The ten commandments of issuing convertibles

The European convertibles market is in its infancy, but for the right issuer at the right time, the opportunities offered should not be underestimated, says Ulrica Marshall.

Convertible bond issuance in the US is much more advanced than the European market, as has been the case with the majority of equity and bond markets in recent years. By the middle of November, convertible bonds with a value just shy of $60bn had been issued into the US market, says Convertbond, a dedicated convertible bond service by Morgan Stanley Dean Witter. By the same date, Europe had issued more than $25bn of convertibles, a sharp increase from an annual issuance of about $8bn just five years ago.

"There has been an explosive growth in European mainland convertible and exchangeable issuance in the last two years," says David Dean, director of equity capital markets at Nomura International. The growth stems from the relaxation of issuing and investor restrictions, and also from the deepening of the investor markets across the region.

The advent of the European single currency spurred a bout of issuance activity in convertibles and a number of issuers ventured into the sector ahead of the opening bell of the euro, in January 1999. Since then, an increasing number of borrowers from both the business and financial institution communities have successfully raised hybrid funding through a broad range of structures.

But the convertible equity market still has a long way to go before ranking alongside the US market in terms of scale and scope. In conjunction with several market experts, *The Treasurer* has compiled a brief 'dos and don'ts' guide for issuers contemplating entry into the convertible bond market.

Thou shall choose your lead bank carefully

Choosing a bank to lead a convertibles issue can be particularly difficult. In the traditional debt or equity markets, the pricing tends to be relatively generic, with little variation between indications. Yet, in the convertible bond sector, a standard pricing rule book is unwritten and pricing could vary substantially from one bank to the next.

> Pricing is just one element of choosing the right bank. Track record in the sector and a credible secondary market back up are also important factors

Intermediaries price convertibles from proprietary modelling software – each bank has its own version and no two are exactly the same. The market is also dependent on a certain degree of market intelligence when it comes to launching an issue that will match investor appetite at the time.

One of the few recognised off-the-peg models available in the market is Monis, which is widely used by investor professionals and non-traders in the banking community to derive an estimate of where a deal should be priced.

Ulrica Marshall

"As convertible issuance continues to grow – and this year it has been huge – more and more corporates are looking for an independent view of the pricing," says Philip Towers, marketing director at Monis. Although the primary client base for the pricing system remains the banking industry, the increase in demand from the business sector echoes the rise of the convertible as a capital-raising vehicle in Europe.

However, pricing is just one element of choosing the right bank. Track record in the sector and a credible secondary market back up are also important factors, and Towers says corporations should "make sure they are comfortable with the bank's whole offering to them".

Thou shall be careful in determining issuing particulars

There are three basic premises that can help a company to decide whether to issue a hybrid instrument instead of straight equity or debt:

- is the issuer looking for a tax-efficient structure? The coupon is tax-deductible, which will lower the overall cost of the funding (although this is the same for straight debt);
- is the risk of share dilution unacceptable? A convertible issue will lower dilution compared to a straight equity issue. The higher-than-market price conversion premium will provide a delay to the effect, although the company will be obliged to post fully-diluted earnings data; and
- does the company wish to maintain a presence in the equity markets at a time when straight issuance is not ideal? Again, a convertible issue could be the answer.

Once the decision to take the convertible route has been made, ironing out the details of the issue can be complex. The advice from competing banks is likely to vary and settling for the ideal issuing format requires careful consideration.

The ground rules state that a traditional convertibles issue can take one of two forms:

- a high coupon matched by a high conversion premium; or
- a low coupon matched by a low conversion premium.

The former clearly places a greater debt interest burden on the company but minimises any share dilution effect, while the latter offers the reverse. There is no right and wrong approach to the equation, which can only be decided with reference to the company's balance sheet and financial strategy.

Hybrids include a much wider range of opportunities than convertible bond issuance, and structures offered by banks are becoming increasingly innovative to provide a tailor-made solution for specific companies and investor groups. Zero-coupon structures have been common for several years, and enable some investors to pay a more favourable capital gains tax instead of a more costly income tax on the coupon.

Equally, exchangeable bonds have recently become popular instruments, largely driven by a change in the German law to allow companies to wave pre-emption rights when issuing convertibles. This development has led to a number of cross-shareholdings between firms to be unwound as part of a corporate restructuring. Clearly, an exchangeable bond does not impact on the equity in the issuing company, which pays a coupon to investors until conversion, triggering the delivery of a holding in the issuer's portfolio.

