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CONVERTIBLE BONDS AS A COMPONENT OF A COMPANY'S CAPITAL STRUCTURE

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Convertible bonds may provide unique benefits within the private company capital structure. Estimating the fair market value of a convertible bond, therefore, requires a number of unique steps to account for the convertible bond conversion premium.

Introduction

Convertible bonds are hybrid investment instruments that have features of a straight bond and common stock.[1] Like straight bonds, convertible bonds provide investors with a consistent and low-risk source of income; however, convertible bonds uniquely offer investors (or in the case of a forced conversion, the issuer) the option to convert the bond into a specified number of shares of stock in the issuing company. As is the case with debt and equity instruments, hybrid instruments, such as convertible bonds, are used to raise capital from investors when traditional avenues are exhausted.

Issuers typically assign lower market yields (smaller coupon payments) to convertible debt than in conventional straight bond issuances. That is because the upside potential of converting to common stock—if favorable market conditions exist—is offset by a lower coupon payment yield. Additionally, if the option to convert is exercised, the company eliminates the principal debt associated with the convertible bond issuance and issues shares to the investor.

HYBRID INSTRUMENTS, SUCH AS CONVERTIBLE BONDS, ARE USED TO RAISE CAPITAL FROM INVESTORS WHEN TRADITIONAL AVENUES ARE EXHAUSTED.

A convertible bond may be favorable to an investor if the investor seeks business downside protection while having the capital appreciation benefits upon conversion to a specific number of common stock shares.[2] Convertible bonds are appealing to investors because the bonds have a higher risk-adjusted return that simultaneously mitigates the downside risk of traditional equity instruments while providing the benefit of participation in company growth.[3] This allows for a more diversified investment with lower overall risk but limited upside. (A well-informed investor should consider his

or her own risk tolerance and investment goals before executing a trade.)

The hybrid element that convertible debt provides is useful because it combines the components of a call option with a fixed-income bond. When compared with common stock or straight stock options, returns are limited by the number of shares an investor is able to convert, but the investor is simultaneously protected against the same loss of principal that a common-stock investor is exposed to.

WHEN AN INVESTOR CONSIDERS CONVERTIBLE DEBT SECURITIES, THE INVESTOR SHOULD UNDERSTAND WHAT TIER OF THE COMPANY CAPITAL INVESTMENT STACK THE INVESTOR WOULD BE IN.

Convertible Bonds in the Private Company Capital Structure

Private companies have evolved from seeking traditional sources of capital—bank financing and equity raised from founders—to involve mezzanine debt capital, private equity capital, and seller financing capital. Generally, each of these sources requires (1) an investment return greater than traditional collateralized bank financing and (2) a security interest higher (from a liquidation standpoint) than common equity investments. To accommodate these requirements, private companies can issue debt and/or equity with rights and privileges that fall between the two traditional capital sources.

When an investor considers convertible debt securities, the investor should understand what tier of the company capital investment stack the investor would be in. There are four primary tiers: (1) senior debt, (2) mezzanine debt, (3) preferred equity, and (4) common stock equity. Convertible debt resides in the second tier: mezzanine debt.[4] While convertible debt may be higher in the capital stack than preferred equity, representing less risk to the investor and a claim to the company's assets, returns associated with private convertible debt are lower than that of stock.

Companies predetermine the conversion price and typically set it higher (out of the money) in private deals because of the adverse market reactions of publicly issuing convertible debt.[5] However, since an investor is able to convert only to a specified number of shares, the upside is capped. Convertible debt is preferable in a volatile market environment because of the higher risk-adjusted returns associated with it.

Valuation of Private Convertible Bonds

The valuation of private company convertible bonds can be summarized into two components: (1) the value of the bond plus (2) the value of the call premium to convert into equity.

Bonds often are considered to be a subset of promissory notes, with longer periods of maturity. A promissory note is characterized as a negotiable instrument that can be transferred with the borrower's permission. Promissory notes can be considered as written promises that the borrower will follow the stated repayment schedule for the principal plus interest. The payments for interest and principal may occur together or separately on a daily, weekly, monthly, quarterly, or annual basis or at maturity—or some variety thereof. The value of bonds, like the value of promissory notes, results from summing the accumulated interest over the period of maturity and the bond's principal.

A conversion premium measures the optionality (both extrinsic and intrinsic) of the right to convert. The difference between the conversion price and the current stock price, in the private convertible debt market, is typically set at issuance between 20 percent and 25 percent more than the current stock price.[6]

