ScotiaMcLeod Convertible Debenture Overview

Introduction

The ultra low interest rate environment that was set in motion by the most recent financial crisis has fuelled investors' quest for yield. With no perfect correlation to equity or bond markets, convertible debentures have emerged as a separate asset class. Convertible bonds are **hybrid securities** that share features of both bonds and equities. Typically at issue, convertible debentures resemble bonds as they make regular coupon payments and have an obligation to pay the principal at a set maturity date. However convertible debentures have a call option on the issuer's common stock and instead of trading over-the-counter, most of them they trade on the exchange albeit a few exceptions. Converts are often issued as an alternative source of financing and allow the company access to another source of capital. Investors in convertible bonds enjoy a degree of downside protection because of the debt features of the security while there is also the potential to participate on the upside related to the equity component of the convert.

These hybrid securities have all the standard features of a regular bond such as a coupon, maturity date and a maturity value that must be redeemed by the issuer at the term of the investment. Established at issuance, the **conversion ratio** and the **conversion price** dictate the number of common shares of the firm that can be obtained per maturity value and the price at which the bonds can be "converted" into stock. It is very important to read the prospectus to be aware of all the features and special provisions associated with this unique type of investment.

Features and Investment Characteristics

By definition, convertible bonds rank below any senior (non-convertible) debt or bank loans a company might carry within its capital structure. They are typically subordinated unsecured debentures that rank above any preferred shares and/or common stock of the issuer. **Conversion premium**, **conversion value**, **intrinsic value** and **parity** are all vocabulary used to describe convertible debentures. The conversion value (intrinsic value or parity) is obtained by simply multiplying the conversion ratio (number of stocks per convert) by the current stock price. The conversion premium is an assessment of the value of the current price of the debenture above its intrinsic value. That figure is normally expressed as a ratio of the conversion value. Resembling a debt security at inception, the conversion premium ratio is usually between 25% and 45% and the debenture is more closely correlated to non-convertible fixed-income securities. The investor pays a "premium" to have the option to buy the stock (instead of purchasing the stock directly) while enjoying the downside protection offered by the fixed income security. *Busted converts* normally have a conversion premium higher than 50% and a significant increase in the price of the **underlying stock** would be required in order for the convert to start participating in any kind of capital appreciation of the common shares. Busted converts perform like regular bonds and are exposed to the same risk factors which may be magnified by volatile equity performance. As the price of the underlying stock appreciates and the conversion premium falls bellow 25%, the convertible debenture progressively shares the characteristics (risk and return) of an equity security.

Here is a list of important factors to consider before purchasing a convertible bond:

- Assessment of the fundamentals and the credit quality of the issuer
- Conversion premium; bond versus equity
- Term and potential call dates; yield-to-maturity versus yield-to-worst
- Shares outstanding and bid/offer spread; liquidity
- Equity outlook for the underlying; risk and volatility
- Macroeconomics; interest rate outlook

Investors need to be careful not to solely focus on the fundamental figures of the company. When looking at the ratios and multiples of an issuer, fundamentals are meant to raise significant questions requiring further analysis, not to provide answers. There is no specific range, target and/or number a fundamental figure needs to reach to be deemed appropriate. The numbers always need to be analysed within a broader context and relative to the figures of other convertible debentures that share similar attributes. In the end, fundamentals are just one component to look into and the investment decision should be based on a quantitative as well as a qualitative analysis of the firm in question.

Convertible Bond versus Equity

The valuation of convertible debentures is fairly complex as there are several interwoven embedded options to be factored in. The price of a debenture is equal to the value of a straight non-convertible bond plus the value of the option on the security. A convert is said to be "**in the money**" when the stock price exceeds the conversion price. The value of the debenture will reflect the value of the conversion option and they will be subject to the price movement as well as the volatility of the underlying stock. Moreover, a dividend paying stock tends to be less volatile than a non-dividend paying common share. The higher the dividend yield on the underlying, the lower the value of the convert. The higher dividend restrains the stock price appreciation and the convert's potential to reach in-the-money status. Convertible debentures with a high dividend yield on the underlying stock will usually perform like a high yield bond. A convert is said to be "**at the money**" when the stock price is at or near the conversion price. The debenture will share the features of both bonds and equities at that stage and they will act like a *hybrid* security. A convert is said to be "**out of the money**" when the stock price is less than the conversion price. The debenture will be much less sensitive to any price fluctuations of the underlying common shares and instead will vary based on the level of interest rates and the credit quality of the issuer just like a regular corporate bond.