Thou shall be certain of the strategy is best-fit for the company

The equity-versus-debt debate remains as important for the issuance of convertible bond issues as ever, as the issuer combines the two. But an issuer cannot rely on the possibility that the convertible will ultimately convert into an equity instrument. If the market share price does not rise above the conversion premium (or rather the mathematical break-even is not attained), the bond will remain a debt instrument. In a number of cases, the convertible will remain a debt instrument unless it is

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very deep 'in the money' as hedge funds will buy the convertible and swap or hold it until maturity while trading the option element. Both scenarios will add to the interest burden of the company and could cause problems for gearing covenants.

But the hybrid market offers good opportunities for innovative structures, which may provide the best-fit for a company.

Exchangeable bonds came to the fore during the past year. In March 2000, Hutchison Whampoa sold a block trade of Vodafone shares at the height of the telecoms euphoria. When the company looked to repeat the exercise in September, the market for telecoms had deteriorated, making a secondary market trade uneconomical.

Hutchison Whampoa instead chose to issue a three-year exchangeable bond of $3bn with a coupon set at 2.875% and an exchange premium 33% above the share price at the time of launch.

The launch was successful and met with the company's business strategy at a time when the straight equity markets were less favourable for the sector. It also locked-in a low coupon, several percentage points below a standard bond issue for the same maturity.

Until the exchange takes place, Hutchison does, of course, benefit from receipt of the dividend of the underlying stock, which should be deducted from the coupon to establish the actual interest rate cost.

In the past year, a handful of UK issuers have ventured into the convertibles market, and most of these chose to issue in euros. They included Standard Chartered Bank and Colt Telecom, which both launched euro convertibles, and SkyePharma, one of the world's leading pharmaceuticals delivery firms, which issued a well-received sterling convertible in June 2000.

Thou shall be wary of market conditions

"Good timing requires the coincidence of three factors: falling interest rates, a rise in equity prices, and market volatility," says Nomura's Dean. The interest rate factor is as important here as it is for conventional debt issuance, while the market volatility impacts on the value of the embedded option. "The issuer derives more theoretical value from convertible issuance at a time when volatility is high," says Dean.

Currently, the convertible market is seeing two of these factors. While equity prices have been stagnant or falling, interest rates are low and equity volatility is high, leading to a favourable issuing environment. The high level of recent issuance clearly shows the opportunities in the sector.

In November, Dutch telecoms group KPN issued an €4bn issue split into €2.5bn of conventional equity and a further €1.5bn of convertible bonds. While the equities portion was well received at a reported two-and-half times coverage, the convertible was 10 times oversubscribed. Broadening the issue to include convertible bonds was intended to widen the company's investor audience – a goal that KPN achieved.

Paying close attention to market conditions is also important in determining the details of a transaction. Investor demand for European convertibles has been particularly strong in the five-year maturity range, says Anne-Marie Smith, a convertibles analyst at Jefferies International: "The simpler the structure, the better." UK investors are historically income investors rather than convertible bond investors, and many prefer to 'front-load' the instrument with a higher coupon.

Thou shall not underestimate the time and planning involved

A frequent borrower and established name in the debt and equities markets can access the convertibles sector at relatively short notice. In some cases, in a few days or less. But where a less well-known name or first time issuer is concerned, the time frame increases dramatically. Newcomers have to complete the due diligence process, print a prospectus and, importantly, undertake an investor roadshow, which could take six to eight weeks at best.

Although a credit rating from one or more of the international ratings agencies is not strictly required, the potential investor audience narrows considerably without a rating. Certain investors are restricted to investing in rated companies and many have a further requirement that the rating should be investment grade or above. But according to financial information group Bloomberg, ratings for convertibles issued since 1994 have fluctuated between the high-As and low Bs. The success of the recent convertible bonds from Colt Telecom, a B1/B+ rated issuer, is a good example that investors will look at the broader rating spectrum.

If a company seeks a rating ahead of issuing the convertible, the launch could, again, be delayed by several weeks or even months.

Thou shall watch out for new accounting standards and legal issues

The value of issuing convertible bonds or other debt/equity hybrids is often linked to the tax and accounting treatment of the instruments in the markets they will be sold. Equally, investor demand is closely correlated to the tax treatment of investments in the sector. Keeping a keen eye on any changes to taxation laws or accounting principles is, therefore, essential when issuing convertibles.

The Emerging Issues Task Force (EITF), a sub-committee of the US Financial Accounting Standards Board, changed the details of its accounting model last year. On September 20, EITF 00-19 came into effect, which called for all mandatorily convertible issues launched after this day to be reclassified as liabilities instead of equity from the start of the contract. Issuers coming to the market prior to this date had until June 30, 2001 to apply the regulation. Some issuers, to their cost, narrowly missed the September deadline.

