CONVERTIBLE BONDS HAVE HELD MANY ATTRACTIONS OVER THE PAST YEAR. BUT A CLOSER LOOK AT THE MARKET REVEALS HIDDEN DANGERS, AS **KWASI KWARTENG** OF CAZENOVE DISCOVERS.

THE FINE ART OF ISSUING

TABLE 1
RISK RETURN MEASURES

Asset class	Compound annual return(%)	Standard deviation (%)
S&P 500	12.97	17.03
Convertible bonds	11.89	12.68
Long-term corporate bonds	8.99	11.90

TABLE 2
EFFECT OF VOLATILITY DIFFERENTIAL ON A CB BOND PRICE

Volatility (%)	Bond price	Coupon (%) (if bond price is held at 100)
25	96.1	3.30
30	99.4	2.65
35	101.9	2.10
40	104.9	1.45
45	107.8	0.90

Much has been written about the benefits of equity linked bonds and much of that commentary is undoubtedly true. But there are also some potential drawbacks, and this article invites borrowers to pause and consider a number factors before deciding to issue convertible bonds.

ATTRACTIONS. I do not dispute the attractions of the convertible bond market, as the size of the market and number of new issues show. Benefits include: the opportunity for diversification of funding sources; the availability of a source of funding when other markets are closed; a broad base of professional investors; low-coupon tax-deductible debt; and the ease of execution provided. These factors undoubtedly prompted the large number of UK companies that issued equity linked bonds in 2003, including Cable & Wireless, Scottish Power, 3i, International Power, Xstrata, BAA, Logica, Hilton, lastminute.com, Lonmin, EMI, Liberty International, Rank and SVB.

And convertibles are also attractive to investors. For the period 1973-2000, research by Ibbotson Associates on the US market indicates that risk and return measures place convertibles between debt and equity. As *Table 1* shows, they have delivered returns approaching those of the equity market but with less volatility, while their risk is more comparable with corporate bond markets.

‘I DO NOT DISPUTE THE ATTRACTIONS OF CONVERTIBLE BOND MARKET, AS THE SIZE OF THE MARKET AND NUMBER OF NEW ISSUES SHOW’

Caveats for an issuer

Having said that there are clearly benefits in issuing convertibles, the question arises whether there are any drawbacks. In attempting to answer this, we would suggest four matters for consideration:

1) They are *not* cheap. The familiar mantra goes: "if it converts, it's cheap equity; if it doesn't, it's cheap debt. Therefore, it's cheap financing".

This is an appealing argument on the surface, but is of course misleading. The use – twice – of the word 'if' in the quote above shows why. The option the company gives to investors to go down either route (to convert or not) is very valuable, and is not built into the mantra set out above.

Think of this from the perspective of existing shareholders. It is wrong to say that their company has either borrowed cheaply or sold equity at a premium. Instead, one should say that it has either borrowed at below market rates and given an option to convert that borrowing into equity, or sold equity at a premium and given a put option to sell that equity back to the company.

A chief executive was recently heard to say: "It's great. My share price is 300p and, at a 33% conversion premium, it's like selling shares at 400p. My existing shareholders will be delighted." This is not the case, it is like selling shares at 400p that also carry the right to be put back to the company after seven years at 400p. The existing shareholders are underwriting this put option.

When I suggest that "a convertible is not cheap", I do not mean it is expensive, just that it is fairly-priced – as evidenced by the fact that one would not expect a fairly priced convertible to trade far from par in the immediate aftermath of its launch.

2) The uncertainty of whether the bond converts is a problem that might be called 'the paradox of the convertible'. If the convertible remains uncoverted, the company may have received 'cheap' money, but its share price may not have performed as well as the issuer expected. Conversely, if the shares perform well and the bond converts, the company might instead (with the admittedly unfair benefit of hindsight) have been able to issue a straight bond instead and repay that without having to dilute its equity capital.

The case of exchangeables is particularly interesting. Although there are a number of reasons for issuing exchangeables, many were done because the issuer wanted to exit the underlying shares and choose an exchangeable in preference to a straightforward share placing, either because of the perceived attraction of 'selling' at a premium, or to defer the crystallisation of the exit for tax reasons. However, the fall in equity markets over the past three years has left some exchangeables out of money and unlikely to exchange. Therefore, the issuer may fail to exit and may face the prospect of having to sell the shares at a lower price than might have been achieved by an outright share placing when the exchangeable was issued.

3) You are selling equity, but the rating agencies do not think so. Most UK corporate convertibles and exchangeables are ratings-neutral. So hybrid equity is being raised that does not improve the issuer's balance sheet and does not support debt in the same way as pure equity does.

This leads to two thoughts: if the balance sheet does not need strengthening, why do a convertible? Why not issue straight debt instead? And if it does need strengthening, what is the convertible achieving? Would a placing of pure equity be better?

4) What about earnings per share (EPS)? Convertibles can dilute EPS. Let us look at the following hypothetical company:

Ebit	100
Interest*	(18)
	82
Tax (30%)	(24.6)
Earnings	57.4
Shares out	100m
EPS	57.4p

*We assume a 3x debt-to-Ebit ratio, so debt is 300 and, at 6%, interest is 18.