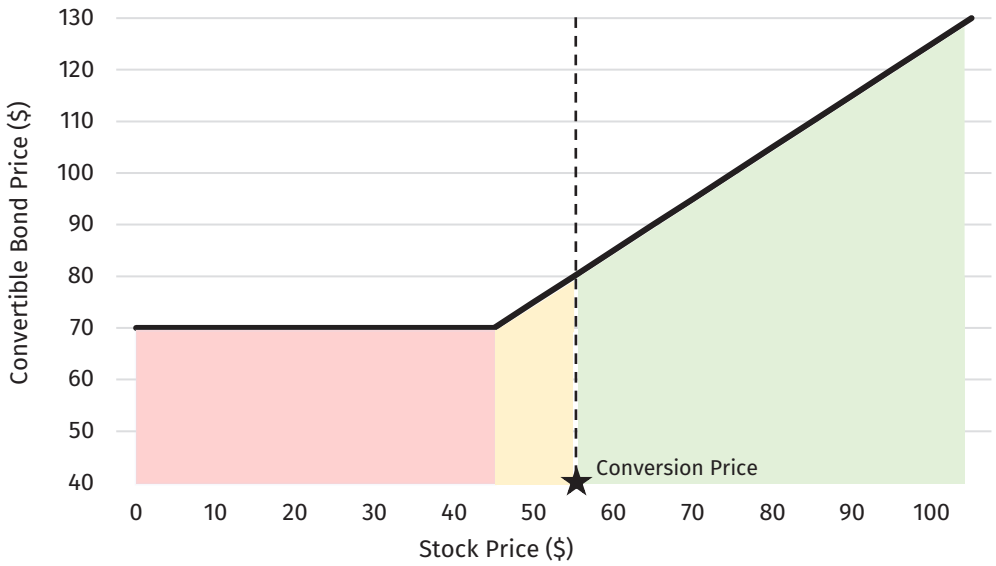
A CONVERSION PREMIUM MEASURES THE OPTIONALITY (BOTH EXTRINSIC AND INTRINSIC) OF THE RIGHT TO CONVERT.

The conversion price is determined by the company board of directors at issuance; it typically is set higher

than the current common stock share price. Once the issuer sets the conversion price, the conversion ratio is determined: the par value of a convertible bond divided by the conversion price. The conversion ratio can be thought of as the number of shares of common stock the investor will receive after choosing to convert.

Figure 1, right, illustrates the market price of a convertible bond as the underlying stock price increases.

Figure 1
The Value of a Convertible Bond Relative to the Stock Price



Suppose that an investor, in a hypothetical world that has no transaction fees and where the issuer cannot force conversion, holds a convertible bond where the par value is $70. The conversion price is set at $55 per share, so the bond's conversion ratio (number of shares the investor will receive after converting) is 1.27 (rounded).

The shading in Figure 1 represents the value of converting such a convertible bond as the stock price increases. Converting to common stock would start "out of the money"—having no intrinsic value—until the stock price increased to $45 per share (red shading).

Beyond $45 per share, the bond price increases as the stock price approaches the conversion price. This is because of the inherent optionality of the convertible bond. As the stock price rises, the option to convert becomes more valuable and so does the convertible bond (yellow shading). When the stock price equals the conversion price, the investment is "at the money."

If the stock price exceeds the conversion price, the investor has the option to convert the underlying bond to common stock. In the case above, if the stock price rose beyond $55 per share (green shading), the option to convert would now be "in the money" and present a profit opportunity for the convertible bondholder.

Before a conversion event, the investor receives a coupon on the bond itself. The coupon rate typically is within the mid-single-digit range.[7] Since this is a private transaction, the terms of the coupon payments are flexible. Issuers may pay coupons using cash or payment in kind ("PIK"). PIK payments are a cash alternative where the issuer pays the lender in additional debt securities. The PIK coupon rate is typically higher than if it were paid in cash, and restrictions often are embedded into the convertible debt issuance that limits the PIK used.

After a stock conversion, the issuing company no longer is responsible for the remaining coupon payments or the repayment of the bond's principal, but the newly issued shares decrease the existing shareholders' ownership stake in the company while also decreasing earnings per share. Shareholders may view this dilutive event as negative because it may have a slimming effect on earnings per share and voting power.

However, from the perspective of the bond investor, converting to an equity stake often provides the investor with newly held voting privileges and the capital gains associated with increases in share price. Nevertheless, the investor also loses the security of consistent coupon and principal payments and is now exposed to the company's share price fluctuations and downside equity risk. By adopting the higher risk after conversion to equity, the investor's expected return increases as well.

If the underlying stock price remains below the conversion price, however, the investor would likely not

convert to common stock. In the absence of transaction fees, a convertible bond's break-even point is where the underlying stock price equals the conversion price set by the issuing company.

A discount for lack of marketability ("DLOM") often is considered to account for the lack of liquidity in trading convertible bonds on the private market. The DLOM can be described as the difference in price that a hypothetical investor will pay for a liquid asset compared to a comparable illiquid asset. In the context of valuing a privately held convertible bond, the DLOM is factored into the selected yield to estimate the straight bond and the price of the underlying security stock in the option model that is relied on in the conversion premium component to value.

According to Judge David Laro in *Mandelbaum v. Commissioner*, an analyst should consider nine factors when applying a DLOM to a subject interest: (1) financial statement analysis; (2) dividend distributions; (3) company history, positioning, and outlook; (4) company management; (5) degree of control in the transferred shares; (6) transfer restrictions; (7) estimated holding period for the stock; (8) company redemption policies; and (9) costs associated with a public offering. Based on the degree of illiquidity (or lack of marketability), convertible bonds may offer a higher yield as compensation for these added risk factors.

The fair market value of a private company convertible bond is equivalent to (1) the value of a plain-vanilla bond plus (2) the convertibility election premium.

Conclusion

As generational changes occur and business cycles change, private companies may seek capital from sources that require an investment return (or a series of rights) that is between traditional debt capital and common stock capital.

Those elements may best be addressed by the issuance of convertible debt.

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