Small growth firms stage a comeback in Europe

Katie Darby and Simon Eagles of WestLB Panmure expect sub-investment grade issuers to become the predominant issuers in the European convertibles market.

Convertibles have become a common funding tool in Europe, with issuance for the past year being in excess of €31bn. But unlike the US market, European issuance has been focused on investment grade issuers, with only 10% of this issuance coming from the sub-investment grade sector. The domination of the market by investment grade issuers has been investor driven as fixed income funds have attempted to achieve improved returns in a low-yielding environment without having to invest in weaker credits.

With this backdrop of large, liquid issues for easy-to-understand credits with well known equity stories, the smaller growth firms have found it difficult to attract investors' attention. But as interest rates rise and the expected returns in the equity markets fall, there is less need for fixed income funds to bridge the returns gap. Accordingly, over time we expect sub-investment grade issuers to become the predominant issuers in the market.

Why issue convertible bonds? – the theory

Growth companies have three principal instruments with which to raise second stage finance: equity, convertibles and high-yield bonds. We recognise it is difficult for issuers to be able to judge the merits of the different instruments relative to each other. Therefore we conduct an analysis for our clients that looks at the cost of capital of each for a given future share price performance. We assume that the issuer refinances each instrument in five years.

The results vary depending upon the underlying business and the structure of the various instruments. Figure 1 shows, in general, our results for sub-investment grade growth companies.

FIGURE 1

Analysis results: Sub-investment grade growth companies

Share price performance over five years	Optimal funding
Increase more than 75% (11.8 pa)	High yield
Increase 15% to 75% (2.8 to 11.8% pa)	Convertible
Increase less than 15% (2.8% pa)	Equity

For established, old economy issuers in a low inflationary environment, growth of 12% a year would appear aggressive. Convertible bonds offer this type of issuer their cheapest form of finance.

Most growth companies, however, would expect their share price to increase by significantly more than 12% a year, and accordingly high yield is their optimal instrument from a mathematical perspective. Equity is a growth firm's most expensive form of funding, for example, assume the company buys an asset for £10m with equity and that the equity then doubles over the next year. The true cost of that asset is £20m (plus dividends paid on the equity) and not the £10m originally paid.

Assume that the issuer had paid for the asset with a bridge loan yielding a high yield rate of interest, say, 15% and is then refinanced with equity after one year. The total cost would be £11.5m, being £1.5m in interest, plus £10m in equity.

A convertible bond falls somewhere between the two alternatives. Whereas a convertible is not cheaper than high yield if the aggressive share price growth assumption holds true, it is often the favoured funding instrument in practice.

If the shares do not perform sufficiently, the bond may need to be redeemed at a time when potentially the growth company has limited refinancing alternatives.

Of comfort at least is that 80% of convertibles issued have been converted. The potential redemption liability may be a disincentive to those issuers with uncertain cashflows when comparing the product against equity that is perpetual in nature. However, even if the convertible needs to be redeemed, it has in the meantime been more cash preserving that high yield.

Further comfort is provided by the fact that the convertible structure has an in-built debt equity swap, which allows the issuer to force the bond into equity by unilaterally increasing the conversion ratio.

Why issue convertible bonds? – the practice

When considering a convertible issue, management will decide its merits relative to an issue of equity or high yield bonds. In addition to the theoretical basis for issuing convertible bonds, we have found that in practice management is also driven by other factors.

Advantages over an issue of equity

- **The dilution argument –** In many growth companies, management and founder shareholders own majority stakes. They are often highly focused on avoiding any unnecessary dilution and on maintaining voting control. By issuing equity at a premium, they suffer less dilution than would be required to raise the same amount through an equity issue. In addition, because the shares underlying the bond do not exist prior to conversion, there is no dilution of voting rights for several years.

Even then, the ability to incorporate

a cash-out option (whereby upon conversion the issuer has the option to deliver the cash equivalent of the value of the underlying shares) allows for the potential of no voting dilution. This was the driving force when EM.TV, a German media company, issued its €400m convertible bond earlier this year.

