Structural advances in UK convertible issues

Buoyant market conditions are allowing UK companies to issue more complex convertibles – with significant advantages. Peter Harrison of HSBC explains.

The Euro-convertible market is currently undergoing a renaissance. The European inflationary spike that gave rise to pan-European interest rate jumps in 1994 reduced convertible issuance to a trickle. Since then, Euro-convertible funding raised by European companies has increased almost eight-fold from $2.6bn in 1995 to $20.6bn in 1998.

This year has already witnessed $12.3bn of issues throughout Europe, and a new jumbo deal is announced almost every month. In January, the French utilities group, Vivendi, launched a $2.0bn issue, one of the largest ever Euro-convertible deals, and in May the company was able to come back to the market with a second $3.1bn issue.

This issuance boom is also evident in the UK, with the $2.1bn of non-property related issues for this year already equalling the total for last year – and greatly exceeding 1997's $870m total (see *Figure 1*).

Reasons for the current boom

An increased desire for gearing
The ever-increasing focus on shareholder value, present in the UK for many years, is slowly spreading as continental Europe develops an increasingly sophisticated equity culture. While fund managers are pressing for enhanced returns, some companies, especially in France and Germany, can no longer rely on the friendly support of large industrial or financial associates to shelter them from external pressures. As a result, more companies are having to gear up.

This pressure is also being sensed by Europe's legislators who, in order to allow capital to be more efficiently allocated within their economies, have been making the process of returning capital to shareholders progressively easier. In early 1998 the French tax system was changed to favour share buybacks and last August Germany legalised buybacks and clarified the tax position shortly thereafter.

Share buybacks are set to become more widespread as the treasury stock provisions of the EU's Second Company Law Directive are incorporated into more of Europe's national laws. All of these measures will further encourage the trend for leverage.

The need for strategic flexibility
While a highly geared balance sheet enhances returns for equity investors, it can also limit the flexibility of management to develop the business. This can be especially acute in industries, such as mobile telephony, which require large capital expenditure injections either as new technology is developed or to meet soaring demand. The need for flexibility is also felt in industries, such as utilities, where financial structure considerations are critical to equity returns.

In these circumstances, convertible debt can be a useful capital management tool. A traditional UK convertible structure allows the issuer to force conversion after four to five years, provided that the share price exceeds the typical 20–25% conversion premium. This represents a compound share price growth of 3.5–4.5%, seen as a very attainable target by most companies. The prospect of an injection of equity capital in a reasonably certain timescale gives some comfort that future strategic flexibility will be retained, while leveraging the balance sheet to deliver shareholder value today. For these reasons, National Grid raised £460m in 1998 via a convertible for a partial funding of its £770m special dividend.

Peter Harrison

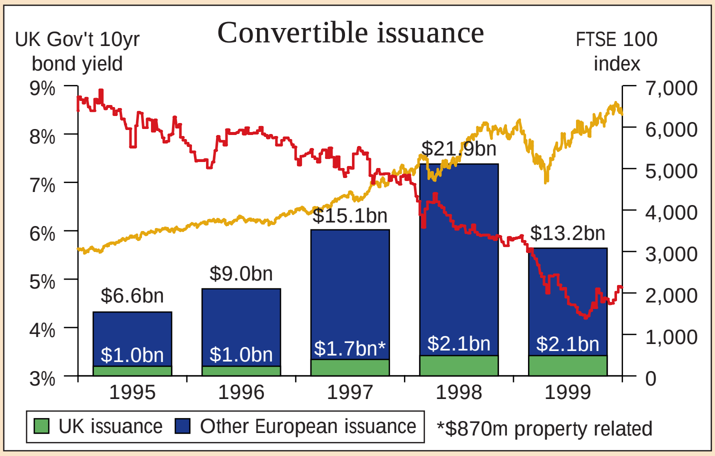
Value maximisation of proceeds in large secondary equity offerings
As the European privatisation programme matures, governments are keen to sell down their remaining stakes. In parallel, shareholder value pressures are causing the unwinding of major cross-holdings throughout Europe. With equity valuations greatly increased by surging European stock markets, the potential for large secondary offerings could strain the cash flows that equity funds have available for investment. The problem is exacerbated by the fact that dividend yields, one of the main sources of investment cash flows, have grown more slowly than stockmarket values.

Against this background, a reduction in the size of a secondary equity offering by simultaneously offering a convertible, targeted at predominantly non-equity investors, is becoming increasingly popular. In recent months we have seen combined equity and exchangeable offerings from France Telecom ($4.5bn) and Energis ($2bn), with a combined offering for Portugal Telecom $1.4bn due soon.

Combination offerings are also attractive to companies that are raising funding for jumbo acquisitions. For example, Repsol is currently reported to be considering a $4–5bn equity offering and a $2bn convertible to refinance partially its $13.4bn acquisition of YPF.

