Convertible Debentures – A Primer

A convertible debenture is a hybrid financial instrument that has both fixed income and equity characteristics. In its simplest terms, it is a bond that gives the holder the option to convert into an underlying equity instrument at a predetermined price. Thus, investors receive a regular income flow through the coupon payments plus the ability to participate in capital appreciation through the potential conversion to equity. Convertible debentures are usually subordinated to the company's other debt.

Convertible debentures are issued by companies as a means of deferred equity financing in the belief that the present share price is too low for issuing common shares. These securities offer a conversion into the underlying issuer's shares at prices above the current level (referred to as the conversion premium). In return for offering an equity option, firms realize both interest savings, since coupons on convertible bonds are typically lower than those on straight bonds to account for the call option, and tax savings as coupon expenses are deductible for income tax purposes whereas dividends are paid from after-tax cash flows.

Convertible debentures offer some advantages over investing in common equity. As holders of a more senior security, investors have a greater claim on the firm's assets in the event of insolvency. Secondly, the investor's income flow is more stable since coupon payments are a contractual obligation. Finally, convertible bonds offer both a measure of protection in bear markets through the regular bond features and participation in capital appreciation in bull markets through the conversion option. Unlike traditional bonds, convertible debentures trade on a stock exchange but generally have a small issue size which can result in limited liquidity.

VALUATION

A convertible bond can be thought of as a straight bond with a call option for the underlying equity security. Therefore, there are two lower boundaries below which the bond should theoretically never trade:

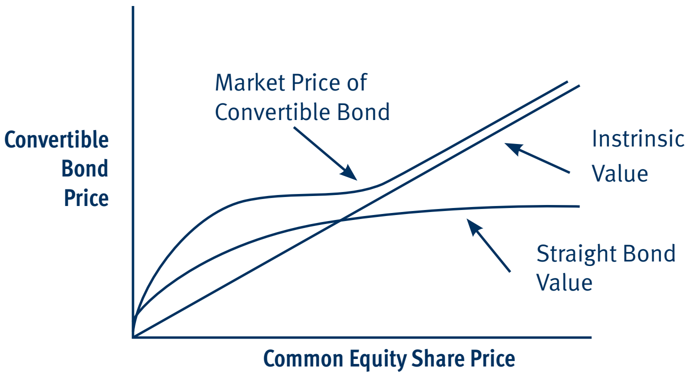
- the straight bond value &
- the conversion/intrinsic value

The intrinsic value of the bond is the current price of the common stock multiplied by its conversion ratio (the number of shares that each bond is convertible into).

CONVERTIBLE DEBENTURES TRADING IN THE MONEY

A convertible debenture will normally trade at the intrinsic value, or a small premium above the intrinsic value, when the underlying equity security is trading above the strike price, or commonly referred to as trading in-the-money.

When a convertible is trading deep in-the-money, it will take on the characteristics of the underlying equity as opposed to a debt obligation. As a result, the yield-to-maturity can become negative and the cash-on-cash (ie. coupon divided by prce) yield can be lower than the underlying dividend yield. If these conditions exist and the convertible debenture



was originally purchased as part of a fixed-income portfolio an investor should reconsider holding this security.

REDEMPTION CLAUSES

Prior to buying a convertible, investors should investigate whether a debenture can be redeemed prior to maturity. Convertibles typically have a non-call period, followed by a soft call and/or a hard call to maturity. The non-call period prohibits the issuer from redeeming the bond without the consent of the bond holders.

- **Soft Call:** The soft call period allows the issue to be called but provides investors with a capital gain to offset the loss of interest income. The most common soft call stipulates that the underlying equity instrument must trade for a specified period of time above a certain price level in order for the bond to be called. Usually, the soft call is set at a level that allows the convertible bond to trade in the money and as such the risk of losing capital under a soft call provision is lower than a hard call provision.
- **Hard Call:** The hard call feature allows the bond to be called at par, or slightly higher, regardless of the price of the underlying security.

Why should you be aware of these call options? All else being equal, a convertible debenture with a higher coupon should trade at a higher price. In the current low interest rate environment, companies can use their hard call option to redeem an outstanding convertible and issue a new convertible at a lower coupon. In order to preserve capital, investors need to be careful when owning a convertible debenture with a hard call option that is significantly lower than the current trading price.

In addition to these redemption clauses investors need to be aware of any soft redemption clauses which allow the issuer to repay the principal amount at maturity/redemption by payment of common shares, as opposed to cash. Most frequently, the clause will state that the corporation may satisfy its obligation to repay the principal amount by issuing and delivering that number of common shares or units obtained by dividing the principal amount by 95% of the weighted average trading price of the common shares during a specified period of time right before maturity. In most cases, receiving units/shares instead of cash is not an issue since you can usually sell them into the market relatively easily. However there are certain situations which could cause a concern:

- **Suitability:** some accounts cannot hold equity so you may be forced to sell the convertible before maturity.
- **Low share price:** where the underlying security trades at a low price and is lightly traded, the bid-ask spread may be sufficiently wide that it may be difficult to sell the shares/units and recoup the full face value.

Convertible debentures that are far out-of-the-money (i.e. the current stock price is well below the conversion price) will normally trade at or near their straight bond value, unless the company is under financial stress. Key pricing considerations include standard fixed income criteria such as the current yield, yield to call, yield to maturity and credit rating (if applicable). Investors should also consider the balance sheet of the company in question as convertible debentures tend to be subordinated debt and clients should note what debt ranks senior to the debentures. Investors need to also be aware that convertible debentures are not generally rated by credit agencies and due to the subordination would likely be rated and few notches below other bond or debentures of the same firm. Many currently outstanding convertible bonds would be considered below investment grade.

Convertible bond pricing becomes most interesting when dealing with issues that are at-the-money. It is here that the bond's call option value becomes fundamental in determining the bond's fair value. Key considerations when evaluating an at-the-money convertible include conversion premium (the lower the better), and call protection (the longer the better). Unfortunately, no rule of thumb exists about what constitutes an attractive conversion premium. Comparative analysis of at-the-money debentures of similar credit quality will highlight attractive issues.

RBC Dominion Securities