The art of conversion

Businesses can benefit greatly from the flexibility offered by convertible bonds. Andrew Moorfield of bfinance.co.uk provides an overview.

Convertible bonds are a form of debt instrument that combines a standard bond with an equity option. As with most bonds, a convertible pays coupons and a principal repayment to bondholders. However, the holder of the convertible bond also has the right to forego these payments in order to convert the bond into a pre-specified number of shares of the issuer. The issuer may also have the right to convert the debt obligation into equity.

Popularity of convertibles

The annual value of total convertible bond issuance has risen significantly over the last three years. This growth was especially notable last year; in the first eight months of 2000, almost $74bn of new convertibles were launched, compared to $97bn during the whole of 1999.

This growth stems largely from the flexibility of convertibles. Compared to other instruments available in the public equity and debt markets, convertible bonds allow treasurers more scope to tailor their funding to their company's specific requirements. For example, treasurers can alter the period and value of coupon payments and select their own conversion terms and redemption amounts. Relative to other instruments, a convertible allows a treasurer to take into account different potential scenarios for the company's cashflow and market value when setting the terms of the issue.

The embedded options contained in convertibles are also becoming more esoteric, for instance, offering investors the opportunity to convert to the stock of more than one entity (perhaps reflecting the future plans of the issuer to float off businesses at a later stage).

Valuation techniques

There are two elements to the valuation of the convertible bond:

- the 'straight' portion of the bond (that which pays coupons and principal), the valuation of which is a standard discount of cashflows; and
- the option to forego these cashflows and convert instead into equity, the valuation of which is achieved through an option pricing technique, such as the Black-Scholes formula.

Why issue convertible bonds?

The primary question for the issuer is 'why issue convertible bonds?', rather than issue either new equity or straight debt. There are generally four scenarios in which it makes sense for a treasurer to issue convertible debt:

(1) Market inefficiencies
(2) Asymmetry of information
(3) Timing of cashflow realisation
(4) Ownership issues

(1) Market inefficiencies

Bankers regularly cite 'market inefficiencies' to support their own preference for the particular type (and timing) of security they believe a corporate client should issue.

In general, when capital markets are liquid and active, different corporate securities will be priced to reflect the market's perceived level of risk in the company. The higher the risk and the lower the confidence investors have in the company, the lower will be the price of a company's debt and/or equity securities.

The validity of the 'market inefficiency' argument hinges on the market incorrectly pricing different classes of securities issued by the same company. For example, bonds may be priced more favourably than equities. Such an occurrence is difficult to justify or identify – therefore it could be argued that treasurers should be somewhat suspicious of these explanations when presented by their bankers.

> The less risky the financing instrument issued by a company, the less likely investors are to under price the instrument

(2) Asymmetric Information

There is often an asymmetry of information between the company's management and the market. This different level of information creates the opportunity for a company to issue financing instruments that can monetise this asymmetry.

The key factors of the asymmetry are the company's expectations on the timing and quantity of future cashflows. Issuing equity at a time when management knows that the market is undervaluing the company will tend to result in excessive dilution (ie, a loss of value and control for existing shareholders). The company may elect to avoid this dilution by delaying the equity issue. For example QXL, the on-line auction company, recently issued a £15m convertible bond to finance its expansion. The rationale for the transaction could be that QXL's management believed their equity was undervalued and as a result they sought to avoid excessive equity dilution by issuing convertible debt.

(3) Timing of cashflows

The less risky the financing instrument issued by a company, the less likely investors are to under price the instrument. As a result, such an instrument is attractive to the company. As debt is less risk than equity, there is an implication that a treasurer should consider debt to be an appropriate alternative to equity. However, depending on the timing of cashflows, a company without a predictable revenue stream (either in terms of

amounts or timing) is not in a strong position to borrow money in the debt markets. Convertible bonds may therefore provide a solution. As a company begins to generate operating cashflows, but continues to require substantial capital for its investments, it could issue debt rather than (dilutive) equity as a source of financing. However, if it faces substantial cashflow uncertainty and wishes to minimise its financing commitments, it can lower the coupon payment for a given face value by offering a conversion option (an embedded warrant) with the bond. This type of convertible offers a means of lowering the under-pricing penalty associated with equity (thus minimising excessive dilution) while reducing the risk of financial distress associated with debt by lowering the coupon obligations.