Buoyant market conditions From an issuer's perspective, the outlook for continued low European interest rates makes it a good time to consider a fixed-rate debt issue, while rising equity markets may cause potential equity issuers to wait for even higher share prices (see *Figure 1*). The convertible allows both of these market conditions to be exploited by issuers: coupons can be struck well inside government benchmark bond yields, while the first 20–25% of any future share price growth can be captured via the conversion premium. From the perspective of convertible investors, who are predominantly fixed-income based, convertibles provide a better opportunity for capital gains in rising equity markets than low-yielding bonds.

FIGURE 1



Recent UK structural developments

The last time that UK companies issued large volumes of traditional par issue, par redemption convertibles, was in the 1993 boom in issuance driven by falling interest rates and rising share prices. Since then, the increasing sophistication of the investor base, together with changes to the UK tax regime for debt securities in 1996 has allowed UK companies to take advantage of current market conditions to issue more complex structures with many funding advantages.

Premium redemption convertibles This structure, although common on the continent, was first used in the UK in 1997 by Daily Mail & General Trust for a relatively small £75m exchangeable into Reuters. By 1998, improving market conditions allowed National Grid to take advantage of this structure in its £460m issue, the largest Euro-convertible by a UK company in recent years. Rather than paying a full coupon, National Grid chose to pay a coupon of 4.25% and to redeem the bond at a premium to provide investors with a yield to maturity of 5.82%.

From a UK accounting perspective, the full yield to maturity on premium redemption convertibles is charged to the profit and loss account which, under current UK tax legislation also makes it tax-deductible. With the UK corporate tax rate currently at 30% this gives, in the National Grid example, a net cash flow cost of only 250bp per annum (4.25% coupon – 30% tax rate x 5.82% yield to maturity). If converted, National Grid will not pay the redemption premium in cash, nor will it need to refund any tax.

As with any convertible, investors will only convert if the issuer's share price exceeds the conversion premium. With premium redemption structures, the share price also needs to grow by the redemption premium forgone by investors who convert. In the National Grid example, a conversion premium of 23.5% at issue and a redemption price of 108.8% when conversion can be forced in year five, still only requires compound share price growth of 5.7% per annum for conversion.

Mandatory convertibles or exchangeables This instrument is new to the UK market, the first significant issue being the $400m mandatory exchangeable into Energis in January of this year. A mandatory convertible is a debt instrument which, as the name suggests, is mandatorily exchangeable at a future date into shares on a pre-agreed basis. Since there is no prospect of the debt being redeemed at par, any fall in the underlying share price will result in a loss for investors. This is in direct contrast to non-mandatory structures, which give investors a high degree of downside protection.

As well as deferring capital gains tax, the issuer of a mandatory exchangeable also typically captures the first 20% of any future share price growth, which is similar to the position with traditional structures, which capture this via their conversion premiums. In the case of a mandatory, this upside capture is achieved by adjusting ratio of shares per bond so fewer shares are issued as the share prices rise (see *Table 1*).

In *Figure 2*, it should be noted that once the exchange ratio has fallen to 0.83 shares per bond the issuer has sold 17% less shares. Consequently 17% of any additional upside over the initial 20% which is fully captured is also retained. This loss of upside suffered by the investor is paid for by the enhanced yield on the mandatory convertible, which will significantly exceed the dividend yield on the underlying shares.

The enhanced yield on these instruments, can be attractive to many investors, eg, mature pension funds, who are forced to meet cash flow requirements while not wishing to forgo an exposure to the equity markets. Even UK institutional investors, who normally prefer plain vanilla structures, are showing an increasing willingness to invest in more complex instruments for yield. In the case of Energis, the coupon on the mandatory exchangeables was 6% compared with a dividend yield of

TABLE 1 Upside capture for mandatory convertibles

Share price at issue			**100p**					
Upside capture			**20%**					
Issue price of mandatory convertible			**100p**					
Share price at maturity	80p	90p	100p	110p	120p	130p	140p	150p
No. of shares per bond	1	1	1	0.91	0.83	0.83	0.83	0.83
Value of shares per bond	80p	90p	100p	100p	100p	107.9p	116.2p	124.5p
Capital gain/(loss) on investment	(70p)	(10p)	NIL	NIL	NIL	7.9p	16.2p	24.5p

