

NEITHER FISH NOR FOWL – THE EQUITY-LINKED AWARD

The catchy title, in our mind, is a fair description of this award category and its odd duck status. In our estimation, convertible bonds, although publicly issued debt, deserve a special category of their own as a consequence of their dual nature. Unfortunately, this award has made infrequent appearances over the years, reflecting the irregular flow of convertible transactions. Things, however, are about to change.

Lately, both investors and issuers have found great advantages in this financial instrument. Hedge funds in particular have increased their focus on convertibles as a means to secure the downside while enjoying the upside. They also serve as a hedging tool for equity exposure.

Issuers, too, love them given their low overall cost. Even with the premium, the convert feature offers investors upside for which the trade-off is a

much lower interest rate than a standard bond. And even the downside risk, dilution, is controllable through various financial engineering techniques including hedges and warrants and treasury stock.

A timely insight was provided by Lars Kirkeby of Nordea who noted that “convertibles are also attractive instruments if there is a high probability that the stock market is on the top of a cycle and the risks of a recession are close. With the significant

decline in share price, today’s value of the convertible element (the stock option) is marginal and as a result issuers have secured funding at very attractive levels. He gives the example of Golden Ocean, whose issue was also nominated for this award, paying a coupon of 3.625% for a 5- year convertible bond versus the LIBOR + 400 to 450 bps they would have had to pay for a like term straight bond.

Among the nominees consid-

Contingent Convertible Senior Notes Offering

Issue:	Contingent Convertible Senior Notes Offering due 2027
Amount:	\$125 million, with \$25 mil. over-allotment option
Ranking:	Senior unsecured
Coupon:	1.875%
Principal Amount per Note:	\$1,000
Last Sale Price (Oct. 3, 2007):	\$58.90
Base Conversion Price:	\$91.30, 55% conversion premium
Incremental Share Factor:	50% of the base conversion ratio
Redemption Options:	Non- callable before October 22, 2014; Putable on October 15, 2014, 2017, 2022 at par.
Use of Proceeds:	General Corporate Purposes
Net Proceeds:	\$145.3 approximately after over-allotment
Conversion Settlement:	Cash/ Stock Combination
Registration:	144A with registration rights

Source: Excel

FIGURE 1

Let's Compare...

	Equity Offering	High Yield Bond	Bank Financing	Convert Bond
Timing	2-3 months	1-2 months After Credit Rating	About 1 month	1-2 months
Use of Funds	Defined Target usually	General Corporate Purposes	Acquisitions	General Corporate Purposes
Amortization	N/A	Bullet	Front loaded	Bullet
Dilution	Very Dilutive	Non Dilutive	N/A	Non Dilutive
				Partially Dilutive after Base Conversion Price
Margin	N/A	Libor +300 bps	Libor +100 bps	Libor -310 bps

Source: Excel

FIGURE 2

ered this year were the previously mentioned Golden Ocean Convertible and an offering by BLT Finance, but for the judges there was a clear winner. This year's award goes to Deutsche Bank Securities as the sole book running manager of Excel Maritime Carrier's \$125 million 1.875% Senior Unsecured Convertible Senior Notes due in 2027. The main terms of the offering are shown in Figure 1.

The terms show its many virtues. Raising \$150 million, with the over-allotment exercised, for 25 years at LIBOR minus 310 bps is quite an accomplishment. But doing it on an unsecured basis with no use of proceeds specified and a conversion premium of 55% borders on extraordinary in our view.

An excellent presentation by Ms. Ismini Panayotides of Excel provides insights into the issuer's and advisor's perspective

on the capital raising exercise. A public company has many options for raising capital that Ms. Panayotides assesses according to key characteristics in Figure 2. In terms of timing, with the exception of an equity offering, all are pretty similar with high yield being somewhat of a question mark due to the timing of the credit rating process. Interestingly, the use of proceeds category is somewhat inflexible. Both equity and bank debt require specificity whereas high yield bonds and convertibles do not. Bank debt also requires amortization unlike equity and bonds, which have no amortization and a bullet payment respectively. Moreover, as a consequence of the credit crunch, raising bank debt is more uncertain these days given the difficulty of syndication. In pricing terms, for the reasons given earlier, the convertible is the hands down winner. In this case, the coupon was based upon LIBOR minus 310 bps reflecting Excel's BB to

BB- debt rating. And finally Ms. Panayotides makes an interesting point on dilution noting that the convertible is initially non-dilutive and only partially dilutive after the base conversion price.

In addition to having an astute investment banker, the stars were clearly aligned providing ideal conditions for a successful offering. Most noteworthy and deal specific was the huge supply demand imbalance in the convertible market in favor of issuers. From 2004 to 2006, there was -58.7 billion in net issuance, which explains the high degree of interest exhibited by 58 investors, which engendered \$250 million in demand resulting in the offering being 2x oversubscribed. On a macro level, the market was highly receptive given the robust dry bulk market as well as more educated and interested investors. At the company level, the share price had trade up 227.1% in six

months with daily trading volume increasing from \$5 million to \$35 million. The company was also financially sound with a strong balance sheet, with low net debt to capitalization and strong interest coverage. Finally, the convertible market was one of the few markets not impacted by the sub-debt crisis.

The beauty and the essence of this transaction is best illustrated by a comparison of the cost of capital of the financing alternatives over seven years. The cost of capital of the convertible is below that of straight debt until it breaks even at a share price of \$129.73 or almost a doubling of the share price at the time of offering. As Ms. Panayotides concludes, "a convertible is deemed a cheaper cost of capital than straight debt if redeemed and cheaper than equity if converted." That's what makes this deal a winner.