(4) Ownership and control

The addition of a call provision, which provides the issuer of the convertible debt the right to force the holders of the debt to convert to equity, can be of benefit to a treasurer. Such a call provision allows the treasurer to effectively delay an equity issue until the market value of the company more accurately reflects its 'true' value. As a convertible does carry the obligation of regular coupon payments, this can increase the risk of financial distress. In these circumstances, a call provision gives the issuer the right to force bondholders to exercise their conversion option after a given period of time. This will lower the company's financial commitments because the treasurer can replace debt with equity. Equally, the treasurer can determine the timing of an equity issue and so influence both the ownership and control of the company.

A company issuing this kind of convertible bond could not only obtain lower coupon payments than straight debt, but also would be able to force conversion. Here, a treasurer can avoid coupon and principal repayments beyond a certain time period. The call provision reduces the risk of financial distress to the issuer while still delaying the issuance of equity if management believes the market is undervaluing the company.

One of the most important trends over the past few years has been the high level of exchangeable bond issuances. Exchangeable bonds are issued by one company, but are convertible into the shares of another. Such structures provide an ideal way for corporates involved in restructuring to sell down their equity holdings at an attractive price.

(5) Credit ratings

Although a treasurer would not issue a convertible bond solely on the basis of improving their company's credit rating, the potential positive credit effect can be an important factor in deciding to issue a convertible debt relative to straight debt. Such a factor is especially important if the company intends to issue additional debt financing and would benefit from an improved credit profile (and hence a lower funding cost).

Issuing costs

Most treasurers are likely to weigh the flexibility offered by convertibles as secondary to the overall cost of funding. As convertibles offer investors an embedded option, the interest payments on convertibles are lower than on straight debt. Note here that zero-coupon convertibles offer issuers the possibility of eliminating annual payments all together in return for a redemption price set at higher than the issue price. In such circumstances, the aim of the company may be to have as few bonds reach maturity – and hence an expensive redemption – as is possible.

Due to the difference in underwriting risk, fees paid to banks when issuing a convertible bond should be lower than for an equity issue. Although convertible fees should be closer to those for bond transactions, banks will argue that the increasing range of convertibles that can be tailored to the specific needs of individual issuers (for example, the use of different types of embedded options) means the banks are effectively customising a product.

This customisation means the banks are adding considerable value, and it would be excessively punitive not to suggest that banks deserve a higher remuneration than with a comparable plain vanilla bond issue.

Until recently, underwriting costs for convertibles had rarely deviated from a standard 2.5%. However, banks have now broken rank and competition for mandates has dragged prices down. In particular, treasurers launching deals valued at more than £1bn are likely to be able to negotiate a discount. Such a discount can be transparent through a reduced underwriting fee or via a less transparent subsidised interest rate swap (if the issue is to be swapped).

At present, banks are likely to open negotiations at about 1.95%–2%, but a more aggressive treasurer (with significant and attractive banking business) may feel they can match recent rumoured fees of below 1.5%. Treasurers with a more limited scale of banking business may find that banks will charge underwriting fees of up to 3%.

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As with most bank negotiations, treasurers can expect some fee flexibility. But bankers will be resistant to aggressive fee deductions – bankers will (quite rightly) point to the added-value nature of their advice and the complexity of the proposed transaction.

Selection criteria

When pressed, many bankers state that there is a view that it is easier to win a mandate on price than to lose one. However, with such a potentially complex transaction, selection criteria must not be solely price-oriented.

Treasurers should apply typical capital markets criteria to convertible bonds, but with an added emphasis upon the bank's ability to structure a complex transaction. Criteria should include the breadth of salesforce coverage, the quality of fixed income credit analysis and investor feedback about the bank.