- **Equity price level –** Management does not like issuing equity at a price below the level of a preceding fundraising. A convertible bond with its conversion premium can result in a conversion price that shareholders are happy with.
- **Equity price pressure –** Equity issues tend to put pressure on the equity price, reducing the funds raised per share and increasing dilution. Our calculations are that equity prices tend to fall on average by over 10% on the back of an equity issue. This figure is on average less than 1.5% for a convertible issue. A good example of the effect on the share price is demonstrated by the BAe part disposals of Orange. In March 1998, BAe sold about $1.3bn and the Orange share price fell by 9.3%. Conversely, when in June 1999 BAe raised a similar amount via an exchangeable bond, the effect on the Orange equity price was negligible, falling by only 1.03%.
- **Expresses confidence –** By issuing a convertible bond, management therefore expresses its confidence in the future performance of the equity. Because the conversion option is fixed at a premium to the current share price, the bond will only convert if the equity performs well.
- **Widens investor base –** Convertible bonds are issued to a new investor base primarily consisting of fixed income and dedicated convertible investors. Equity investors would typically take less than 20% of a new issue. In addition, the geographical spread of investors is much wider than a typical growth firm's equity base. For a typical European convertible, we would expect the following breakdown: the UK 35%, France 15%, Switzerland 15%, Germany 10%, Italy 8%, Benelux 7%; and the Rest of Europe 10%.
- **Equity market closed –** The equity market is not always receptive to a new issue of equity. The convertible market does not tend to completely close and it is possible to issue a convertible in all but the very worst of market conditions. For example, during the recent market volatility four convertibles were launched in Europe, raising €3.84bn in aggregate.

Advantages over an issue of high yield debt

- **Lower cash cost –** This tends to be a key factor when choosing convertibles over high yield. A convertible has a lower coupon and the conversion feature reduces the redemption likelihood. For example, Colt Telecom, the UK telecoms provider, issued two seven-year bonds at the same time in December 1999. The bonds ranked *pari passu*, with the high yield bond having a coupon of 7.625% and the convertible having a coupon of 2% and being callable after four years. Assuming the share price performs and the call forces conversion, the total cash cost per €100m nominal raised of convertible will be only €8m. Conversely, the cash cost associated with €100m of high yield will be €153m over its life.
- **Larger issue size –** The size of a convertible bond offering is determined by the growth prospects of the underlying business. In addition to good growth prospects, high yield requires an improving credit story. This means the convertible market can accommodate a larger fundraising than high yield. For example Kamps, the German bakey company, raised €340m of zero coupon convertible and only €250m of 8% high yield.
- **No rating –** Convertibles do not need the rating required for high yield debt. This is exemplified by EM.TV's unrated €400m issue.
- **No US offering –** There is sufficient demand from European investors for even the largest convertible bond offerings. For example, only five of the 15 largest convertibles (€1bn-plus) had a US tranche. This allows the relatively lean management structures of many growth companies to avoid the expensive and time-consuming hurdles required to issue high-yield debt – a 10-b-5 legal opinion to sell bonds to US investors under Rule 144A and accounts restated in US GAAP.
- **No onerous covenants –** Convertible bonds allow growth firms to grow their business unfettered by restrictive covenants usually required for high yield.

> The size of a convertible bond offering is determined by the growth prospects of the underlying business

Advantages over both an issue of equity and high yield debt

- **Potential for frequent fundraisings –** Over the life of a convertible, as the share price performs, convertibles trade as quasi equity with none of the original bond-like characteristics. The original fixed income and convertible investors constitute a 'fan club' of investors in the company that can no longer hold the bond. Accordingly, they are receptive to a new issue. The benefits are evidenced by issuers such as Colt Telecom and Infogrames, the French software distributor, which have both visited the convertible market four times within 18 and 24 months respectively.

Conclusion

Convertible bonds provide flexible long-term funding for growth companies. While in analytical terms debt provides growth companies with their cheapest cost of capital and equity with the most expensive, in reality other factors influence the choice of instrument. Convertibles are often chosen because of their lower coupon cost, lower probability of redemption, more flexible covenants, simpler issuance procedure, and the availability of larger issue size. The issue of dilution often drives issuers towards convertibles rather than equity. ■

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