S-chips corporate failures are again back in the spotlight and there appears to be common thread that links many of these failures – an inability to repay convertible bonds.

The South China Morning Post reported in Jan 2009 that 6 out of 11 Singapore-listed Chinese companies that had issued convertible bonds between 2005 and 2008 have defaulted on their bonds. Among the biggest casualties was China Milk, which had a large cash hoard and seemed more than capable of repaying its convertible bonds.

The “6-in-11” statistic triggered concern among small investors that companies that issued convertible bonds have a larger probability of collapse than those which didn’t.

Is such a reasoning sound? Why do companies issue these bonds in the first place?{loadposition advert1}

Convertible Bonds - A Primer

A convertible bond (CB) is a type of bond which pays interest and grants the holder the option (but not the obligation) of converting the bonds to shares of the company issuing the bond.

Convertible bonds are listed on a company's balance sheet as a type of liability, distinct from bank borrowings and trade payables.

A convertible bond has 3 main variables: (1) a strike price which is typically set a level higher than the prevailing share price, (2) a yield and (3) a maturity date.

As an illustration, a CB with a yield of 5% is sold at a strike price of $1.20 and expires 2 years later. In the event that the share price of the issuing company rises from $1 to $1.30, the bondholder may choose to exercise the conversion option. He trades his convertible bonds for shares at $1.20 apiece and thereby gains $0.10 by subsequently selling the share on the open market. On the other hand, if the share price continues to languish below $1.20 (the CB's strike price) over the next 2 years, the holder of the CB can choose to hold the CB to maturity and receive the principle plus interest. In another scenario, the CB holder may choose to redeem the CB before it reaches maturity.

Several variants of convertible bonds exist. Zero-coupon convertible bonds are those that do not pay periodic interests but are initially sold at a discount to face-value. The yield is thus derived from the discount to the face value that is repaid at maturity. Mandatory convertible bonds are a less common type that obliges the bond holder to convert the shares on or before the maturity date (i.e. the principle would not be repaid in any case).

Convertible bonds are usually only available to sophisticated investors such as private equity funds and high net-worth individuals. In some cases, convertible bonds can be traded on the secondary market, not unlike shares.

The Case for Convertible Bonds

A convertible bond allows the holder to benefit from potential upside from the increase in the issuer's share price. On the other hand, the issuer benefits by raising funds without immediately diluting the shareholding base of the company.

Convertible bonds are also cheaper than banks loans, since bondholders would usually

sacrifice some yield in exchange for an opportunity to ride on the issuer's business expansion. For instance, the average Singapore dollar (SGD) prime rate is 5.38% (as of 12 Feb 2010). In comparison, Ezra and Swiber (two Singapore companies which recently issued convertible bonds) pay effective yields of 4% and 5% respectively on their convertible bonds.

Convertible bonds, like regular bonds, have yields which are fixed at issuance. In contrast, bank loans usually have floating rates tied to SIBOR (Singapore Interbank Offered Rate) or LIBOR (London Interbank Offered Rate). Convertible bonds are thus a good instrument to lock in low interest rates, which are widely expected to rise in the next 2 to 3 years.

Drawbacks

The biggest downside of convertible bonds is that if converted, they lead to a dilution of the shares in the issuing company. Dilution means that an existing shareholder owns a proportionally smaller piece of the company and gets a smaller spit on profits. Furthermore, convertible bonds are often repayable on demand and thus pose a potential strain on the cash flow of companies that issue them.

From the perspective of investors, convertible bonds sometimes hide the true liability positions of companies, due to the fact that net gearing (a commonly used financial ratio to compare the indebtedness between companies) does not take convertible bonds into consideration. Without a detailed reading of the balance sheets, the investing public may erroneously view a company with a high exposure to bank loans as being less credit worthy than another whose liabilities are in the form of convertible bonds.

Look at Fundamentals

In most of the recent S-Chip failures, default on convertible bonds appears to be the result (rather than the cause) of financial distress. Since convertible bonds are targeted at sophisticated and institutional investors, issuing companies are probably subjected to levels of scrutiny no less stringent than those for bank loans. A failing company is thus perhaps just as likely to default on bank loans as it does on convertible bonds.

Therefore, convertible bonds should not used as a sign of impending corporate failures. One way to judge whether a company is in danger of defaulting on its convertible bonds would be to look at the company's fundamentals, in particular its free cash flow levels. A company with a healthy free cash flow would give higher confidence to bond holders against premature redemption of the bonds. Even if the bonds are abruptly called in, such a company would be in a better position to divert operation cash surpluses towards repaying the bonds.

Conclusion

Convertible bonds allow businesses to borrow at a lower rate than banks would offer. They also allow companies to diversify their sources of financing and are also a sign of a well-developed capital market. Ultimately, the primary factor responsible for the collapse of the S-chips such as FerroChina is mismanagement, rather than convertible bonds per se. Investor would therefore do well to not evaluate a company's future solvency based on whether it has issued convertible bonds in the past.