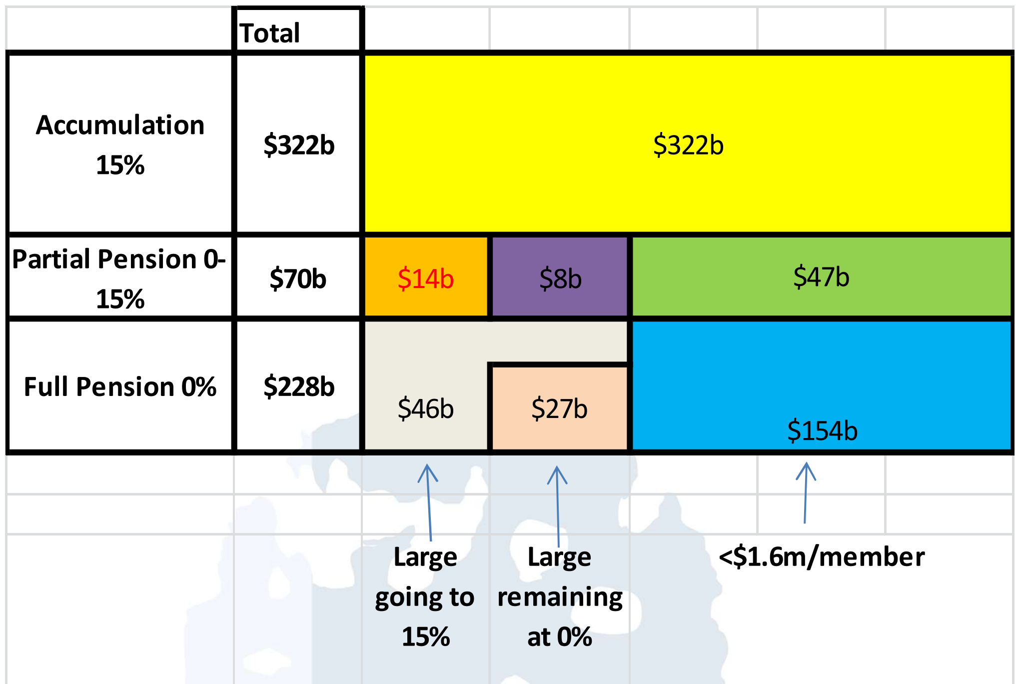

Maybe 25% - 30% of SMSF assets are affected

The majority of Super Fund assets remain in accumulation phase which pay 15% tax and receive no excess franking credits. The SMSF segments, that will be sellers, hold assets of around $181b (i.e) the blue and pink segments which represent the 0% taxpaying members which are less than $1.6m and that portion of the large (>$1.6m members) which will remain at 0%.

So what does that mean for asset allocation

The ATO provides data on asset allocation and the pie chart below shows how the $181b is invested (if it follows the average asset allocation). We think that, for ATO purposes, hybrids fit into the Direct Shares segment which is the $56,110 figure in the main pie chart. How much of that Direct Shares segment is hybrids? We have no real idea. We estimate the holding by calculating the size of the relevant indices. The ASX 50 which represents the popular retail stocks is $1.26b and the amount of the Elstree Hybrid Index that matures post 2020 (ie the ones that will be sold if the changes occur) is $31b. So, if the affected investors hold according to “index” weights, there is $1.4b to be sold (the little orange sliver on the right exploded pie chart) if investors held hybrids in relation to the ASX 50 index. Maybe, they hold 2 or 3 times the exposure in which case, there is c$3b - $4.5bto be sold.

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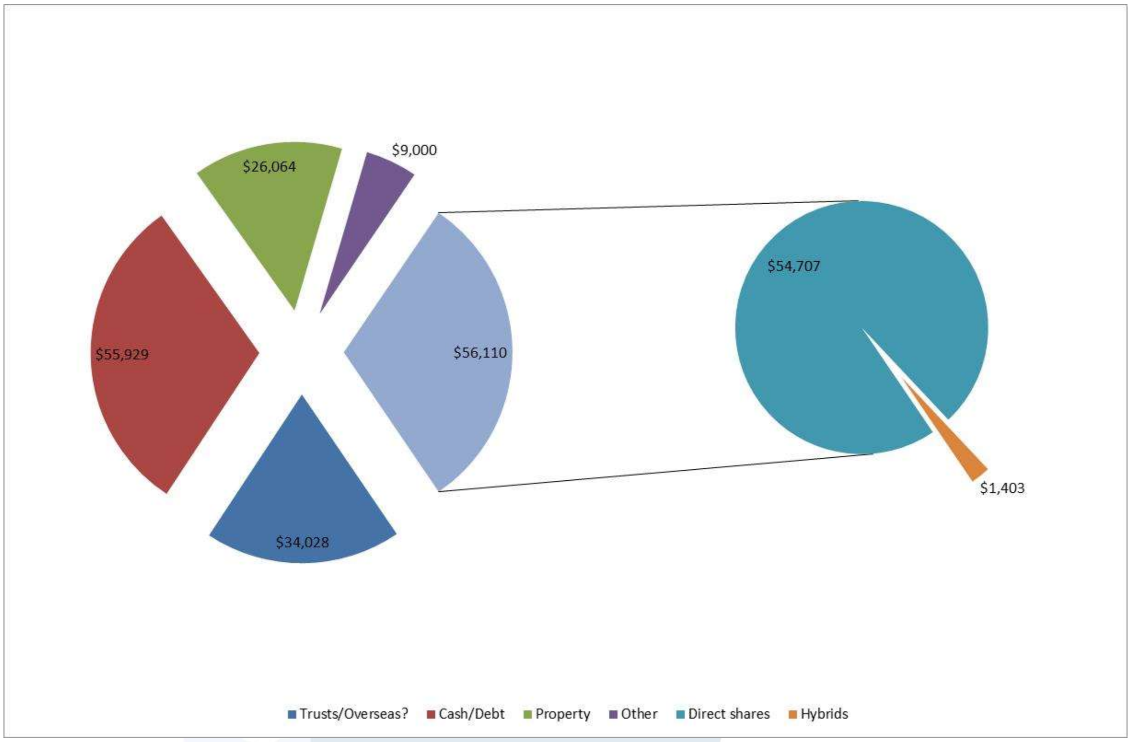

Conclusions

We've tried to be relatively conservative in our analysis;

- This analysis assumes that SMSF are the only holders of hybrids. Clearly this is unrealistic. If there are other categories of investors who hold hybrids, the forced selling will be lower.
- We suspect we have underestimated the size of the really large Super Funds (ie >$1.6m/member) that are in pension mode. That segment will transition to 15% tax rate. If that is the case, the forced selling will be lower
- An additional $3 - $5b of forced selling is the equivalent of what used to be a normal year's issuance. The maximum margin movement, if we had an additional $3 - $5b coming onto the market (via unanticipated issuance for example) is an increase of 0.50%
- From the issuers point of view, this change remains 'live. A prudent Bank or Corporate Treasurer would probably attempt to increase issuance, just in case the forced selling and margin movement becomes material.
- From a budgetary perspective, the restructuring of very large 0% tax paying Super Funds to primarily 15% tax paying status puts a big hole in the revenue gain. if the ALP eventually softens the policy to offer compensation to the smaller excess franking credit recipients, it will raise even less.

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