

Converting to convertibles

UK TREASURERS APPEAR TO BE OVERCOMING THEIR AVERSION TO USING CONVERTIBLE BONDS AS AN ALTERNATIVE FUNDING SOURCE, REPORTS **GRAHAM BUCK**.

Conditions change swiftly and sharply. Less than two years ago the convertible bonds market was effectively closed for business for several months, and more recently a fledgling revival has ground to a halt.

Available to only a limited group of investors, with hedge funds

their main buyers, convertibles offer an interest rate, or coupon, for a number of years until the buyer chooses to convert them into shares at a set price, or have them redeemed like any bond. Convertible bonds have proved a popular source of funding in much of Europe, with a host of French issues last year and companies in Germany and Austria, particularly industrials and real estate, also using them regularly.

While the convertible bond market often thrives in times of volatility, and when other sources of funding become more constrained, the market shutdown in late 2008 resulted from a 'perfect storm' of contributing factors. These included falling equity markets, widening credit spreads, the demise of Lehman Brothers and near-collapse of AIG, and the fall in hedge funds' ability to access leverage.

Another major contributory factor was the temporary ban imposed on short-selling of financial companies, officially to restore market stability. Its effect on the convertible bond market proved to be quite the opposite; activity promptly ground to a halt as investors were no longer able to hedge themselves by selling short the underlying stock – a key requirement for active hedging; the most common convertible investment strategy at the time.

The situation began to improve early last year, as some dipped their toes in, the bond and equity markets again edged higher in anticipation that the recession was coming to an end. As stock markets rallied, steel giant Arcelor Mittal reopened the European convertibles market at the end of March 2009, with a €1.3bn issue of bonds maturing in 2014. The issue, to refinance the group's debt by extending its maturity, broke a nine-month drought and was also the biggest issue seen in the market for two years.

As the group's general manager for funding and investor relations, Maureen Baker, told this magazine, it represented "part of a number of steps to get us into the capital markets, to lengthen our debt maturity profile, to diversify away from bank debt and, importantly, to send some messages to investors."

FOLLOW THE LEADER Having revived the market, Arcelor Mittal was swiftly followed by FTSE 100 stalwarts – J Sainsbury, media group WPP and miner Anglo-American – which all decided to



re-enter the convertibles market as a faster or cheaper alternative to a rights issue or borrowing. The latter two kicked off in April; Anglo American's ambitious issue of \$1.7bn of convertible bonds, due in 2014, being earmarked for "general corporate purposes"; while WPP's £450m issue of senior unsecured convertible bonds, also due 2014, was to refinance its acquisition of Taylor Nelson Sofres. The conversion price of 600p per share represented a premium of 40% over the prevailing share price and the coupon was set at 5.75% per annum, payable semi-annually in arrears.

In June Sainsbury assembled a £432m war chest to add to its network of stores, with a £190m convertible added to its rights issue of 78 million new shares worth £242m. As analysts noted, buyers receive a 4.25% interest rate until their 2014 maturity, or holders alternatively could convert into equity at a price of £4.185. As Sainsbury shares were trading at £3.16 at the time of the issue, the share price had to improve by about 35% over the five years for the conversion right to be valuable.

By last summer, Europe's airlines had been persuaded to include convertibles in their fund raising strategies. In June, Air France increased its original €575m offering to €661m after good initial response from investors, with the bonds' maturity in 2015.

The following month British Airways, which many had expected to resort to a rights issue, announced it would raise a total of £600m to strengthen its balance sheet. The figure included a £350m 5.8% senior unsecured convertible bond offering to existing shareholders that was also heavily oversubscribed (see case studies below).

Late 2009 saw Cable & Wireless successfully completing a £230m convertible in November – increased from an initial £200m – for an entity that did not legally exist and had no balance sheet or other typical credit benchmarks to offer the market, the soon-to-be-demerged Cable & Wireless Worldwide. The deal, based on a five-year maturity and a coupon of 5.75% per annum, was described as the most complex transaction completed in 2009. Yet it proved immensely popular with investors, and pleased them, customers and stakeholders such as the pension fund, who were keen to see the newly-formed entity backed from the outset with a strong balance sheet and good liquidity. This achievement earned C&W the Overall Winner award of The Treasurer's Deals of the Year in 2009.

Convertibles also played a role in the agreed merger last December of Yorkshire Building Society and Chelsea Building Society, which involved a £200m writedown on the latter's bad debts. Yorkshire issued £100m of 15-year convertible bonds to some of Chelsea's creditors on which the annual interest was as high as 13.5%. A variation on standard convertibles, contingent capital bonds or enhanced capital notes (ECNs) attracted attention late last year when they formed part of Lloyds Banking Group's £22.bn capital raising (see CoCos not to all tastes; February 2010).

STARTING FROM A LOW BASE Despite this resurgence, convertible bond issuance still began 2010 at its lowest for more than a decade. In the US, total convertible bond issuance last year was \$35bn, the lowest figure since 1997, but analysts forecast that the recovery would continue with the total reaching \$50bn this year.