Given the importance of structuring, pricing and distributing a convertible bond, a treasurer should avoid the temptation to reward his large lending banks with the transaction if they fail to meet his selection criteria.

Joint mandates are increasingly common, although treasurers will find that banks will protest vehemently. Treasurers should not select two lead managers as an opportunity to 'play the banks off against each other' to receive the best convertible bond price. When a transaction is priced, the banks will have

the same view on the book and will not be arbitraged by the treasurer.

Conversion pricing

In pricing discussions with the lead manager, the main aim of the treasurer is likely to be to set the conversion price at a value as close to what he believes is the appropriate price for the company's shares.

This is particularly the case if the treasurer has decided to issue a convertible because prevailing market conditions had prevented him from issuing equity at the company's desired price.

In theory, convertibles are a useful way of improving a company's share price. For example, if a bond was priced at a 25% premium to the share price, full conversion would mean that the company has succeeded in getting investors to pay more for the company's shares than the prevailing stock price at time of issue. In comparison, an equity placement would inevitably have been priced at a discount.

Conversion can take place either at a set date or at given strike price (that is, the share price reaching a predetermined level).

Pricing convertibles

As with any debt refinancing, the pricing process for a convertible bond must take into consideration the valuations of comparable issues. Such relative value analysis is difficult because convertible issues are increasingly issuer-specific. The pricing must also account for perceptions of investor sentiment to the company and its sector.

As a convertible bond has a number of potential outcomes, investors will require the issuer gives a full and clear account of corporate strategy – both up to and after conversion. Mergers, takeovers, rights issues and special dividend payments could all have an impact, and investors will need to be convinced that management will deliver on a specific programme. Convertible prospectuses that include specific clauses are increasingly common.

The rights of convertible bondholders in the event of a merger is currently a point of contention, with some issuers forcing investors to convert prior to any transaction. Most European investors will now require that the implications of the majority of conceivable events be clearly laid out in the prospectus.

Investors

As with the corporate bond market, the US and European convertible markets are at different stages of evolution. In the US market, convertible issues are dominated by high growth companies, while the European market largely remains the preserve of blue chips (which account for 75% of all convertible issues).

This distinction can be attributed partly to investor appetite: there are a greater proportion of highly sophisticated high-yield investors in the US that specialise in smaller companies. Therefore, it is likely that European telecoms, media, technology (TMT) firms that are attracted to convertible financing may have to source US investors and issue US dollar-denominated issues until the European market reaches a similar level of maturity.

The US also leads Europe in the development of funds that invest in a more diverse portfolio of convertibles. Should such funds expand in Europe as they have in the US – where they already account for a significant proportion of the market – these may prove to be an increasingly important source of demand for convertibles.

As the debt holders can be converted into equity holders, the treasurer must ensure that a continuing dialogue with this investor class reflects both a debt and equity perspective. This will ensure that investors will not be subject to mixed messages (especially regarding issues such as commitment to rating categories and share buyback policies) once a conversion takes place.

Further development of the market has also been assisted by the number of convertible indices recently launched by investment banks. These funds are an attempt to provide investors with a new market benchmark to replace the somewhat imperfect combination of equity and bond indices.

Hedge funds remain active in all the regional markets. Whereas investors are concerned with the outright performance of convertibles, hedge funds generally take a view on the volatility of the underlying share. As a result, hedge funds and investors buying convertibles for absolute performance may buy and sell at different times, which improves the liquidity of the market.

Conclusion

Convertible bonds are a highly flexible instrument to raise funding for companies in specific circumstances. Compared to bond or equity issues, they are more complex because they combine attributes of both instruments. As structuring, pricing and distribution will determine the success or failure of a transaction, it is critical that the treasurer select his lead managers on the basis of these criteria. Relative to a plain vanilla transaction, the skill of the bankers is even more vital for a successful convertible debt transaction. ■

Andrew Moorfield is Managing Director at bfinance.co.uk, a financial transaction portal.

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