TAKE THINGS ONE STEP AT A TIME

PAUL REYNOLDS OF CAZENOVE PROVIDES AN INVALUABLE INSIGHT FOR TREASURERS AND FINANCE DIRECTORS WHO ARE TAKING THEIR FIRST STEPS INTO THE UNCERTAIN WORLD OF CONVERTIBLE BONDS.

This article is intended to be brief. It is not intended to deliver a detailed analysis of equity-linked debt but is aimed at corporate treasurers and finance directors who are considering an issue of convertible bonds. Clearly, individual circumstances are of paramount importance in forming a view, and general remarks may not be appropriate in all circumstances. Familiarity with capital markets mechanisms and the basics of convertibles and their benefits are assumed. The intention is to raise some valid concerns which should not be overlooked.

A 'GOOD THING'. The attractions of the convertible bond market are not disputed. Clearly, they are obvious to many, as the growth in the number of issues and amount of capital raised in the convertible and exchange markets shows. Diversification of funding, profile raising, broad investor base, liquid secondary market, increased liquidity of underlying shares, low coupon tax deductible debt, premium to current share price and ease of execution all feature in the debate about why convertibles are 'a good thing'. In addition, the current unusual market conditions (high historic volatilities, low interest rates and unsatisfied investor demand) have made issuing conditions particularly good.

SOME TRICKY ISSUES. The assumption that convertibles are a good thing just because so many people are doing them, however, needs to be reviewed. In Europe, at least, a great deal of equity-linked issues have been exchangeables, allowing companies in certain European jurisdictions to optimise their capital gains tax position while disposing of stakes in other listed companies. Much convertible issuance has been in jurisdictions where shareholder protection culture (manifested in pre-emption rights) is limited. Amid the frenzy of equity-linked issuance in 2001, only seven UK companies issued bonds convertible into their own shares and, of these, all bar none had sound strategic rationale rather than being opportunistic 'cheap debt' issues.

Unless there are clear strategic reasons for issuing deferred equity, companies find it difficult to make an overwhelmingly convincing case for purely opportunistic issues to their boards and key shareholders.

Uncertainty of ultimate outcome, disposal at less than full value (notwithstanding premium), short-selling effect on share price, existing shareholder response, true costs and investor base cannibalisation are a few of the issues that shoud be clarified and considered early in the evaluation process.

WHAT YOU SHOULD CONSIDER… in no particular order:

- Do you really want to issue equity? The market may interpret this as acceptance that shares are fully valued at current levels.
- Uncertainty of ultimate outcome. If converted, equity will have been issued cheaply relative to the then prevailing price. If not converted, the issue will need to be refinanced when the share price has underperformed against reasonable expectations at issue.
- Association of British Insurers (ABI) guidelines restrict the number of new shares that may be issued by UK companies, by way of a convertible to 5% of shares in issue a year or 7.5% over a three-year period. This may limit issue size.
- It is not cheap debt. Equity-linked usually increases cost of capital compared with debt funding. For the period 1957-1999, risk and return measure place convertibles firmly where you might expect – somewhere between debt and equity (see *Table 1*).
- Convertibles are inevitably issued at less than full value compared with historic volatility. Value is transferred to specialist convertible buyers and away from shareholders. An issue results in significant pressure on share price and a leap in turnover, as dominant

TABLE 1
ASSESSING THE RETURNS.

Asset class	Compound annual return	Standard deviation of return
S&P 500	10.9%	16.4%
Convertible bonds	8.5%	13.8%
Long-term straight bonds	7.1%	10.8%

Source: Ibbotson Associates

‘THE CONVERTIBLE BOND IS NOT ALWAYS MARKETED FOR THE RIGHT REASONS AND WE WOULD ENCOURAGE TREASURERS AND FINANCE DIRECTORS TO BE SCEPTICAL’

specialist convertible buyers open large short positions (typically shorting 50% of the shares in the issue) to capture the volatility value on offer.

- Care needs to be taken to ensure that corporate actions do not prejudice existing shareholders by preferment of convertible holders through conversion price adjustment process. Documentation routinely includes a ‘new owner’ protection clause that dramatically lowers the conversion price during the first few years of the bonds in the event of a change of control. This destroys value for existing shareholders under these circumstances and can impact significantly by the value created by a zero premium merger.
- Bonds may migrate to specialist investors which create synthetic floating rate notes (FRNs) in addition to shorting shares. These FRNs are marketed to relationship banks on premium terms to traditional bank lines, thereby shrinking credit limits and increasing the cost of bank lines to the company.
- Rating agencies, banks and other lenders typically treat a convertible as debt and do not ascribe full value for equity treatment.
- Ability to redistribute this supply of shares is a key criterion in choice of book-runner. A convertible issue has to be set in the context of the ordinary share register and significant equity demand must be identified to mitigate this.
- And last and probably not least, the fees charged (about 2%) with no firm underwriting (open price, coupon range, size and the like). The green shoe is a further free option to the managers.

HEALTHY SCEPTICISM. Convertibles can provide a fresh inflow of competitively priced, low (tax deductible) coupon funds providing increased financial flexibility in times of an uncertain operating environment or increased firepower at a cyclical low point of the asset cycle. Convertibles increase the diversification of funding sources and often extend the shareholder base. In the right circumstances convertibles are a great product, particularly when a company would otherwise issue straight equity.

However, the product is not always marketed for the right reasons and we would encourage treasurers and finance directors to be healthily sceptical.

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