The merger and acquisitions frenzy in Europe could also cause problems for issuers. When a merger between two European issuers was proposed last year, one of the parties refused to trigger a premium adjustment clause on an outstanding convertible. Arguably, the merger warrants such an adjustment, and finding a loophole out of this commitment is likely to dampen investor demand for future deals from the issuer, and is also likely to make investors scrutinise legal documentation and accounting standards to a greater degree.

"In the last couple of years, the M&A activity has highlighted the importance that proper provisions are made to protect convertible bondholders and that they are clearly worded," says Jefferies International's Smith.

She stresses that the issue of protection has taken on particular importance for convertible bondholders, who are often afforded less protection than straight debt holders.

Thou shall be mindful of your investor base

Over the last couple of years, the investment community for convertible and hybrid bonds has increased dramatically. Traditionally, the investor base has been a mix of hedge funds and retail investors, with Switzerland and the UK ranking high on the take-up scale. According to Fundamental Data, a London-based financial statistics service, 13 closed-end funds out of a total 380 UK investment trusts offer dedicated convertible funds.

The UK market clearly has some way to go before rivalling the US sector. According to a market professional, some of the blue-chip institutional investors still refer to convertibles as "funny money".

But the investor universe is widening. Many European investors have been restricted to fixed income investments in the past and missed out on the equity rally, and convertibles are a good way to enter the market at a time when the direction of equity prices looks more uncertain. Some investors remain tied to straight equity or straight debt, unable to invest in derivative products represented by the conversion option, but the market is expanding.

> Defensive sector issuers, such as food and pharmaceuticals companies, tend to perform particularly well when the equity climate is less favourable

The best-fit market characteristics of a successful deal are often cited as a formula of an investment-grade credit offering exposure into a volatile new economy stock, which will find investor appetite among a broad range of buyers, ranging from bond investors to hedge funds.

Clearly, investors will be mindful of the default rate of convertible issuers. Although a real trend in Europe is too early to determine, judging by US standards, 32 issues defaulted in the year to November 2000, according to Convertbond. None of these had been issued less than two years previously, but as a portion of total issuance for the year to date this represents 22%.

Almost half of the firms in default had filed for protection under Chapter 11. To reach a wide audience of investors other than high-risk funds, it is important that the issuer has a stable balance sheet.

Thou shall be a certain type of company

Traditionally, the US issuing market has been peppered with start-up issuers accessing the convertibles market, such as naissant biotech and technology companies. The reason for raising capital in this way can be explained by a higher level of acceptance of speculative bonds in the US.

Convertibles could appear compelling to the issuer, as the higher-than-market conversion premium ensures that the dilution effect is limited – a considerable portion of these young firms tends to be owned by the management.

But the benefit of the conversion premium is far outweighed by the downside of the coupon.

For nascent companies to take on a debt burden may be ill-advised, and with the vast volatility often typical of the sector, the conversion premium may be swallowed up within a matter of days. In fact, some of the best-fit corporates for the market and the European sector sit on the other side of the fence.

"The type of companies that lend themselves best to issuing convertibles are those with sound balance sheets, which have an easily identifiable credit story," says Dean.

Defensive sector issuers, such as food and pharmaceuticals companies, tend to perform particularly well when the equity climate is less favourable. Financial sector names may also perform well at such times, if the entity has grown organically rather than through a high-risk acquisition strategy.

Thou shall be wary of common pitfalls

As with any form of capital raising instrument, misjudging the market and launching an unsuccessful convertible is likely to impair the company's chances of tapping the market again – at a reasonable cost of funds. The main remedy here is to keep a close and frank dialogue with the underwriting bank. At the end of the day, they are no more keen to lose face in the market than the issuer.

Equally, it is important that the underwriting banks support the bond in the secondary market. A primary issue success may be quickly forgotten if secondary performance disappoints. In both instances, an experienced and focused bank will provide this service, while a 'fly-by-night' and tough talking underwriter may fall short of expectations.

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If the worst happens, thou shall learn from experience

As with every form of capital raising, convertible and hybrid issuance is not fail-proof and some companies have discovered this the hard way. A few companies have failed to access the investor base they were hoping for and ended up 'giving away' a cheaper retail targeted issue to hedge funds. Others have underestimated or overestimated the inherent option value of the convertible leading to a high level of convertible bond arbitrage, where the underlying credit is stripped from the option element by investors to be traded separately.

The European convertibles market remains at a an early stage of its development, but for the right type of issuer at the right time and suitable market conditions, the possibilities offered through this sector should not be underestimated. Convertible bonds have arrived in Europe, and they are here to stay. ■

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