Convertibles: a corporate perspective

Treasurers have an important role to play in determining the future of the European equity-linked market, says Robert McAnally of ICI.

Convertible bonds – generally referred to as equity-linked debt – have been used as an alternative means of raising capital for several decades. The US, as in other areas of the capital markets, has led Europe in issuance levels of equity-linked products and in diversity of products within the asset class.

European issuance of equity-linked products has grown over the last five to 10 years reaching record levels in 1999. This recent increase has been partly fuelled by new economy firms seeking alternative means of accessing the capital markets. In addition, proposed changes in German tax legislation concerning the treatment of capital gains on long-term holdings has resulted in a spate of issuance from German firms looking to dispose of minority holdings. This year these include, the €1bn exchangeables issued by Allianz into Siemens and Munich Re into Allianz. The use of exchangeables has allowed these companies to monetise their stakes while deferring capital gains tax.

In contrast to the US market, European issuance of convertible debt has come principally from investment grade firms and has largely been restricted to vanilla instruments. This is expected to change as a result of increased capital market activity and greater reliance on public debt over bank debt due to banks diverting capital to more profitable revenue sources.

One of the attractions of the equity-linked market is the ability to structure a product to meet the individual requirements of a firm. Unfortunately for European firms, the equity-linked market can appear impenetrable due to the wide variety of products presented by investment banks and the acronyms that are used to differentiate each bank's product.

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Characteristics of equity-linked products

Despite the many products available, their characteristics can generally be defined by their 'proximity' to debt or equity. *Figure 1* depicts the after-tax funding cost of several different equity-linked products.

Products range from mandatory convertibles (not shown on *Figure 1*) which exhibit equity-like characteristics to a zero coupon convertible which behaves similarly to debt, albeit with a different payment profile.

Original issue discount (OID) convertibles pay a below market coupon and are issued at a discount to provide a higher yield to maturity than conventional convertibles. In their extreme form, zero coupon convertibles pay no coupon and are issued at a deep discount. The maintenance or 'running cost' of a mandatory convertible is much higher than a conventional convertible due to the lack of downside protection afforded to the investor. In comparison, a zero coupon convertible pays no interest to the investor, but is accounted for as debt until converted. Consequently, the after tax funding cost reflects the yield-to-maturity of the convertible, rather than the cash cost.

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The effective conversion premium of a zero coupon convertible increases with the accreting value of the bond, making conversion much less likely than conventional convertibles. Therefore, a zero coupon convertible requires a higher share price compound annual growth rate (CAGR) for conversion to occur.

Variations of these vanilla products include:

- mandatory convertibles, where the number of shares the bondholder receives upon conversion depends on the share price performance; and
- convertible preferred stock issued out of offshore limited liability companies (or trusts) designed to achieve equity credit by the rating agencies while still receiving tax-deductibility on payment of preferred dividends.

Nevertheless, the basic characteristics shown above are endemic to many equity-linked debt products and enable corporate treasurers to determine which equity-linked products suit the financial profile of the firm.

Motivation for issuance of equity-linked products

The decision by corporates to use equity-linked debt for capital funding purposes instead of debt or equity, is

often driven by a number of conflicting constraints. For some companies, it may be the only means of accessing the capital markets.

This may certainly be the case for smaller, less mature, high growth firms with cash constraints. A convertible lends itself to the characteristics of this type of company due to its relative neutrality to changes in the risk associated with the issuing firm. Due to their hybrid nature, convertibles are less sensitive to the risk of the issuing firm, because the increasing risk of the debt component is offset by the equity component. Therefore, a convertible may be better suited to the cash-flow pattern of a rapidly growing company, as the lower running cost presents the firm with a lower probability of default than straight debt. Other benefits of equity-linked debt for rapidly growing firms include access to a broader investor base and less restrictive covenants than straight debt.

One aspect often overlooked by issuers of equity-linked debt, is the role it plays in mitigating conflicts that arise between shareholders and bondholders. These conflicts, or agency costs, arise as a result of the potential for managers to increase the risk profile of the company through investment decisions more geared to shareholders interests than bondholders.

Convertibles provide a dual role of reducing the funding cost of future investments while allowing bondholders to participate in the additional revenue created from successful investments by converting into the underlying shares.

