Love or loathe?

Executive summary

- In the last six months, major corporates have turned with relief and enthusiasm to convertible funds to rebuild their balance sheets. But shareholders, wary of hedge fund involvement, are much less enthusiastic. Treasurers must take a hard-headed view of a proposed convertible issue and the company's reasons for choosing this route.

A recent headline in the Financial Times trumpeted that "Convertibles are back" as Air France-KLM commenced marketing a €575m deal to investors. The paper noted that the market had swallowed similar convertible offerings from Sainsbury, Nexans, Publicis, Alliance Oil and Vedanta over a few days and "seems hungry for more".

And that appetite is being met. Lufthansa followed its rival with a €750m seven-year convertible at the start of July. Later that month it was the turn of British Airways, as news of the airline's second-quarter operating loss of £100m was eclipsed by its revelation of plans to bolster its cash position by up to £680m. Nearly half the amount, £330m, will come from banking facilities that BA's pension fund trustees were persuaded to make available; the remaining £350m comes from the airline's first convertible issue in 20 years.

Convertible bonds offer companies a means of securing an injection of capital in hard times to rebuild their balance sheet without having to turn to their shareholders. Convertibles also eliminate any immediate worries about upsetting shareholders, although the latter suffer a possible dilution of their holdings if convertible investors exercise the equity option.

A further attraction is that convertibles may offer a cheaper and quicker means of accessing funds than is possible with a rights issue, or borrowing. A convertible bond combines the elements of a conventional bond with a warrant enabling it to be exchanged for a predetermined amount of the company's equity, either at maturity or earlier, and usually at the bondholder's discretion.

As a hybrid security, a convertible offers investors the relative safety of bond coupon payments along with the potential upside of equities over the longer term, particularly if the company's longer-term prospects appear favourable and the shares look undervalued. The downside is that convertibles pay a lower coupon than traditional bonds, and they have also been viewed as undermining existing shareholders' pre-emption rights.

HIT BY THE HEDGE This has been the case particularly in the UK, where the reputation of convertibles has been harmed by their popularity with hedge funds. Hedge funds would buy convertibles and then promptly bet against the equity of the same company, driving down the share price.

"The situation does become more difficult when ordinary shareholders aren't attracted to buying a convertible and would prefer to buy more of the ordinary shares," says Michael McKersie, assistant director of capital markets at the Association of British Insurers (ABI). "So the issue of whether a convertible is done pre-emptively is a sensitive one."

Hedging, then, is a bone of contention. Convertibles permit the tapping of a new pool of capital but too often those investors who take them up do so merely to hedge out their position in the market.

"Too often there is selling upfront of the ordinary shares, so that the pricing of the new issue isn't done on attractive terms," adds McKersie. "Although the pricers are aware of this possibility, it still happens, so it's difficult to calculate the efficacy of capital raising." As a rule, pricing that comes in below 95% of the existing share price is regarded as unfavourable for the company.

BACK IN THE SPOTLIGHT As with discounted rights issues, convertibles currently represent something of a boom market, and have regular hit the headlines over recent months.

Some reports suggest that their renewed popularity owes much to

THEY RAISE THE HACKLES OF SOME INVESTORS, BUT CONVERTIBLE BOND OFFERINGS HAVE RETURNED TO FASHION IN A BIG WAY, AS **GRAHAM BUCK** REPORTS.

the demise of Lehman Brothers, which initially caused a crisis of confidence in the market but forced many companies to consider alternative sources of financing as bank lending began to dry up.

However, McKersie suggests that Lehman's fate had only a limited impact. He points out that convertibles have regularly gone in and out of fashion, typically gaining popularity when markets are volatile.

"They are seductive to companies, which believe they get a cheaper form of finance, although as they are paying the right price for it convertibles don't offer any free lunch," he explains.

"The company must decide whether it expects market volatility to be lesser or greater going forward in deciding whether to opt for a convertible. This is something that the CFO or the treasurer doesn't really know."

Both CFOs and treasurers will take a somewhat different view from investors of a convertible, McKersie adds, regarding it as a cheap means of raising debt finance without necessarily appreciating the equity dilution that results to the detriment of existing shareholders.

Straight bond investors don't rate convertibles very highly, says McKersie. They are put off by the relatively weak covenants, their lack of creditworthiness and their low coupons, and see them as little better than junk bonds.

But other investors appreciate the potential upside. They will profit if the company performs well, and if it doesn't they will at least get their money back. Hedge funds are also likely to take a position in convertibles while offsetting their position in ordinary shares.

WHO'S ISSUED WHAT "If you are an FTSE 100 company that has the necessary documentation in place, the convertible bond market is accessible and transactions can be launched rapidly," says Antoine de Guillenchmidt, head of UK equity capital markets at Morgan Stanley. "The market for convertibles has historically been the last to close and is currently benefitting from the resilience of the credit markets."

Convertible issuance in both the UK and continental Europe in the first half of 2009 was well ahead of the same period last year, but closer inspection reveals that larger companies dominated, with mining and materials companies representing a major proportion.

Steel group ArcelorMittal launched a $1.5bn convertible in March, and miner Anglo American followed with the same figure in April. More recently India's Vedanta Resources launched a $1bn convertible, due in 2016 but with a five-year put option, that was swiftly increased to $1.25bn.

A smaller offering, which nonetheless garnered much interest, came from Sainsbury, whose June share placement of £242m to fund new stores was supplemented by a further £190m from a convertibles issue. Investors in the bonds receive an interest rate of 4.25% until 2014, when the bonds convert into equity at a price of £4.185.