In the Europe, Middle East and Africa (EMEA) region, activity was high early in the decade with totals of €25bn in 2002 and €38bn in 2003 respectively. There followed a falling off for several years – for example in 2006, when credit was relatively cheap, the total was

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€13bn and mostly comprised a handful of major issues – before a sharp recovery to €27bn in 2007.

This year was initially subdued, with bankers and fund managers reporting that investor demand continued to outstrip supply for top quality names. Activity then began to pick up, with Swiss pharmaceuticals group Novartis issuing a €3.7bn bond in March, with a three-year maturity paying a coupon of 1.9%. Car maker Volkswagen indicated that it would seek shareholder approval for using convertibles to help fund its takeover of Porsche, but subsequently opted to rely solely on its rights issue proceeds.

At the time of writing, it is unclear whether this improvement can be maintained. Pervading uncertainty from late April over the future of the euro zone and subsequent moves by Germany to again clamp down on short shelling has put credit markets generally in “wait and see” mood, says Rahul Bhandari of JP Morgan, and even if this setback proves to be a blip, it may take a little longer for normal conditions to be restored.

Other factors that could yet thwart the revival include continuing problems for many hedge funds and the prospect of interest rates continuing at historically low levels for months to come. For many companies, this lessens the incentive to issue convertible bonds while the primary bond markets are still available for borrowing at low rates without the need to issue equity and dilute existing investors’ holdings. So indications that interest rates could now begin rising sooner than previously anticipated should whet the appetite of more companies for convertibles.

Nor does the announcement of a convertible bond issue always receive a positive response from investors. For example, shares in the

FTSE 100’s biggest IT group, Autonomy, slumped 5% in a day last February when it unveiled a £500m convertible to pay down debt arising from an acquisition – although it had more than fully recovered within three weeks.

However, over the long-term the virtues of convertible bonds should weather any fresh setbacks. They offer companies an attractive source of low-cost, long-term capital that can be used for funding acquisitions and strengthening their balance sheets.

Convertibles typically pay less interest than standard bonds and also avoid the need for an immediate dilution in earnings per share as investors are looking to gains in the share price over a longer term, such as five years. The market does not require ratings, is sector specific, and offers more flexible pricing and limited financial covenants.

These benefits are appreciated by European companies, which particularly like the fixed cost of convertible bonds and the ability to avoid dilution of equity. By contrast, treasurers at many British firms have traditionally been suspicious of the convertibles market and are only now overcoming their reservations. This year’s ACT conference reflected the changing mood; a JP Morgan-hosted track session on alternative funding proved to be standing room only, and those attending were encouraged to take a fresh look at the convertibles market.

As Bhandari observes, corporate treasurers are keen to diversify their funding sources and, provided there is willingness to accept that convertibles involve a degree of dilution, their use in the UK may grow closer to continental Europe levels.

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Box 1: Case studies

TUI Travel, the FTSE 100-listed company formed in 2007 from the merger of First Choice Holidays and the tourism division of Germany’s TUI AG, has successfully tapped the convertible bond market twice in the last year. In September 2009, the group successfully launched a £350m bond, with maturity in 2014 with a coupon of 6% and a conversion premium of 33%. In April this year it returned to the market for a second round, with a £400m convertible maturing in 2017, with a coupon of 4.9% and conversion premium again at 33%. The group cited the following as part of its rationale for the issues:

- the market was open and there was good investor appetite. Both issues were well-received by the market;
- the relatively low cost of carry, compared to straight bonds;
- ease of issue and low issue costs – no road show was required and each offering was less demanding in terms of senior management time when compared against a straight bond issue and, where necessary, the related ratings process; and
- diversification away from reliance on bank debt, while lengthening the group’s debt maturity profile

British Airways’ £350m convertible bond in July 2009 played “a critical part” in a package



of measures to boost the airline’s total liquidity to around £4bn as of last November. The issue, BA’s first equity capital markets (ECM) transaction in 20 years, allowed the group to avoid resorting to shareholders with a rights issue, further diversified its funding sources and was priced at an attractive rate to BA’s cost of capital. With maturity in August 2014, a coupon of 5.8% per annum and a conversion premium of 37.62%, the deal also benefited from an innovative structure of using subsequent shareholder approval at the EGM to go beyond normal UK limits on convertible bond deal size.

FTSE 250-listed media services group **Aegis**, which last accessed the convertible market in 2002, returned in March this year with a £191m convertible bond offering, for which JP Morgan Cazenove acted as joint bookrunner. The issue included a £21m over-allotment option which was exercised, with maturity in 2015, a coupon of 2.50% and conversion premium of 35%. The offering stated that proceeds would be used to diversify the group’s funding sources and extend its debt maturity profile; Aegis has also spent £40m on acquisitions in recent months, including a joint venture in China. The offering priced at the best end for the issuer on both the coupon and premium ranges, while the conversion price of £1.6442 will, if reached, be a nine-year high for the share price.