For more mature (investment grade) corporates, the decision criteria changes. Funding cost certainly plays an important role when considering funding mechanisms. Access to the debt or equity markets is not usually an issue, although ambitious investment or acquisition plans may lead to potential financial distress that could be avoided by investor diversification. Due to the capital-intensive nature of certain industry sectors such as telecoms, bond markets can sometimes become swamped with paper. The equity-linked market can provide a ready alternative to the debt markets and can often be used to refinance outstanding debt while delaying the impact of earnings dilution.

The convertible debt market also provides an efficient means of raising capital when timing is critical in merger and acquisition-type transactions.

Corporate treasurers are generally required to manage the funding requirements of firms according to financial policies prescribed by the board. These policies specify the framework within which the treasurer operates. One of the key criteria in dictating treasury policy is the firm's target credit rating. Ratings agencies place a great deal of importance on ratios, such as funds from operations/average net debt, which highlight a firm's ongoing ability to generate sufficient earnings to meet its financial obligations. Specifying a credit rating allows a

FIGURE 1

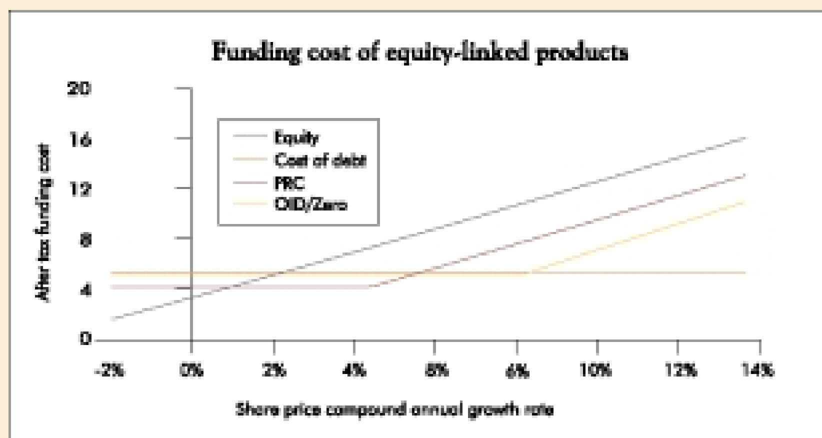

FIGURE 2

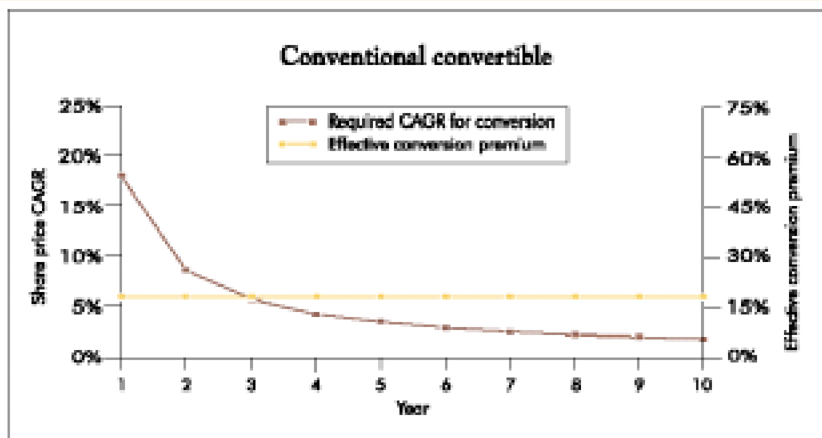

FIGURE 3

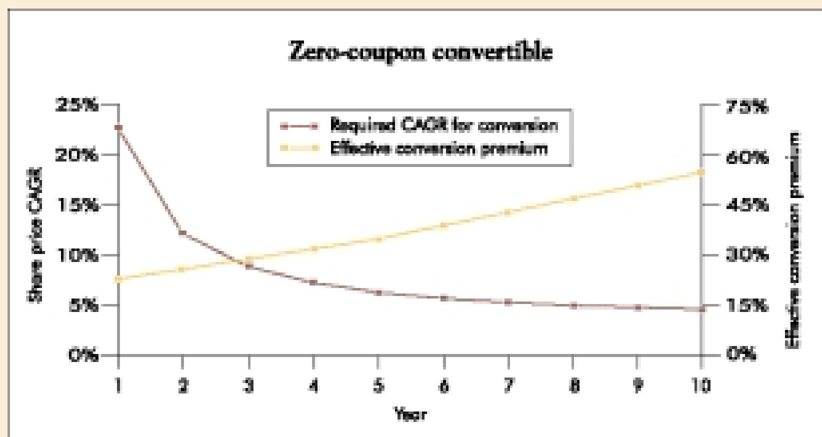

TABLE 1

The impact of equity-linked products shown previously in relation to straight debt and equity.