Example 1:

Ticker	**EQTY.DB**
Coupon	6.30%
Maturity	6/30/2014
Ask Price	**$138.00**
Conversion Ratio	5.747
Conversion Price	$17.40
Status	In the Money

Stock Return	**-10%**	**-5%**	**-2%**	**-1%**	**Current**	**1%**	**2%**	**5%**	**10%**
Stock Price	$21.60	$22.80	$23.52	$23.76	$24.00	$24.24	$24.48	$25.20	$26.40
Conversion Value	$124.14	$131.03	$135.17	$136.55	**$137.93**	$139.31	$140.69	$144.82	$151.72

Example 2:

Ticker	**BOND.DB**
Coupon	7.00%
Maturity	12/31/2014
Ask Price	**$103.00**
Conversion Ratio	5.216
Conversion Price	$19.17
Status	Out of the Money

Stock Return	**-10%**	**-5%**	**-2%**	**-1%**	**Current**	**1%**	**2%**	**5%**	**10%**
Stock Price	$10.80	$11.40	$11.76	$11.88	$12.00	$12.12	$12.24	$12.60	$13.20
Conversion Value	$56.33	$59.46	$61.34	$61.97	**$62.59**	$63.22	$63.84	$65.72	$68.85

From the examples above, we can see that the intrinsic value is correlated with the price fluctuations of the underlying stock. Example 1 shows that the offer price of $138.00 is positively correlated to the conversion value of $137.93 when it is "in the money". In Example 2, the conversion value continues to fluctuate based on the price of the underlying stock. However the convertible debenture is "out of the money" and the offer price is at $103.00 because of its *bond-like* attributes.

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Risk Factors

The potential risks that should be considered before purchasing a convertible debenture should not be underestimated. The market of convertible debentures simply represents an alternative source of financing for a company that would typically be subject to much less restrictive covenants if there is any. Generally, this type of hybrid security is not rated by a credit rating agency or it tends to be non investment grade if it is rated. Assessing the firm's ability to meet fixed debt charges remains crucial. Although they are considered debt on a company's balance sheet for accounting purposes, convertible bonds are subordinated debentures that rank below the senior debt on the firm's capital structure.

Not only do investors need to look into the changes and the volatility of interest rates, the price of the underlying stock as well as its volatility can be a source of concern. The price of a convert may fall below its **straight value** (price of the convert if it did not have a conversion option) and by a greater proportion than its stock when a company is in distress. Many of the firms that issue convertible debentures are small to medium sized firms in terms of market capitalization. Overall, converts are less liquid than bonds, preferred shares or stocks. Also, exercising your conversion right further dilutes the stocks of the company. Stock splits or stock dividends dilute the value of the conversion privilege unless the conversion ratio gets adjusted. Many convertible issues have call features that allow a company to redeem its debentures at par value before the maturity date. On the other hand, converts can sometimes get extended beyond the original maturity date if the company is in distress and it is voted on by debentureholders. Lastly, most issuers retain the right to meet their interest and principal payment obligations by delivering newly issued common shares.

Due to these risk factors, convertible debentures are viewed as suitable for investors with a moderate to aggressive risk tolerance.

Convertible Investors

As noted above, investors in convertible debentures should have a medium to high risk tolerance. This type of investment is not suitable for individuals with a low risk tolerance, a secure/conservative investor profile and/or those that have a need for the preservation of capital. The equity component of convertible bonds leaves it subject to a higher level of volatility compared to non-convertible investment grade corporate bonds but with a lower volatility than holding the common share.

Each investor should consult their tax specialist to carefully evaluate the tax consequences of investing in converts. This investment vehicle can be held in a non-registered account as well as a registered account. The typical investor includes but is not limited to:

- Defensive equity investor
- High yield bond investor
- Equity investor seeking income while still maintaining growth potential participation

Summary

Not all stocks appreciate at the same time and by the same level. Bonds tend to outperform equities in poor economic times. Purchasing a convertible debenture facilitates the participation in two asset classes and it enhances a portfolio's diversification due to the lack of pure correlation with either bond or equity markets. Convertible bonds allow for the participation in the upside of a growing firm while offering the stability and the downside protection of a regular fixed income security.

Reference: Author, Frank J. Fabozzi with Steven V. Mann (2005). *The Handbook of Fixed Income Securities*. (Seventh Edition). New York NY: McGraw-Hill

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