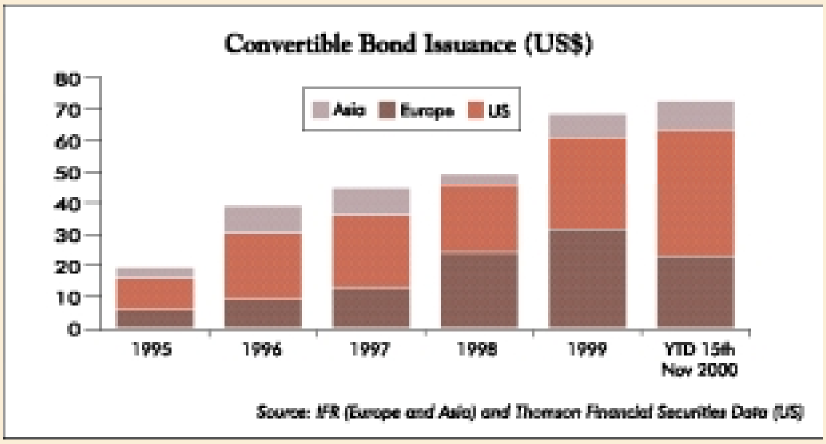
Financing growth the convertible way

Claude Rieffel of Barclays Capital asks whether growth companies can benefit from issuing convertible bonds.

Thomson Multimedia, the fourth largest manufacturer of consumer electronics, launched a €780m convertible bond on 27 September 2000. Maturing on 1 January 2006, the offering will pay an annual coupon of 1% and will have a yield to maturity of 2.75% – which is much lower than what Thomson would have paid on a straight bond. Despite the low coupon, the offer was well received and was significantly over-subscribed, prompting the lead managers to close the book-building process five days early.

The Thomson deal is representative of the growing European convertible bond market, where an increasing number of investors are willing to receive a lower coupon rate in order to have a stake in a company's growth opportunities.

FIGURE 1



Background

The convertible bond market and growth companies have an association that emerged in late 19th century America, when railroad and telephone firms used this financing instrument to fund their expansion. After a long, dormant period, these hybrid securities re-surfaced in the 1970s when investors sought protection from high and unpredictable inflation levels.

Convertibles exhibited continued growth in the 1980s as nascent telecoms and media organisations tapped into this funding source. Issue sizes and the number of deals launched stepped up in the 1990s, with the mushrooming of new economy players.

A recent development is the arrival of infant technology companies that have been skipping the last round of venture capital and tapping the pre-IPO convertible market by launching a hybrid security with a rare feature. That is, a conversion premium that is not predetermined, but is contingent upon how quickly the company goes public. In the US, more than $29.3bn in new convertible bond issues (exclusive of convertible preferred shares) came to market in 1999, significantly surpassing 1998's $21.8bn. In 1999, European convertible issues grew at almost the same pace year-on-year against the US (31% versus 34%, respectively), and totalled the equivalent of $31.7bn against the 1998 level of $24.1bn (see *Figure 1*).

Growing importance in Europe

In Europe, an increasing need for financing growth, acquisition finance and the unwinding of cross-shareholdings has brought about the growing importance of convertible bonds. In addition, favourable market conditions, especially at the beginning of 1999 – low interest rates, good outlook for the equity markets and higher volatility – have allowed the convertible market in Europe to offer real liquidity, attracting more interest from a larger investor base.

Despite a recent slowdown in issuance, technology, media, and telecoms still dominate half the sector, with a 31%, 7%, and 6% share respectively of the market by volume of issues this year. Financial institutions accounted for 23%, followed by consumer and leisure, both at 11% (Source: *Risk Magazine*, October 2000).

While the US convertible market has been characterised by non-investment-grade issuers (about 80% of issues in 1999), the European market continues to be dominated by jumbo issues from investment-grade players such as Mannesmann (now part of Vodafone Group plc), Vivendi, and Roche. In addition, investment-grade convertibles for the US tend to be event-driven, whereas in Europe they are seen as a lower-cost alternative to straight debt.

The European convertible landscape is changing fast, though. Sub-investment-grade issues, which are largely made up of relatively fast-growing companies, now account for 20% of the market, up from 10% last year. This growth trend is expected to continue.

Of European issuers, triple-A credits make up 20% of issues, double-As make up 13%, while single A and triple B credits make up 18% and 29%, respectively. More companies will come to the market as a growing number of investors widen their predominantly fixed-income investment focus to include equity-linked or hybrid instruments (*Risk Magazine*, October 2000).