Let us now assume a convertible into 10% of the share capital (10 million shares), a 6x PER (so the share price is 344p), a 35% conversion premium (so the conversion price is 465p and the issue size £46.5m) and a 2.5% coupon (so the company saves 3.5% interest, or £1.6m per year).

Interest now falls to £16.4m, and earnings rise to £58.5m, but the diluted share capital is now 110 million, so diluted EPS is 53.2p, a 9.1% fall. Is this really in the interests of existing shareholders?

Clearly, this example has been manufactured to make a particular point, and it must be stressed that many – and perhaps most – convertible bonds will not be dilutive.

FIGURE 1
EUROSTERLING CREDIT INDEX SPREAD (BASIS POINTS OVER GUILTS) (JANUARY TO 5 DECEMBER 2003)

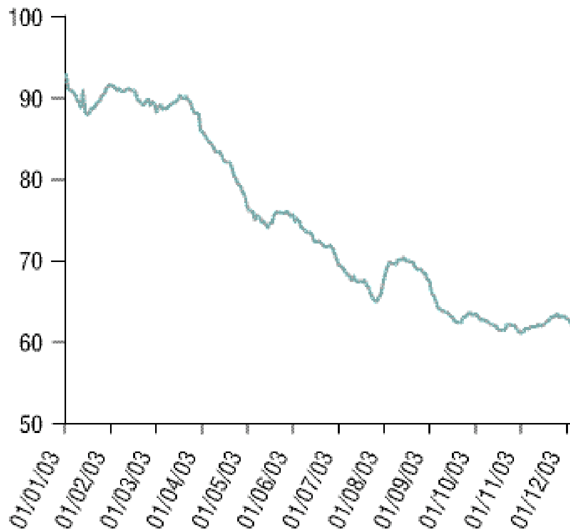
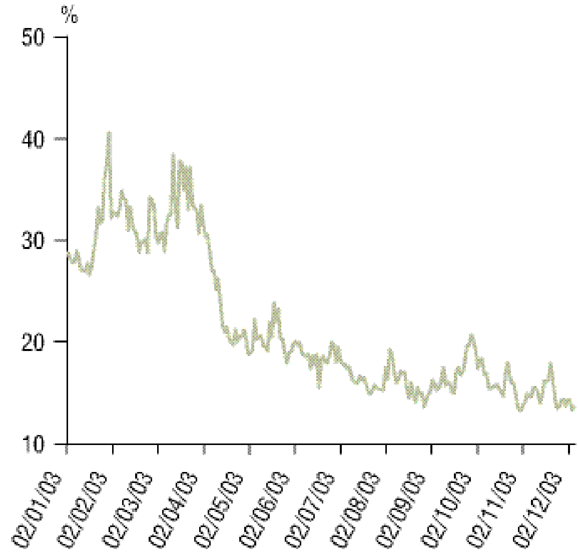


FIGURE 2
FTSE IMPLIED VOLATILITY (JAN 2003 TO 2 DEC 2003)



'LAST YEAR WAS BUSY IN THE EQUITY LINKED MARKET AND CONVERTIBLE ISSUANCE IN EUROPE REACHED RECORD LEVELS IN A YEAR THAT SAW HISTORICALLY LOW INTEREST RATES, HIGH VOLATILITY AND TIGHT CREDIT SPREADS'

A CHANGING MARKET CLIMATE? I have presented some structural reasons for pausing for thought before issuing a convertible but, as a separate matter, changing market factors may reduce their attraction in 2004 compared with 2003.

Last year was busy in the equity linked market and convertible issuance in Europe reached record levels in a year that saw historically low interest rates, high volatility (at least at the beginning and middle of the year) and tight credit spreads. The principal ingredient of a healthy primary market – unsatisfied investor demand – has also been prominent.

However, benign conditions for issuance in 2003 may not last indefinitely. A glance at the performance of the Eurosterling Credit index shows that UK corporate credit spreads are currently at historically very tight levels (see *Figure 1*) and European corporate credit reveals a similar story. How long will this trend continue?

Since tight credit spreads are partly an indication of strong investor appetite, it follows that a falling demand for credit may cause some widening pressure on spreads. A scenario in which demand for credit weakens could have an adverse effect on convertible bond issuance.

More important for convertible bond issuance is a consideration of equity volatility. The beginning of 2003 was marked by an unusual degree of political uncertainty, as the global debate concerning Iraq took place and the pace of recovery of the global economy looked uncertain. As political and economic uncertainty diminished, volatility levels fell to more traditional levels and may remain at these lower levels for some time (see *Figure 2*). This is important because, traditionally, convertible bonds have been sold with an implied volatility in the broad region of 25%, but in the second half of 2003 this volatility crept up to almost 45% in some cases. The effect of volatility on price and coupon can be seen in *Table 2* (on page 18). This looks at a hypothetical seven-year convertible, with no call in the first three years, a 130% trigger, a 35% conversion premium and a 2.5% coupon for a company that pays 1.5% in dividend yield.

This analysis shows the substantial effects of equity volatility on pricing. At levels of high volatility in the underlying equity, corporates raise more money up front or pay lower coupons during the life of the bond. This explains one of the attractions of convertibles for those who issued during 2003.

IMPORTANT CONSIDERATIONS. None of these observations should be seen as arguing against convertibles. Instead, this article has simply tried to draw attention to some considerations that any treasurer should bear in mind when he or she seeks Board approval for a convertible bond issue.

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