# Hybrids and convertibles

While the financing principles of debt and equity finance are readily understood by treasurers, the hybrid/convertible form of finance can often appear as a black art. Relative to straight debt markets they still only represent about 5% of European debt issuance. Many factors have held them back as financing product; the opacity of accounting treatment; the risk of the product not being fully tax deductible; the variety of products available; finding common ground between investor and issuer; or even the difficulty of explaining the full implications of such financings to PLC Boards. That said, the European convertible market has trebled in size in the past five years and there is every reason to believe that convertibles will become a much larger proportion of UK PLC's balance sheet.

The objective of this Spotlight is to remove the mystique of the product so that the treasurer is an informed buyer of convertibles from the sophisticated marketeers of such financial products. For those readers who are new to the principles of the convertibles products then please refer to the Treasury Essentials article on page 26.

Accounting treatment for convertibles can be crucial to their applicability. **Nigel Dealy** of PwC helps to explain how the two key accounting standards FRS 4 and 5 interact and in addition provides some practical hedging advice on convertibles issued in a foreign currency. His colleague **Mohammed Amin** examines the intricacies of convertible taxation which together with Nigel's article hopefully helps us to find the elusive Holy Grail of tax deductible equity.

**Robert McAnally** provides a rare and valuable corporate view on convertibles. He makes the important point that traditional convertibles which convert can obtain full tax deductibility via use of a 'cash out' options. These options can also help manage the debt/equity mix at conversion.

Growth companies are heavy users of convertibles: a remarkable 80% of US convertible issues are sub-investment grade. **Kate Darby** and **Simon Eagles** of WestLB Panmure provide some compelling arguments as to why convertibles are an important source of finance for sub-investment grade issuers and how this US phenomenon is set to grow rapidly in the European markets. **Claude Rieffel** of Barclays looks at growth companies in general and how convertibles can pose significant refinancing risks for bombed out technology stocks.

Our regular journalist, and MCT, **Ulrica Marshall** looks at the Ten Commandments of convertibles. Ulrica provides some critical advice:

- don't underestimate the planning required, and make sure market conditions are right since convertible investors are a fickle lot;
- be mindful that convertibles are always on the hit list for the accounting standards authorities; and
- finding the right price can be fraught for such a unique product – choose your lead bank carefully.

Finally, Morgan Stanley Dean Witter wraps up with two articles. **Danny Palmer** looks at the drivers of demand for convertibles and some of the latest structural innovations. In particular he looks at the growth in jumbo exchangeable bonds and how they can be used by companies as a route to release capital tied up in unwanted equity investment rather than, say, via an IPO. **Piers Harris** and **Andrew Readinger** provide in-depth insights into the rating impact of hybrid instruments and the sensitivity of investors to a variety of funding structures. ■

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