Equity-Linked

The €671m mandatory convertible launched by Swiss Re, the world's second largest reinsurance group, in July 2004 has the potential to be a market changing deal. It not only provided a perfect solution for the company's future financing needs, but allowed the group to improve its existing debt financing structure.

Maturing in July 2007, the convertible was marketed with a coupon range of 6.125-6.625%, and came in at the bottom of the range. It saw high demand and sold out quite quickly on the morning of its launch. Excellent market conditions – low volatility, low volumes of issuance and volumes of equity-linked investors keen for new paper helped the deal do well.

From a market perspective, its success was demonstrated not only by the speed with which it sold, but also by the strength of the share price at launch. While most mandatory convertibles in Europe experience a discount of around 6%, Swiss Re shares only traded down by 1.15% on launch day.

However, it was the structure of the offering that appealed to *The Treasurer*'s voters and its Deals of the Year judging panel. Swiss Re unlocked value by buying call options from bookrunners which removed its obligation to issue shares under a 2021 convertible issued in 2001. These were bought back at a much lower price than that implied at the time of issue in 2001. The original convertible had a conversion price of US$124.51 while shares were hovering at around US$64 in late June when the deal was launched.

"This was a structured solution which enabled Swiss Re to raise capital in an efficient manner," says Mike Hammond, Head of Equity-Linked Products at Merrill Lynch, joint bookrunner and joint lead manager on the deal with BNP Paribas. "It allowed Swiss Re to unlock substantial value.

"By repackaging the stock into the transaction Swiss Re accomplished its goals for financing, got the deal out and received rating agency approval for doing so."

The convertible received "E" basket, or full equity treatment from Moody's, and fell into the 25% hybrid basket for Standard & Poor's, receiving Super Hybrid capital treatment. This was the first time that a deal from a European financial institution has received the highest equity credit from both Moody's and S&P, according to Hammond.

An equity-linked convert

Swiss Re's mandatory convertible provided flexible financing for the group, unlocked value from existing financing and was well-received by the market. It also created a structure that is applicable to other corporates. The deal was groundbreaking in that it demonstrated that a mandatory issue

The best possible deal

Juerg Hess, Group Treasurer at Swiss Re, explained that there were three main reasons why the transaction provided the best deal possible for the company. Firstly, the deal received maximum equity credit from both Moody's and Standard & Poor's (first of its kind by a European financial institution) which supported the group's financial strength.

Secondly, by purchasing OTC call options that offset the exposure to deliver shares under the convertible launched in 2001, the group avoided using any of the conditional capital increase approved by shareholders in May 2004. "We also now have a conversion price defined in euros rather than in US dollars. As such, Swiss Re will not be exposed to any additional decline in the US dollar," adds Hess.

Andreas Weber, Head of Corporate Finance at Swiss Re, continues: "A straight rights issue would have had much higher dilution. Rather than using new shares the dilution was prevented to a high degree by buying back the Over the Counter (OTC) options. Also the mandatory convertible allowed for a rapid execution process."

The deal also offers tax benefits that are inherent to fixed income. "The deal as it stands provides us with some tax shelter for the next three years until conversion," adds Weber. "In addition, doing a rights issue in Switzerland is rather difficult to do, quite time-consuming and burdensome legally, so the mandatory convertible really was the better choice."

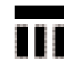
The deal came to market in June 2004, a time that provided Swiss Re with excellent market conditions. "Stock volatility was low and we had attractive interest rates. In addition it was a situation where there was not too much activity in the convertible market. Convertible investors were eager to see new issuance and we were able to take advantage of that," adds Hess.

Groundbreaking transaction

In addition to providing an excellent

Swiss Re's head office at Mythenquai.

Swiss Re



Principal terms

Issue size **€671m**
Maturity **July 2007**
Coupon **6.125-6.625%**
Conversion premium **20%**
Bookrunners **BNP Paribas, Merrill Lynch**

transaction for Swiss Re, the mandatory convertible is also groundbreaking for European financial issuers in general. "In the past, mandatories have always been issued out of a position of weakness. We were able to demonstrate that a mandatory issue can also make sense from a position of strength."

With the Swiss Re deal as a model, this structure could become a more standard tool in the financing toolkit of companies. "It could lead to a paradigm shift in the applicability of mandatory convertibles across the market," says Hess.

Highly-commended

Materials handling products company Linde's €500m convertible was launched to finance its buyback of €400m of bonds and was commended for being one of the most aggressively placed issues in 2003.

The five-year deal was very attractively priced – issued at a premium of 22.5% and a coupon of 1.25% (-232bps over swaps).

"We decided to launch the deal because interest rates were quite favourable and our share price had performed rather well over the last year, and we were able to achieve an implied volatility above both historic and Over the Counter (OTC) levels," said Treasurer Erhard Wehlen.

The deal was very well received by investors and saw a well-balanced placement between Continental Europe and UK/US offshore markets. UK/US offshore markets accounted for 42% of the allocation, followed by France (27%), Germany (16%) and Benelux (5%). There was an even breakdown between outright and hedge fund investors with the latter accounting for 49% of the issue.

The deal was also noted for its limited impact on Linde's share price during the placement due to the focused allocation strategy.

Bookrunners on the deal were SG Corporate & Investment Banking and Dresdner Kleinwort Wasserstein.