# THE FAST EVOLVING CONVERTIBLE BOND MARKET

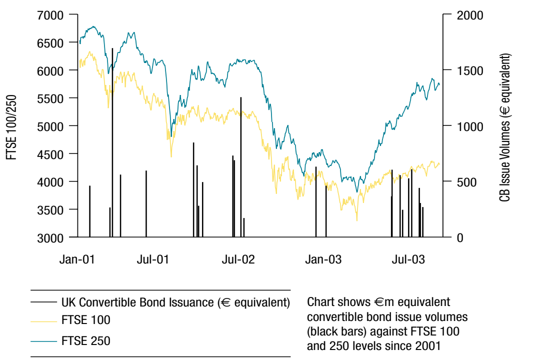
OVER THE PAST THREE YEARS UK FIRMS HAVE INCREASINGLY TURNED TO THE CONVERTIBLE BOND MARKET FOR FUNDS. SO WHAT ARE THE ATTRACTIONS? **SG CORPORATE & INVESTMENT BANKING** GIVE AN OVERVIEW.

The convertible bond (CB) markets are nothing new to UK companies. The benefits of CB issuance are well-known: low interest costs and equity issued at a premium. However, there was a time when plain vanilla convertible bonds were a company's only equity-linked fund-raising choice, and fears of dilution and loss of shareholder value dominated UK plc's perception of CBs. Over the past three years the UK convertible market has evolved tremendously in the issuer's favour, both in terms of attractive pricing and flexibility of structure.

**A GROWING SOURCE OF ATTRACTIVE CAPITAL.** Over the past three years capital has been hard to come by for UK businesses. Difficult markets have meant that investor demand for equity capital raisings has been weak, and there has been little appetite from companies to raise equity at (a discount to) historically lower valuation levels. In this environment, UK plc has rediscovered CBs as an attractive fundraising route.

**PACKED WITH ATTRACTIVE FEATURES.** The equity-linked market today is very much a seller's domain. We are entering a period that will see many outstanding CBs maturing, and investors are losing opportunities to invest in paper with interesting equity sensitivity. As a result, companies are able to derive benefits from this market that were not available at the beginning of 2001. Today's CBs are packed with features to the issuer's advantage, including:

FIGURE 1
**UK CB ISSUANCE SINCE 2001**




*Source: SGIB*

- Issuers can choose to structure a CB as an instrument very close to debt (option to 'convert' into cash equivalent of share value) or close to equity (option to 'redeem' debt with shares to the value of par).
- Issuers consistently raise capital above 5% of outstanding shares (plus premium). The pre-emption limit has become flexible for equity-linked issuance.
- It is now possible to achieve a level of 'equity credit' from rating agencies, through the structuring of 'hybrid' equity-linked products.
- Issuers are beginning to adopt derivative overlay structures on European CBs. This enables the issuer to achieve a much higher premium for marginal extra yield cost.
- Finally, and most importantly, investors are willing to pay much higher value today for a CB issue. For the issuer, this translates as lower yields, higher premiums and a willingness to accept more tailored structures.

In addition to these CB developments, the evolution of the wider market has made CB issuance an obviously attractive choice. Historically low interest rates and credit spreads have combined with high equity volatilities – the perfect climate for CB issuance.

Against this background, a wide range of UK companies have successfully raised capital on the equity-linked markets (see *Table 1*).

**WHY RAISE EQUITY-LINKED CAPITAL?** First and foremost, CBs achieve significantly lower yields than 'straight' debt. Investors 'pay for' the conversion option by accepting a lower coupon – sometimes up to 300bps lower than, say, the same company's Eurobond or US private placement debt.

As CBs address a broad demand pool, issuance is an easy and effective method of achieving a wider investor base. Demand comes from equity funds, fixed income, CB-dedicated investors and hedge funds, and is now spread across Europe, including London and US offshore. For a company that has recently raised equity, for example, or has several straight bonds outstanding, the CB market can represent a source of as yet untapped funds.

Executing a CB is comparatively straightforward. Many bonds today are issued within hours of banks being mandated, and tend to launch and price on the same morning. We rarely see any roadshows or sustained marketing, and management time requirements are kept at a minimum.

The charge most often levelled at CBs is that there is a danger of equity dilution. This was mostly true before the recent evolution of the market, but nowadays the issuer has a range of options to retain control over this process, such as:

- High premium CBs, coupled with derivative contracts between issuer and bank, can require stocks to rise considerably before conversion is feasible. SG CIB this year issued a convertible for Alcatel with a 100% premium – the European record to date.
- The yield savings on a CB versus a comparable straight bond are today so attractive that a CB is often the more earnings per share (EPS) enhancing structure, even allowing for new share issuance.
- As above, 'conversion' can be achieved through cash equivalent, if desirable.

These have all been key factors in the recent acceleration of the UK convertible market.

