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New UBS AT1 - a core hold for IG portfolios

By Jenna Hayes

We like the risk profile of the new UBS AT1 with a first call in March 2031 (~5.5years). The notes are rated Baa3/BBB- (Moody's/Fitch). Importantly, the new UBS AT1 will be convertible into equity and therefore contrasting to the write-off format of Credit Suisse's AT1 securities as discussed below. The relative value is very good when compared to the largely dwindling ASX-listed AT1 curve or even the A\$ kangaroo T2 issuance recently. In our view, this should be a core holding for any investment-grade portfolio, down to a yield of 6.375%. We like the coupon being fixed as it will give investors the ability to add duration in and that the issuer has a strong track record of calling either AT1 or T2 securities.

One key development is that Swiss AT1 hybrids are currently in consultation regarding coupon payment conditions. As per BondAdviser research, regulators have proposed hard wiring a two-part test: coupons may only be paid if the bank has distributable reserves and a positive cumulative profit over the prior four quarters, with FINMA (Swiss regulator) obliged to suspend or resume payments accordingly. This framework has not been approved, so could potentially change with consultation ahead. However, putting this development aside, dividends to UBS shareholders would be trapped in this scenario, protecting cash leakage for AT1 hybrid holders.

Regarding the background on the old UBS 4.375% AT1 security.

On July 11th 2024, it was announced that UBS actioned their August call and redeemed their Additional Tier 1 (AT1) securities at a price of \$100.00. This was a great outcome for noteholders who bought these securities as low as \$87 when IAM's credit team first released our Buy recommendation. Below is a summary of the events that took place and the basis of IAM's strong conviction in this trade. In fact, the UBS notes had less than 1.5 years to call (March 2023 - August 2024) and UBS had never missed a call before (either AT1 or T2), further strengthening our conviction to form a Buy recommendation.

Credit Suisse's collapse in March 2023 sent shockwaves through the global financial system. This was understandable given that Credit Suisse was one of Switzerland's top lenders, had been operating for 167 years, and had previously weathered the Global Financial Crisis. Credit Suisse eventually found itself in a crisis that led to its acquisition by rival UBS, facilitated by the Swiss state to avert a global financial crisis.

One of the fallout from this was that Credit Suisse's Additional Tier 1 (AT1) securities were written off despite shareholders retaining some value. The deal was put together at immense speed to restore confidence across the European banking sector. Nonetheless, the decision to write down the AT1s to zero led to an aggressive sell-off in the wider European bank AT1 market. We saw this as an overreaction by the market, with similar European banks being affected by a 'guilty by association' scenario, rather than anything specific to their credit profiles, including UBS. The UBS 4.375% AT1 security was caught up in this sell-off, with the outright yield on these

securities widening to 12.5% from around 6% prior to the event. This situation demonstrated that in a dislocated market, the quantum of the bid often dictates the price. IAM credit team saw this as an opportunity for investors to take advantage of the heavy sell-off in the European perpetual securities sector while the market was dislocated.

IAM credit team's UBS recommendation was based on the following points:

- UBS had always been a much stronger credit than Credit Suisse.
- The Credit Suisse AT1s that were written off were sub-investment grade, whereas UBS's was rated BBB-.
- Credit Suisse's problems began to intensify in Q4 2022, with significant outflows of deposits and assets under management, putting it on a downward trajectory before the crisis.
- The UBS bonds had a high coupon reset margin if they decided not to call, incentivizing them to avoid.
- Post the Credit Suisse/UBS merger, UBS is considered a Global Systemically Important Bank (G-SIB) giving addition credit comfort.

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