# Investor demand driving European convertibles

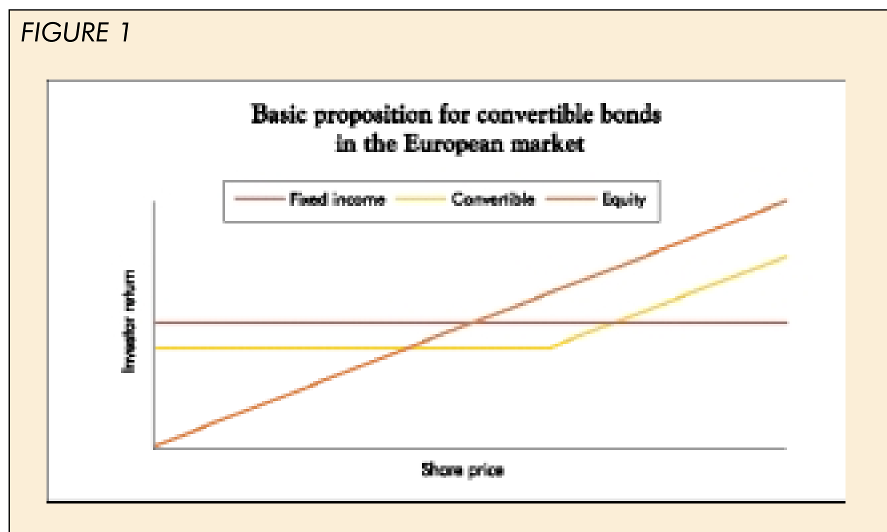
Daniel Palmer of Morgan Stanley Dean Witter discusses the huge growth in European convertible bonds and the reasons for the demand in this capital market.

The European convertible market has grown dramatically over the past five years. The level of annual issuance has increased from $9bn in 1995 to nearly $30bn in 2000. The size of new issues is also significantly greater now, with nine separate $1bn-plus transactions so far this year.

The main driver of this growth has been investor demand. The number and size of investors actively looking to put money into European convertible bonds has led to a significant re-rating of the entire market. Theoretical valuations, and therefore achievable new issue terms, have improved markedly and this has encouraged corporates to access the market, many for the first time.

The liquidity and depth that has developed means that convertibles now represent a significant capital market in their own right.

FIGURE 1




***Redeemable convertibles and exchangeables***

Although there are numerous structural alternatives available, the basic proposition of 98% of all convertible bonds in the European market is the same: if the share price of the underlying company goes up, you share in the gain and, if it goes down, the bonds are redeemed and you get your money back. This sounds like a great deal for investors, but there are two costs of this attractive combination of features:

- although investors can get their money back, they receive a relatively low coupon on their money during the life of the bonds; and,
- if the share price does go up, investors miss out on the first part (typically about 25%) of its performance.

The return on a convertible bond is a familiar shape as its dependence on share price performance is that of a straightforward call option (see *Figure 1*). For this reason, the theoretical valuation of convertibles relies on option theory and is undertaken using numerical models that are very similar to those used to value other derivatives. However, unlike a call option, the cost of exercising a convertible is paid up-front. This affects the value of the option, but more importantly it means that a significant part (typically 85% at the time of issue) of the value of a convertible is derived from the underlying bonds and therefore on the credit standing of the issuer. Most issuers that tap the market are attracted by the very low financing costs that are achievable. Typically, companies save around 3% on their normal borrowing costs by adding a conversion feature. Equity dilution is an issue, however, for companies that feel their share price is fairly valued, giving investors the right to buy shares 25% above that level is usually easy to defend.

> The number and size of investors actively looking to put money into European convertible bonds has led to a significant re-rating of the entire market

For growing companies, that intend to issue further equity in due course, a convertible can also be used as a way to signal management's expectation of future share price appreciation.

Between a half and two thirds of annual European issuance is in the form of primary convertible debt: bonds issued by a company that can be converted into new shares of the same company. The remainder is exchangeable debt, where the bonds are issued by one company but are convertible into the shares of another. These instruments are used by corporates as a way to monetise large shareholdings. For investors, the two alternatives are very similar and they trade alongside each other on the same basis in the secondary market.

From an issuer perspective an exchangeable bond has several particular attractions. In most jurisdictions, capital gains tax is only levied at the time of exchange and therefore using an exchangeable bond allows a holding to be monetised now, but for tax to be deferred for several years.

An exchangeable bond also provides low cost finance without the disadvantage of possible dilution for shareholders of the issuer.

However, arguably the major reason why exchangeables are issued is that they provide an exit (or at least a good chance of an exit) from a previously strategic holding without the negative signalling associated with an outright sale of shares.

It is for this reason that the instrument has been used so widely in continental Europe to raise financing whilst also unravelling the complex web of cross-holdings that, in many cases, have been in place for decades.

### Drivers of demand

The largest inflow of money into the European convertible market in recent years has been from fixed income funds. This is part of the overall trend of, what have historically been bond-oriented investors in Continental Europe turning to equity markets.

In this change, the convertible market is a natural stepping stone, as it allows exposure to equity performance while also providing a familiar bond-like minimum return.

The impact that fixed-income investors have had on the European convertible market can be understood by comparing the size of the two markets.

Annual issuance in the straight debt market in Europe is approximately $800bn per year, more than 26 times the level of issuance in the convertible market. It is the diversion of probably only a small part of this straight debt market to convertibles over the past few years that has enabled the dramatic growth in convertible new issue volumes coupled with a dramatic re-rating of secondary market valuations.