**WHO SHOULD CONSIDER CONVERTIBLE BOND ISSUANCE?**
*Figure 1* shows that despite the vicissitudes of the equity markets since 2001, UK companies have consistently accessed the equity-linked investor base as a source of attractive long-term capital. There have been 26 UK convertibles since 2001, raising a total of more than €14bn (£9.6bn). This market has successfully been accessed across all sectors, and has provided UK firms with significant capital in sterling, euros and US dollars. Now the market is fully developed within the UK, funds are available to any plc with a market cap of more than $1bn (£599.5m). A CB is an attractive source of funds in almost any situation, but especially so as acquisition finance, given the short/flexible execution timetable.

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*The ACT Convertible Bonds Symposium, Thursday 11 December, 6pm-8pm, at One Great George Street, London SW1P 3AA.*

*The ACT has teamed up with SG Corporate & Investment Banking's convertible bond advisory specialists to give a symposium which will address the key points of interest for UK treasurers. Emphasis will be placed specifically on earnings per share (EPS) management and achievement of excellent terms.*
*Brian Barker, Group Treasurer of Hilton Plc, has kindly agreed to speak on why Hilton chose to issue a CB in September 2003, and what he sees as the pros and cons for Hilton versus different capital raising instruments. After the presentation there will be a Q&A session with SGCIB's convertible professionals.*
*For further details, please call Makayla Rahman on 020 7213 0703 or visit www.treasurers.org/events.*

## TABLE 1
## UK CONVERTIBLE BONDS 2001 TO DATE

| Issuer (underlying if different) | Total issue amount (€m) | Launch date | Currency | Issue premium | YTM | % of market cap | S&P rating | Underlying sector |
|---|---|---|---|---|---|---|---|---|
| BP Finance (Lukoil) | 456 | Jan 2001 | $ | 23.8% | 3.00% | 4.02% | AA | Resources |
| Woodstock-Dixons (Wanadoo) | 260 | Mar 2001 | € | 20.0% | 1.00% | 2.53% | None | Technology |
| Cable & Wireless (Pacific Century Cyberworks) | 1690 | Apr 2001 | $ | 17.0% | 0.00% | 5.79% | A | Telecoms |
| Old Mutual Finance | 555 | Apr 2001 | $ | 29.3% | 3.63% | 5.15% | None | FIG |
| South African Breweries | 591 | Jul 2001 | $ | 20.6% | 4.25% | 7.38% | None | Retail/Leisure |
| Legal & General | 843 | Nov 2001 | £ | 30.0% | 2.75% | 4.99% | AA | FIG |
| Carlton Communication (TMM) | 638 | Nov 2001 | € | 30.3% | 2.25% | 4.22% | BBB | Technology |
| Corus | 275 | Dec 2001 | € | 30.0% | 4.75% | 6.73% | BBB | Capital goods |
| United Business Media | 488 | Dec 2001 | $ | 24.4% | 2.38% | 14.29% | BBB | Media |
| WPP | 726 | Mar 2002 | £ | 45.0% | 3.00% | 3.65% | A | Media |
| BAA | 684 | Mar 2002 | £ | 20.1% | 2.94% | 5.18% | AA | Transport/logistics |
| Anglo American | 1250 | Apr 2002 | $ | 35.0% | 3.38% | 3.34% | None | Resources |
| Aegis | 165 | Apr 2002 | € | 30.0% | 3.88% | 5.98% | None | Media |
| Man Group | 626 | Nov 2002 | £ | 32.0% | 3.75% | 10.05% | A | FIG |
| Friends Provident | 455 | Dec 2002 | £ | 30.0% | 5.25% | 6.28% | AA- | FIG |
| Cable & Wireless | 360 | Jun 2003 | £ | 48.0% | 4.00% | 7.45% | BB | Telecoms |
| Scottish Power | 599 | Jun 2003 | $ | 25.2% | 4.00% | 8.12% | Baa1 | Utilities |
| 3i Group | 550 | Jul 2003 | € | 45.0% | 1.38% | 7.21% | A+ | FIG |
| International Power | 239 | Jul 2003 | $ | 50.0% | 3.75% | 7.41% | BB | Utilities |
| Xstrata | 521 | Aug 2003 | $ | 39.6% | 3.95% | 15.55% | None | Resources |
| BAA | 603 | Aug 2003 | £ | 20.4% | 2.63% | 6.96% | A+ | Transport/logistics |
| Hilton Group | 435 | Sep 2003 | £ | 30.5% | 3.38% | 7.31% | BBB | Retail/leisure |
| LogicaCMG | 300 | Sep 2003 | € | 50.0% | 2.88% | 7.53% | None | Technology |
| EMI Group Finance | 264 | Sep 2003 | $ | 40.0% | 5.25% | 12.23% | BBB- | Media |
| Lonmin | 189 | Sep 2003 | $ | 30.2% | 3.75% | 7.64% | None | Resources |
| Liberty International | 343 | Sep 2003 | £ | 19.7% | 3.95% | 10.00% | None | Real estate |
| Average | 542 | | | 31.39% | 3.27% | 7.19% | | |
| Total | 14,104 | | | | | | | *Source: SGIB* |