The primarily fixed income focus of investors, however, requires that they be given a clear understanding of an issuer's credit, particularly as more unrated and high-yield-rated organisations come to the market.

In Europe, depending on the type of convertible bond structure offered, we estimate that fixed-income investors take up about 35%–40% of convertible bond issues, with the remainder largely going to dedicated convertible funds. Equity funds are estimated to represent 10%–15% of primary convertible distribution. The take-up by equity funds should be managed to minimise the negative impact on a company's share price from selling off long equity positions to offset their investment in the bond.

Different types of financial instruments attract different investor classes. For example, convertible bond funds focus on hybrid securities and represent a unique investor profile. A company that raises financing through a range of instruments consequently attracts a wider investor base and, as result, lower overall financing costs.

What characterises a typical convertible bond issuer?

Convertible issuers tend to come to the market early in their lifecycle, a prime example being the many internet companies that have raised convertibles while in their infancy. Many companies that have come public within the last several years, especially in the telecoms and media sectors, have unveiled extremely aggressive growth plans that require massive capital expenditures. Many do not have the luxury of growing their capital bases organically and, as a consequence, have opted to take to market simultaneous convertible bond, equity, and straight debt issues.

Firms that have issued convertible bonds include portal and e-commerce heavyweights such as Amazon.com ($1.25bn 4.75% 2007; €690m 6.875% 2010), telecoms services providers such as Colt Telecom (€402.5m 2% 2007) and KPN (€1.5bn 0% 2005), and data services providers such as Atos SA (€150m 1% 2004).

Financing the requirements of growth companies

Although many growth companies have

> Convertibles enable companies to finance expansion by providing a means of building its capital base through reducing the gap between the company's and the market's perceptions of the firm's risk.

been successful in tapping the equity markets, in some cases subsequen financing is needed, either because implementation timetables have slipped, or they have entered into a second expansion phase.

Companies may be reluctant to raise new equity as they believe that the market has undervalued their stock price and do not want to suffer an unfair dilution. This usually occurs at the early stages of the expansion, when the market may not yet have fully understood and assessed the value of a company's growth opportunities.

Academics classify this as a form of information asymmetry, where a firm's management would have better information about the actual value of the company than its investors. This could also be used to a firm's advantage, because management could time equity issues when the market has overvalued the firm. Historically, investors have lowered their estimates of issuer's values to compensate for this informational disadvantage.

Studies have shown that the average two-day abnormal common stock return after a share offering announcement was about negative 3%. In general, the riskier the security being offered, that is, the more a company has uncertain opportunities, the larger the discount that the market assigns to the securities.

However, if the company looks at going through a debt financing route, prospects hardly fare better. Growth companies are often reluctant to use significant amounts of straight debt financing because they face high interest costs of financial distress. A company in financial trouble could choose to invest in riskier projects at the expense of bondholders. It may also choose not to make necessary capital expenditures and maintenance expenses. Bondholders, aware that firms with risky growth prospects are more likely to get into financial trouble and then take on risky projects or under-invest at the bondholders' expense, therefore demand a lower price (hence, ask for a higher yield) on the debt they invest in.

Growing capital needs, risky growth prospects and limited debt capacity, which is the profile of many growth companies, points to a higher probability of financial distress and is an ideal situation for investors to demand high interest rates on a firm's debt.

Convertible bonds help to resolve this dilemma by providing the bondholder the right to convert the debt they hold into equity and by allowing the firm to pay a lower interest rate, improving their odds against getting into financial trouble. The convertibility option gives bondholders a chance to participate in the share value's upside - resulting from additional risky investments, or from taking on more debt. At the same time, the lower interest rates reduce the probability that the company gets into financial trouble and forgoes value-adding investments.

Convertible bonds can significantly lower a company's interest costs. A study on the US market has shown that, while the average promised yield on double B-rated straight debt in 1986 was 11.8%, the average promised yield on the like-rated convertibles issued in the same year was much lower at 7.9%. The savings of almost 400bp (basis points) indicated would have been larger in practice because most participants would not have been able to issue double B-rated debt Source: E Altman, The Convertible Debt Market: Are the Returns Worth the Risk? Financial Analysts Journal (1989).

Are convertibles actually cheaper?

