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Convertible bombs

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A gambit to escape the commercial-paper crunch backfires

ONE explanation for the wretched share performance of many American companies is the wretched condition of their industries. But the pain of a tough economy was compounded, in some cases, by a bull-market bias in their balance sheets.

Many large companies are facing agony after making use of a special form of convertible bond known as “quasi-commercial paper”. The stuff was hugely popular last year, when it seemed an ideal solution to their problems. In late 2000 and during 2001 the commercial-paper market became increasingly restrictive after some well-publicised blow-ups, including Finova, a finance company, and Xerox. That forced many companies out of the short-term debt market and into the more expensive long-term market. At the same time, share prices had become more volatile. It was not long before creative financiers on Wall Street came up with an idea that magically seemed to restore their clients' access to low-cost debt.

The trick was a special kind of long-term convertible bond. As usual, it would allow buyers to benefit from any significant rebound in the share prices of sponsoring companies. The catch was a put option that allowed investors to force companies to repurchase the bonds at their original price at a future date.

Enthusiasm for these convertibles grew fast, and bonds outstanding rose from \$10 billion at the end of 2000 to \$32 billion in 2001, according to Morgan Stanley. The effective coupon on this debt was less than commercial paper—in most cases under 2%. But the put option was a nasty sting in the tail once the markets turned mean.

As an issuer's prospects dimmed, its share price would fall. That made the likelihood of being able to convert debt into equity increasingly remote, and gave bondholders less reason to hang on to their bonds. Credit considerations might make them want to bail out anyway. So, just as a company's need for cash was growing, and its sources were drying up, there was a threat of being forced to repay the bonds. That

triggered fears among shareholders that companies needing to repay bonds would tap the equity market for the necessary cash, and dilute their shareholding accordingly.

As in so many other problem areas of finance, the groundbreaking company was Tyco. On December 4th 2000, Tyco issued \$5 billion in face value of convertible bonds, maturing in 2020. The interest rate was a meagre 2%. Buyers had the opportunity to sell back the securities to Tyco on November 17th 2001. A time line drawn up by Anand Iyer, global head of convertible research at Morgan Stanley, gives a curious picture of how Tyco managed to get by. Just days before the decision date, the Fed cut short-term rates, increasing both the attractiveness of Tyco's yield and the prospect of an economic rebound. Then Tyco held an upbeat investor meeting, stoking demand for its shares. The put option was largely ignored, much to the regret of many investors, given Tyco's later nosedive.

They have been less forgiving since. All the companies forced to repurchase all or part of their convertible issues, including Solectron, Anadarko Petroleum, Calpine, Stillwell Financial, Marriott and US Bancorp, have seen their stock hit hard. Interpublic, a large advertising agency, has a put date next year, which has almost certainly played a role in driving down its share price from \$35 this summer to \$13. Other companies, including Cendant and Neuberger Berman, have bought off investors by sweetening terms, such as adding an interest payment, call protection, or opportunities for future puts.

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If there is any benefit in issuing these convertibles, it is the effect of forcing a financial restructuring. The debt reduction comes at the expense of equity holders, as in a bankruptcy, but without the drama or the cost, observes Alan Muschott, manager of a convertible-securities fund run by Franklin Templeton. It is an elegant solution to a problem, even if not quite the one companies had in mind when they issued the bonds.