Structure	Debt	Zero-coupon CB	OID CB	Conventional CB	Equity
Accounting/ covenant treatment	Debt	Debt	Debt	Debt	Equity
Tax efficiency	✓✓✓	✓✓	✓(✓)	✓	✗
Initial servicing cost: cash	✗	✓✓✓	✓✓	✓	✓✓
YTR	✗	✓	✓✓	✓✓✓	N/A
Fully diluted EPS	✓✓✓	✓(✓)	✓(✓)	✓	✗

Note: YTR – Yield To Redemption

company to build a financial profile based on key ratios within which it can operate. This allows the treasurer to maintain financial flexibility and enables companies to absorb financial shocks or to finance acquisitions as opportunities arise without imposing financial distress.

While few equity-linked debt products receive significant equity credit by rating agencies, the flexibility they provide treasurers in managing a firm's capital structure is well recognised. The call provisions built into many convertible products enable treasurers to call the bond and force conversion early.

A recent innovation in the equity-linked market is the addition of a cash-out option. Under the cash-out option, conversion can be pre-empted by a cash payment of equivalent value to the convertible bond. The cash payment is economically equivalent to the automatic repurchase of shares at market price. The cash payment should generate a tax deduction on the difference between the cash amount and the par value of the bond at that time. Investors are generally not price sensitive to the cash-out option so it is sensible that corporates build this valuable cost free option into their documentation.

Judicious use of cash-out out options in conjunction with call provisions allows the treasurer to alter the firm's capital structure and communicates the managements continuing commitment to maximising shareholder value.

Convertibles can also often be used by heavily geared corporates to manage debt covenants.

Traditional convertibles are sub-ordinate to bank debt and normally have weaker or no financial covenants. More importantly banks may be prepared carve out interest payments and the financial liability of convertibles from interest cover and gearing tests provided that the convertible debt matures beyond the bank debt.

From *Table 1* it should be clear that there is no simple rulebook from which corporate treasurers can choose, because the appeal of different equity-linked products will depend on the specific circumstances of each company. A phrase often used by corporate treasurers is "convertibles are debt when we want equity and equity when we want debt".

With the breadth of instruments now available in the equity-linked arena, it is usually possible to find a product that meets the immediate and ongoing requirements of the organisation.

The future of the European equity-linked market

For corporate treasurers, the equity-linked market provides a means of investor diversification. This is becoming increasingly important in European capital markets. Increased market activity due to merger and acquisition transactions, disposals of non-strategic shareholdings, and the need for the telecoms industry to fund the purchase of 3G licences, has changed the demand/supply equation of both the debt and equity capital markets.

> Treasurers and investment banks both have a role to play in determining the future for the European equity-linked market

This activity has pushed bond spreads to levels last seen during the LTCM crisis in the fourth quarter of 1998.

While debt and equity capital markets remain accessible to most firms, the value objective of minimising funding costs will drive treasurers to look outside traditional markets for funding. Within the next few years it is entirely possible that the equity-linked market in Europe emerges as a separate asset class. The investment banking community has significantly increased the staffing of its structured product desks to meet the anticipated demand for this type of transaction.

The treasurer's role

Treasurers and investment banks both have a role to play in determining the future for the European equity-linked market.

Treasurers cannot afford to ignore a product, which in many cases is able to meet the funding requirements of the firm, comply with corporate policy, diversify the existing investor base and offer the financial flexibility to manage the capital structure of the firm.

Equity-linked products do impose additional responsibilities on treasury departments. Treasuries need to be able to enter the trade into their treasury management systems and ensure the accounting treatment, which can often be very different to the cash impact, is correct.

With many products containing call provisions, it becomes essential to monitor the performance of these products to determine if it is optimal to exercise these options. Treasurers must ensure that the firm's treasury systems are capable of performing these functions.

Investment banks must recognise these constraints and take the time to tailor products to meet individual needs so making the funding, tax and accounting advantages of such instruments readily apparent. ■

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