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Insight INVESTMENT

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CONVERTIBLE BOND BRIEFING
AN INTRODUCTION TO CONVERTIBLES

INTRODUCTION

A convertible bond is a fixed-income debt security that can be converted into a pre-specified number of equity shares. The nature of the security makes for interesting and complex pricing dynamics and provides unique opportunities for both investors and issuers. The terms of convertible bonds can vary and will be specified in the **bond indenture**.

UNDERSTANDING CONVERTIBLE BONDS

Convertible bonds act as a hybrid security, offering investors the fixed income features of a bond such as interest payments and face value at maturity, alongside the opportunity to own the underlying company stock. A convertible bond essentially acts as a regular bond with an embedded call option on the company stock; where a call option is an agreement that gives the holder the right, but not the obligation, to convert into a financial instrument (normally the underlying equity) at a specified price within a specific period.

For a traditional 'Vanilla' convertible bond, If the stock price rises to a point where the **conversion value** (the value of shares that holder can redeem), is greater than the fixed income value then the holder is likely to convert the bond to equity and receive the pre-determined number of shares, known as the **conversion ratio**. Otherwise, the investor can simply continue to hold the bond and receive coupon payments and the face value at maturity.

Companies typically issue convertible bonds to raise capital in a similar way to regular bonds or equity. Whilst convertible bonds can be issued by private companies with equity stock, they are more commonly issued by public companies with equity traded on an exchange or through over-the-counter market makers. Our analysis suggests that the global convertible bond market capitalisation is approximately 500 billion USD, with issuance biased towards the US and market liquidity similar to that of traditional corporate bond markets.

TYPES

There are a number of convertible bond types, with the most common being:

Vanilla: allows the **investor** to hold the bond until maturity or convert it to common stock at a predetermined **conversion ratio**.

Mandatory: automatically converts the bond to common equity on a predetermined date or event, at the **conversion ratio**.

Reversible: gives the **issuer** the right to convert the bond to equity at the **conversion ratio**, or keep the bond as a fixed income investment until maturity.

QUALITIES

Investors benefit from exposure to both fixed-income and equity qualities such as capital appreciation and potentially dividends following strong company performance. However, the fixed-income coupon rate tends to be lower compared to traditional bonds as the equity conversion option also provides value to the investor. As a result, if the stock performs poorly the investor is unlikely to convert and will be stuck with a return below that of a non-convertible bond.

Whilst investors may see additional equity option risk for companies with uncertain performance outcomes, they will also have added downside risk management with less volatility compared to equity alone, as bondholders are paid before common stockholders in liquidation.

From an issuer perspective, the company may enjoy paying the lower coupon rate derived from the equity option value mentioned previously. The firm may also prefer to issue a debt security in the medium-term as interest is tax-deductible. In the long term however it may prefer an equity issue, which the instrument provides, where the issuer will no longer have to repay at maturity with cash if the bond is converted.

Additionally, when a company issues shares it can dilute the existing investor ownership as it adds to the number of shares in circulation, depressing share price and EPS. Issuing convertible bonds can therefore help to reduce negative investor sentiment that results from equity issuance by issuing bonds that can be converted at a later date when the company is performing well.

PRICING DYNAMICS

When the issuer's equity price is low relative to the **conversion price** (the effective price that the bondholder would pay per share if they converted), the convertible bond price is most sensitive to the market's view on the issuer's creditworthiness (see Zones 1 and 2 in Figure 1). If the **bond floor** (the theoretical minimum price of the underlying bond) is considered sound, the convertible bond's price will hold up as the underlying equity

price falls, because investors are confident they will receive the coupons and principal offered by the bond (see Zone 2). However, if that perceived **bond floor** collapses, the convertible bond loses its 'safety net' and theoretically behaves like an equivalent 'distressed' traditional bond issued by the company (see Zone 1). Traditional bond pricing reflects a function of the present value of future cash flows, alongside other factors such as the interest rate climate and credit spread.

An option's sensitivity to an underlying equity is known as delta. As the equity price of a company increases towards the **conversion price**, the convertible bond price becomes increasingly sensitive (i.e. the delta increases) to the equity price moves because the convertible starts to derive further value from the equity option. This is referred to as 'high gamma' (see Zone 3).

When the equity price has risen further towards, or even above, the **conversion price** (see Zone 4), the convertible bond price tends to be much more sensitive to factors that drive the equity price, experiencing similar volatility and value to the underlying stock. This is because at the **conversion price** the convertible bondholder would logically convert their bond to common shares (if a continued price rise or stabilisation is expected) for the higher equity payoff.