There has also been growth amongst dedicated convertible funds. These are split between outright accounts, which often manage funds on a discretionary basis for private clients, and technical funds that invest, usually on a leveraged basis, to gain exposure to the option characteristics of convertible bonds. These technical funds use a variety of methods to hedge convertible positions, by trading in the underlying shares and other related derivatives.

### Accounting treatment

Redeemable convertibles are treated as straight debt until the time of conversion under UK, US and most European GAAP. On conversion, the book cost of the bonds is transferred to the equity account as a new issue. In the profit and loss statement, the low cost of debt is booked as interest expense, which is mainly earnings enhancing for basic EPS.

Depending on the conversion price achieved, the\ calculation of fully diluted EPS can sometimes result in earnings dilution as it assumes that the bonds are converted immediately and the low-interest cost is reversed out.

Under international accounting standards, convertibles are treated differently. Here the equity option component of the bonds is valued at the time of issue and separated from the debt component. The equity portion is taken straight to the equity account, whilst the bonds are accounted for as straight debt until conversion. The result is therefore less flattering to basic EPS than under other accounting regimes. Under US GAAP, accounting for redeemable exchangeable bonds falls under FAS 133, which requires that these are both treated as derivatives and marked to market through the profit and loss statement.

Importantly, US GAAP does not allow exchangeables to be set against the shares that underlie them (which are often held at cost), leading to some unusual accounting results. UK and most European GAAP treat exchangeables as debt until the time of conversion, as did IAS until this year. However, IAS 39, which is due to be implemented in 2001, is set to impose a US-style mark to market accounting treatment on exchangeable bonds.

### Credit rating agency treatment

Although convertibles are equity hybrids, the money-back guarantee of a redeemable convertible means that it turns into debt when a company most

## Common convertible structures

### Conventional structure

- A conventional convertible bond is issued at 100% of par and redeemed at maturity (if not already converted) at the same price.
- The conversion price is fixed at a premium to the share price at the time of issue. This is used to calculate the fixed number of shares delivered on conversion throughout the life of the bonds.
- Depending on the balance struck between the coupon and premium of the structure, the bond can be more equity-like (low coupon, low premium) or more debt-like (high coupon, high premium).
- This is the most straightforward structure and arguably the most popular for investors as it provides a high running yield.

### Premium redemption structure

- This bond is issued at 100% of par and redeemed at a premium to par at maturity. The accreting nature of this structure means that the cash coupon is lower than the yield to maturity.
- As the underlying redemption value of the bonds increase over their life, the effective conversion price also rises. This is because investors would forgo any interest accrued but unpaid on conversion.
- To compensate for the higher conversion premium, investors demand a higher yield on a premium redemption bond. This results in a more debt-like structure which appeals to fixed income funds.

### Zero coupon structure

- The logical extreme of the premium redemption structure is when the coupon on the bond is taken to zero. This is achieved by raising the redemption amount which further accentuates the accretion effect.
- The resulting instrument has a relatively high effective conversion premium and a low probability of conversion. This structure is characterised by a very high bond content. ■

needs equity. For this reason, from a credit perspective, convertibles are treated as debt until the time of conversion. Similarly, exchangeable bonds are treated as debt until the time of exchange. There are convertible structures that provide a degree of equity credit. Although these are widely used in the US, where convertible investors are more equity-oriented, they have not been widely accepted amongst bond-oriented European investors because:

- convertible preferred share issues typically receive 40-60% equity credit from the rating agencies. Economically, they are similar to redeemable convertible bonds, however, they rank lower in the capital structure of the issuer and have significantly longer maturities (20 years or more); and
- mandatory convertible bonds do not have a cash redemption feature so that, regardless of share price performance, they are converted into shares at maturity. This certainty of equity issuance allows mandatory convertibles to receive 50-80% equity credit from the rating agencies. To encourage investors to buy mandatory convertibles they typically carry of high coupon of 6% plus.

### *Structural innovations*

The strength of the European convertible market in recent years has allowed considerable scope for innovation around the redeemable structure. Recent developments include:

- embedding complex options which give the investor the choice of stock into which the bond converts;
- reducing the coupon and yield to maturity of the bonds, to zero in some cases;
- increasing conversion and exchange premia to untested levels (the highest in Europe being over 50%); and,
- concurrent offerings of equity and convertible bonds (and high yield debt in a number of cases).

As with all innovation and structural changes, not all of these have been popular with investors and some have had unforeseen consequences.

### *Future drivers of European issuance*

Attractive valuation levels alone have led a number of companies to access the convertible market over the past few years. But there are several other generators of new issuance. Exchangeable bonds have already been used extensively across Europe to manage the sale of previously strategic cross-holdings. However, the value of remaining stakes far outweighs the issuance to date, suggesting that this source of new issuance is set to continue for several years. The high level of M&A activity in Europe has also generated new issue activity. Most issuance to date has been by acquirers raising funds to pay for cash acquisitions. But new issuance has also resulted from share for share transactions where corporate recipients of shares have used exchangeable bonds to monetise these positions.

In the US convertible market, the majority of issuance is by TMT companies raising funds for growth. This has been a small but fast-growing segment of the market in Europe. Although this has slowed with the recent correction in TMT stocks, this remains a significant medium to long-term driver of convertible issuance in Europe ■

*Daniel Palmer is Managing Director, Head of European Convertible Origination at Morgan Stanley Dean Witter.*

*Daniel.Palmer@msdw.com*
*www.msdw.com*