A BUSY TIME FOR ISSUERS

SUMMER IS TRADITIONALLY A TIME OF SLUMBER FOR ISSUERS, BUT THIS YEAR SAW AN IMPRESSIVE LIST OF FIRMS COMING TO MARKET WITH CONVERTIBLE ISSUES THAT COLLECTIVELY RAISED ALMOST £2BN, SAYS *THE TREASURER'S* MAN IN THE MARKETS.

Few treasurers will be unaware of the strong performance of the convertible bond market over the summer, if only because they have probably been subjected to a barrage of presentations on the subject from just about every bank under the sun suggesting that they should join this particular party. It has certainly been a busy time for those UK treasurers and directors of finance who issued convertibles – a list that includes Adrian Coats of Scottish Power, Mike Grant of Cable & Wireless, Peter Barlow of International Power, Kim Holdsworth of BAA, Ian Wall of Xstrata and Geoffrey Barker of Hilton, who collectively raised nearly £2bn.

THE BIG ISSUES. Scottish Power's was the largest issue, raising $700m. It also had a relatively unusual structure, designed to gain credit from the rating agencies. The bonds are perpetual and subordinated, so even if conversion never happens, Scottish Power will have the benefit of junior debt that can support its more normal senior borrowings. Standard & Poor's and Moody's, therefore, gave partial equity treatment to the bonds. In one case they counted 50% of the proceeds as equity, when running internal credit analysis models on the company, and in the other 25%, which will clearly help Scottish Power's coverage ratios. It goes without saying that few companies could contemplate issuing perpetual subordinated debt at attractive rates, but Scottish Power's A2/A- rating, £6.6bn market cap and stable utility nature enabled this.

BAA, Xstrata, Hilton and Cable & Wireless's bonds were more traditional: senior debt, maturing after six or seven years. International Power chose a 20-year maturity with investor puts at par in years seven, 10 and 15, thereby holding out the possibility of achieving longer-term funding than traditional shorter-dated convertibles allow. BAA's issue followed its £424m convertible just over a year before and coincided with its calling an earlier convertible that was due to mature soon.

Cable & Wireless and International Power are both rated BB, and their issues demonstrated that the convertible market has been a ready provider of large-scale financing for lower-rated companies at a time when investors in the straight bond or high-yield markets were, in many cases, demanding higher yields and/or tighter covenants than the companies would have been prepared to agree.

What all these issues have in common was the fact that they were launched during summer months, when conventional wisdom has it that the markets are thin or closed over the holiday season. That was certainly not the case in 2003.

GREAT ACHIEVEMENTS. Driven by a highly favourable combination of record-low government bond yields, strong equity markets and, most importantly, high share price volatilities, issuers were able to achieve lower coupons and/or higher conversion premia than would usually have been the case. This lead to extremely attractive funding rates for the companies, while strong demand from hedge funds kept demand high. This demand from hedge funds is worth noting. Convertibles and exchangeable are now taken up almost entirely by hedge funds or specialist arbitrage funds, rather than traditional long-only investors.

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The funds cover their risk by selling significant amounts of the underlying shares at the same time as they subscribe for the bonds, in a proportion called the 'delta', which may be as high as 60%: to do the maths, a £100m issue with a 30% conversion premium, where 80% is placed with hedge funds and the delta is 60%, would involve the short selling of £37m of shares.

In many cases, the investors also hedge their credit risk through the credit derivative swap market. Therefore, in many of the recent issues, the lead managers have chosen to run a formal placing of the underlying equity to accommodate the necessary short positions, as well as offering credit protection to subscribers. This has become a fundamental part of the issue process, and treasurers need to be aware of and manage the equity short (and consequential effect on their share price) and credit default swap interest as much as the sale of the bonds themselves.

Although volatilities have come off somewhat since the summer, levels are still attractive for issues, and it is likely we will see more convertibles launched in the next few months. If any treasurer reading this article is contemplating a convertible issue, it might be worth contacting, in confidence, one of your fellow treasurers who has recently completed one. Members of the ACT can use the online Members' Directory at www.treasurers.org/membership/.

The Treasurer welcomes commentary on the current state of the debt and equity markets. If you would like to contribute 750 words, anonymously or otherwise, please contact Managing Editor, Mike Henigan, at **mhenigan@treasurers.co.uk**.