FIGURE 2

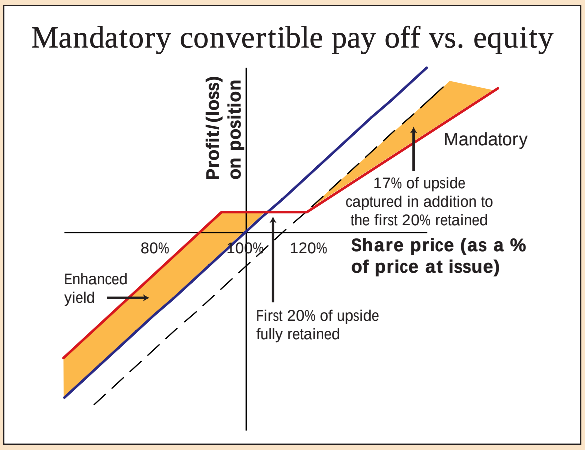
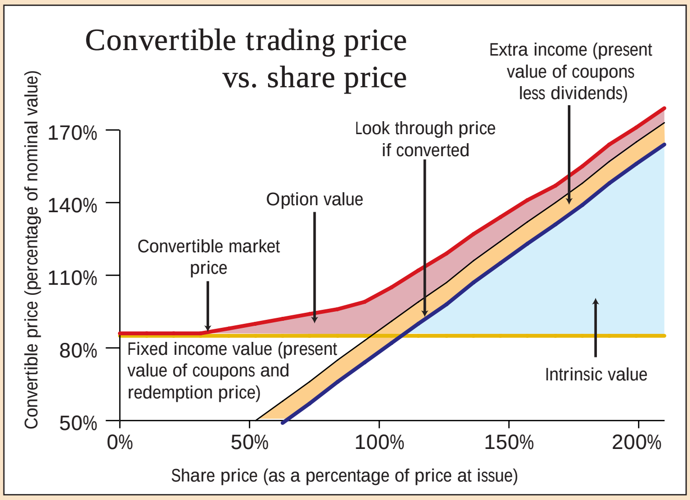


FIGURE 3



around 1%. Thirty one percent of the issue was sold to yield-seeking UK investors despite the issue being designed to sell predominantly into the US.

Cash out features As share prices rise, a convertible will trade at an ever-increasing premium to its fixed income value (the present value of the convertible coupons and redemption price as a pure bond play). This trading premium consists of the following three elements (see *Figure 3*):

- intrinsic value, representing the excess of the market value of the shares underlying the convertible bond over the fixed income value;
- extra income, representing the present value of future coupons to be paid prior to conversion, less any dividends that would be received if conversion were to occur today; and
- option value, representing the value of being able to have the convertible redeemed for cash should the share price falls below the conversion price.

Under current UK accounting rules, should a convertible be repurchased early for cash, any excess of the repurchase price above the convertible's nominal value would be charged to the profit and loss account. This figure would be excluded from normalised earnings calculations by the equity market when looking at share price valuations. However, it would be tax-deductible.

If the repurchase of a convertible bond were to take place just prior to normal conversion, the extra income and optionality element of any repurchase premium would be negligible. The transaction would therefore constitute the cancellation of rights to shares for a tax-deductible cash payment linked to share price appreciation since issue – in effect this is a tax-deductible buy-back.

As Euro-convertibles are bearer securities, it can be difficult to ensure that all investors would sell to an issuer wishing to repurchase rather than convert. In addition, investors are likely to demand a premium to market value in the same way that equity investors demand a small premium for most share buy-backs.

To overcome these disadvantages, cash out clauses have been included in some recent convertible issues, allowing the issuer to pay a cash sum (based on the average closing share price for a number of days prior to conversion) rather than delivering shares on conversion, thus ensuring a clean takeout with no buy-back premium.

OCEANS This structure is a variant of a cash out option and has been used in most large French issues since the EU treasury stock rules were incorporated into French law in 1998. Under the OCEANS structure, the issuer has the option of delivering either new or existing shares to investors on conversion. Therefore, at maturity, if the issuer does not wish to issue additional share capital he or she can purchase shares via the equity market for delivery at conversion. In addition, under the treasury stock rules, issuers also have the option to buy shares for delivery at conversion over the life of the instrument, allowing them to take full advantage of any short-term negative sentiment affecting their share price.

The UK has yet to legalise to allow treasury stock and the associated accounting and taxation issues have yet to be clarified. However, this structure is likely to become a feature of future UK convertible issues, potentially in anticipation of treasury stock rules being adopted.

The future of UK convertibles

The Euro-convertible market is currently undergoing a boom, with very large investor appetite allowing companies to issue on extremely fine terms against the background of a low interest rate environment. Issuers are also finding that they can launch increasingly sophisticated structures which provide many strategic and funding advantages.

UK issuers have begun to exploit the use of such instruments, eg, premium redemption convertibles designed to achieve very cash flow funding indeed, the disposal of a large block of Energis shares has recently been achieved via the issue of a mandatory exchangeable bond.

Despite the structured nature of such transactions, the issue sizes have been at the higher end of the UK spectrum. The drive to provide shareholder value is likely to see the number and complexity of UK convertible issues increase further. ■

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