At the time of the issue Sainsbury shares were around 316p, so the share price will have to rise by 35% over the next five years for

Box 1: International Power's good timing

One company whose convertible bond offering last year was well received is International Power. The group was able to use a window of opportunity in June 2008 to launch its offering, initially for €400m but subsequently increased to €700m. Its success saw the group highly commended in The Treasurer's Corporate Finance Deals of the Year.

Peter Barlow, International Power's director of finance, said the group had three basic options for accessing permanent capital: bank finance (typically shorter term), high-yield bonds (usually five to seven years) and convertibles (also five to seven years, but with the option to convert).

"If the share price doesn't perform, convertibles represent a relatively cheap method of finance," Barlow says. "And if the share price does perform, the buyers are rewarded, the company is happy and the existing shareholders are content as they also benefit."

He acknowledges that if International Power had held off the offering until later in 2008, conditions would have been much tougher and the share price even lower.

"As it was, the worst of the credit crunch had yet to hit and our credit default swaps are still at a reasonable level," Barlow says.

The success of International Power's offering was helped by the fact that its convertibles carry a relatively high premium, based on an improvement of 35% to 45% in the share price and reflecting International Power's reputation for being a growth company. Barlow points out that some companies work on a figure as low as 25%, which makes the convertible more of a disguised equity issuance.

"You could argue that what's good for us is less so for investors, but this is a seven-year instrument and those who took it up should be well rewarded," he says. "Our view is that while a convertible is dilutive, existing shareholders are protected as the conversion is done at a high share price."

Barlow adds that the raft of convertible offerings since the start of this year is understandable. Many believe the stock market has bottomed out and it is still tough to access finance from the banks, so convertibles offer a good compromise.

"We haven't had a need to return to the market more recently with a further offering but it's certainly something we'd consider doing again," Barlow says.

CONVERTIBLE BONDS OFFER COMPANIES A MEANS OF SECURING AN INJECTION OF CAPITAL IN HARD TIMES TO REBUILD THEIR BALANCE SHEET WITHOUT HAVING TO TURN TO THEIR SHAREHOLDERS.

investors to realise a profit. The percentage was in line with the recent average share price improvement, or conversion premium, of 32% needed to make the convertible profitable.

The fundraising dented the Sainsbury share price as the number of shares in issue increased by 7% as a result of the convertible bond issue, diluting existing investors.

BA's £350m bond offering, which was increased from an initial £300m, carries a relatively high yield of 5.8%. The bonds, due in 2014, will be convertible into between 15% and 20% of BA's issued share capital. The issue was offered to existing institutional shareholders as part of the bookbuilding process. It will boost the company's liquidity, which mid-year stood at around £1.25bn plus £130m in general facilities, to about £2bn. "You can never have enough cash," said chief executive Willie Walsh, who described the liquidity increase as "an eminently sensible thing to do".

The general reaction was that despite BA's current problems, the group could survive without the cash injection but was probably sensible in taking the opportunity to tap the market. Such a move could prove more difficult if its fortunes deteriorate further over the months ahead. Ratings agency Moody's Investors Service, which had already lowered the airline's credit rating to Ba2, or two levels into junk status, lowered it once more to Ba3 in early July.

The BA issue was also notable in giving three UK banks – Barclays Capital, HSBC and RBS Hoare Govett – the role of joint bookrunners alongside Deutsche Bank and Bank of America. None of the trio has the reputation of being a major player in the European convertible bonds market.

THE RIGHT REASONS As a major investor, the ABI always queries the dilutive effect when a company issues a convertible, which it regards as very similar to that of issuing shares for cash, says McKersie.

"We are concerned that the decision is made for the right reasons and is not just a means of circumventing shareholders' pre-emption rights," he says. "Some of our members dislike them intensely, but we accept that they have a role to play, provided it is done properly.

"They may be a better proposition for some companies than others – for example, infrastructure companies seem to particularly like them."

He suggests that the following are basic considerations for any company mulling a potential convertible issue:

- A convertible shouldn't be seen as an alternative to a rights issue, but as an issue of equity shares and should be priced very carefully.

- A convertible doesn't provide the same security as long-term finance if the share price fails to rise.

- Some companies may find that the convertible won't convert, and then have to go through the process of refinancing it.

- If the company's post-issue performance is poor, a convertible can prove no better than a bond, so both companies and investors should recognise the implications.

This makes it incumbent on the treasurer to take a hard-headed view of a proposed convertibles issue and the company's reasons for choosing this method of fund raising.

Graham Buck is a reporter for The Treasurer.
editor@treasurers.org

Box 2: Expansion fuel for Sainsbury

Sainsbury's chief executive Justin King was able to present investors with a strong case for supporting its expansion plans when the supermarket group launched its £445m capital raising, including a £190m convertible, in June.

Having trailed rivals such as Tesco and Asda a few years ago, Sainsbury has now delivered continuous like-for-like quarterly sales growth for more than four years and accelerated the pace with its From Recovery to Growth strategy outlined in May 2007. In the 12 weeks to mid-June this year, it achieved sales growth of 7.8%.

So despite the recession, the chain plans to add 15% more selling space by March 2011 and is acquiring a further nine stores from the Co-operative Group to add to the 24 it has already purchased.

According to the CEO, the fundraising provides the group "with the financial flexibility to take advantage of current opportunities to grow our business further and faster. We can speed up our growth in areas of lower market share, maintain the strength of our balance sheet, and invest in the long-term growth of the business."

Generally, the City was impressed. Analysts at JP Morgan noted that for the first time in many years Sainsbury is set to outpace Tesco in opening new stores and extending existing sites.

But some added a note of caution. Analyst Clive Black at Shore Capital questioned why the group felt it needed to tap the market for additional funds. "Sainsbury's has a strong balance sheet with low gearing and a strong asset base, and I am a little perplexed that they have gone to raise money to fund expansion," he said.