At the extremes, a convertible bond's price will tend to reflect equity characteristics on the upside or creditworthiness on the downside. During the transition where both factors are priced in, a convertible bond with a sound bond floor can exhibit a convex price relationship with the underlying equity. The convertible will hold up relative to a down move in the underlying equity, as investors focus on the credit value; the convertible can also outperform the underlying equity on a move up because its delta increases. This convexity can lend itself well to convertible arbitrage strategies taking long positions in the convertible versus the underlying equity.

TERMINOLOGY

Conversion ratio: determines the number of shares that the holder will receive by converting one bond. For example, a 5:1 ratio means that one bond would convert to five shares of common stock.

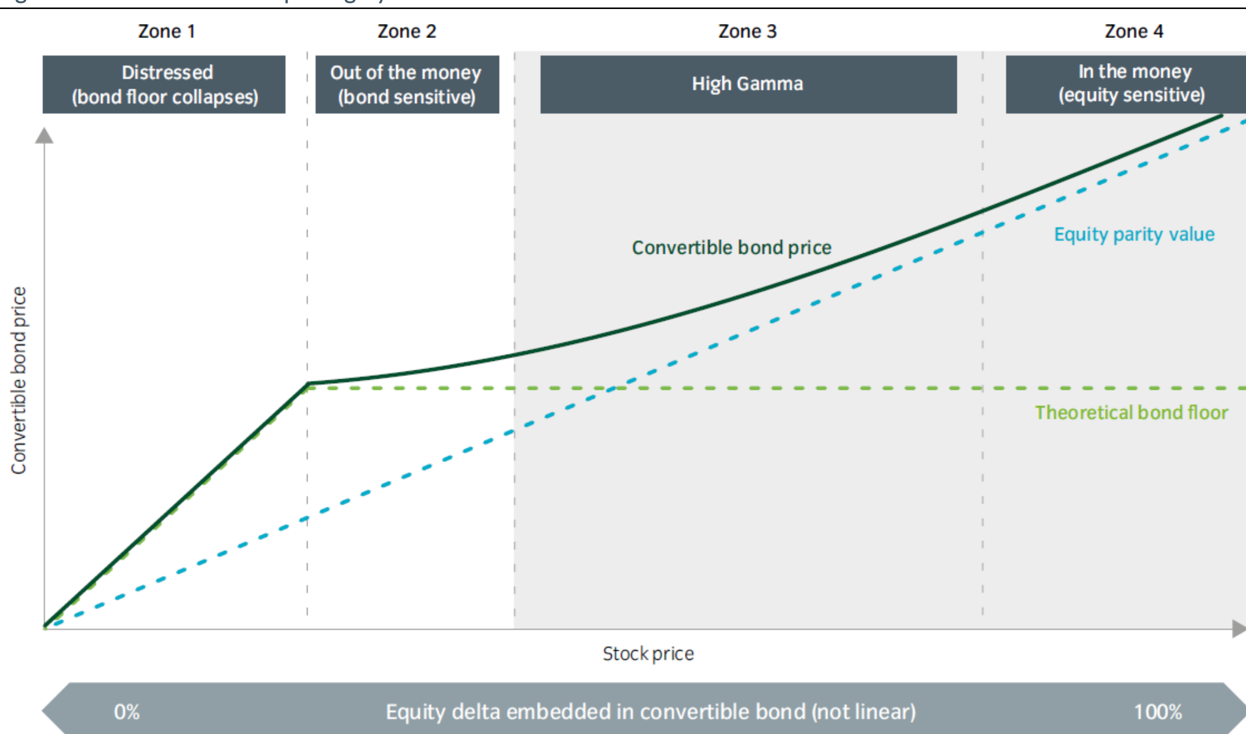
Conversion price: the effective price that would be paid per share, should the convertible option be exercised: the price paid for the bond divided by the number of shares received.

Conversion value: represents the value of the shares that the holder can redeem: the number of shares received times by current market value of the shares.

Bond floor: theoretical minimum price or 'safety net' assigned by bond markets (assuming no distressed events): the present value of future cash flows, accounting for credit worthiness and spreads.

Bond indenture: this is the contract associated with the bond; containing a description and terms of the bond such as redemption value, coupon details, issuer restrictions and failed payment conditions. For a convertible bond, the terms of conversion will be included here; such as the conversion ratio and the period during which the bond can be converted.

Figure 1: Convertible bond pricing dynamics[1]



[1] For Illustrative purposes only.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.
The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

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Currency hedging techniques aim to eliminate the effects of changes in the exchange rate between the currency of the underlying investments and the base currency (i.e. the reporting currency) of the portfolio. These techniques may not eliminate all the currency risk. Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment. Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio. Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio. Where leverage is used through the use of swaps and other derivative instruments, this can increase the overall volatility. Any event that adversely affects the value of an investment would be magnified if leverage is employed by the portfolio and losses would be greater than if leverage were not employed.

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