Having mentioned that convertible bonds allow the relatively risky company to pay a lower coupon rate, we ask ourselves, are convertibles actually cheaper than other forms of financing? Michael Brennan and Eduardo Schwartz, The Case for Convertibles, Chase Financial Quarterly (Fall 1981) examines the popular argument that convertible bonds provide 'cheap debt' and allow growth companies to sell stock 'at a premium' relative to the current market price. They, however, show that this argument effectively looks at the cost of convertibles against a debt issue under one set of circumstances (no conversion) and looks at an equity issue under another scenario (conversion occurs).

In contrast, the issuer would have fared better by issuing equity under the first set of circumstances and straight debt in the second.

However, we note that all this is with the benefit of hindsight. When a company with large but risky growth prospects is choosing among investment options, we would argue that a convertible bond offers the sensible solution to the objectives of minimising short- to medium-term funding costs and minimising dilution among equity investors.

Brennan & Schwartz also put forward that the real value of a convertible bond is that it is relatively insensitive to the risk of the issuing company. Increases in the company's risk reduce the bond component of the convertible, but increase the equity component through higher volatility of asset returns.

Convertibles then serve as a practical and cost-effective tool in reducing information gaps between a company's and its investors' perception of the riskiness of the firm's operations. It is also largely for this reason that the typical convertible issuer has tended to be the smaller company with more volatile earnings.

Is there a danger in going to the markets early?

There is no danger as long as stocks perform well and they are able to force conversion. The recent downturn of new economy share prices has prompted some commentators to say that issuing convertible debt too early in a company's growth process is not a good idea.

With share prices soaring last year and earlier this year, many newly-hatched technology companies took on large amounts of convertible debt. The idea was to take the readily-available funds and later convert the bonds into equity shares.

For many convertible bond issuers in this sector, however, this year's market downturn pushed equity values far below the conversion price of the bond, and converting into shares would be a large loss to investors. This in turn means that issuers are saddled with having to make quarterly payments on a debt many did not expect to service beyond the first few years.

> A lot of these firms have systemic problems with their business plans and are losing money with no profits in sight

If the present situation of depressed share prices persists, these issuers, already struggling to meet operating costs, will have to cough up the face values of these bonds when they mature. Take the case of Titus Interactive, a software developer for video and multimedia applications.

The company issued €105m 2% coupon convertible bonds on February 2000 to mature on July 2005. The bond had a conversion price of €70 per share. At the time of issue, Titus Interactive was trading at about €57 per share. In mid-October, the Titus Interactive hit an all-time low of €14.10 per share and has gradually moved up to €17 per share.

The company's share is now way out of the money and there is some doubt whether the bond will ever be converted into equity. However, Europe-based ST Microelectronics, a semiconductor company, launched a $514m 0% callable/puttable convertible bond on June 1998, with a conversion price equivalent to $18.62 per share.

The shares are trading at €59 ($51), and the convertible has been trading at more than 2.5 times face value, clearly moving in step with value of the underlying shares.

> Real and costly conflicts of interest between bondholders and growth firms place a heavy burden on these companies' financing costs

Some analysts have commented that the problem was not the coming to market early. A lot of these companies have systemic problems with their business plans and are losing money with no profits in sight. They issued hybrid debt on the back of share valuations driven to dizzying heights by hype.

This is a separate matter from whether issuing a convertible bond early is dangerous, though.

Issuing hybrid securities such as convertibles should give more benefits to companies early in their growth path because the higher risk they usually have translates to higher funding costs from debt. Raising equity would also be more expensive because of higher information asymmetry costs.

Conclusions

We have seen that raising equity at an early stage of a company's growth can be expensive, given the resulting dilution and the drop in share prices that may result from this kind of signalling. However, real and costly conflicts of interest between bondholders and growth firms place a heavy burden on these companies' financing costs. Because of this high cost of debt, a company would want to build a large equity base to fund its growth policy. Convertible bonds enable it to finance its expansion by providing a means of building its capital base through reducing the gap between the company's and the market's perceptions of the firm's risk.

Instead of having to wait for more favourable share price levels before issuing new shares, a convertible bond allows a company to bring forward proceeds from a potential equity issue in the future through the conversion option in the bond. It also provides a company with the flexibility to manage its capital structure through embedded features such as call schedules that effectively force conversion. As a firm's value increases and its debt is converted into equity over time, the more robust capital structure enables the company to tap financing alternatives as it sets itself for further growth. ■

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