

CONVERTIBLE DEBENTURES

A PRIMER

What are convertible debentures?

They are hybrid securities, combining the features of a conventional debenture with the option of converting, under certain circumstances, into the underlying equity of the issuer or of another company.

Why are they issued?

They are issued for different reasons:

1. The coupon rate is lower than it would be for a non-convertible debenture issued by the same company. This reflects the value of the conversion option so the issuing company thus saves interest costs;
2. The issuing company's credit rating or size does not allow it to issue conventional bonds;
3. A company can avoid or delay dilution to its equity holders by issuing convertibles. Perhaps the company has used the proceeds to make a capital investment. When such investment comes on stream and begins to make a contribution to earnings, the company would force conversion of the debentures.

What do they look like?

Here is an example of a recently issued convertible debenture:

Issuer: H&R Real Estate Subordinated Debentures

Market Price: \$ 101.00

Share Price: \$ 18.00

Coupon Rate: 5.90%

Maturity Date: June 30, 2020

Conversion Terms: Each \$ 1000 debenture is convertible into 42.5532 shares of H&R Real Estate Investment Trust (HR-U). They are therefore convertible at $\$ 1000 / 42.5532 = \$ 23.50$ per share.

Call Feature: H&R may call them anytime after June 30, 2016 at \$ 100.00
Investors have the option of converting before the debentures are called.

Convertible Valuation

Intrinsic Value: This is calculated by multiplying the number of shares per bond times the value of the shares. In this case it is:

42.5532 times \$ 18.00=\$ 765.96 or \$ **76.60** per
\$ 100 in conventional bond terminology

Premium: The difference between the market value of the debenture (101 in this example) and its intrinsic value:

101.00- 76.60= **24.40 points** or $24.40/76.60= 31.85\%$

Why does this premium exist?

It exists to reflect the value of the conversion option plus the current yield advantage versus the yield on the underlying equity.

Cash flow advantage:

Current yield on bond (not yield to maturity): 5.84%

Current yield on the common stock: 3.34%

Advantage: 2.50% per annum

Payback Period

The next calculation displays the period of time needed to recoup the premium paid for the bond.

The first calculation is the income per \$ 100 debenture. That is simply the coupon rate times 100. In this case, it would be $5.90\% \times 100= 5.90$.

The next calculation provides the amount of income that would be produced using the equivalent amount of shares per \$ 100 debenture and multiplying it by the annual dividend.

This would be $4.3(42.55/10) \times 0.61= 2.62$

The payback period is the conversion premium divided by the difference between the annual income on the \$ 100 debenture and the annual income on the equivalent amount of shares.

$24.4 / (5.90-2.62) = 7.44$ years.

Thus the premium would be recouped before maturity. Please note that these variables are dynamic. In H&R's case, the company has signaled that it will be raising its dividend payments gradually so this calculation will change.

Nevertheless, the debenture holders will have the added security of owning the debenture along with more income. Should H&R increase its dividend significantly, that should help to boost the share price and, indirectly, the debenture price.

Characteristics

Fixed Income

Convertible debentures are similar to conventional bonds in that they offer a fixed income stream of interest payments plus the repayment of principal at maturity. They rank ahead of the underlying equity on a company's balance sheet and are therefore safer. Owing to the convertible option, however, the coupon rate on the convertible debenture is lower than for an equivalent non-convertible debenture. Most convertibles issued in Canada are unsecured and are not rated by the credit rating agencies. One other notable feature of convertible debentures is that, unlike conventional bonds, they are all listed on the Canadian Exchanges.

Equity

Since they offer a convertible feature, convertible debentures tend to fluctuate along with the underlying equity. This is certainly more typical when the stock price rises.

When the stock price falls, the convertible debenture will fall too until it reaches its value as a bond and thus stabilizes even as the stock price continues to fall. This occurred frequently in 2009 and the term "busted convertible" became commonplace, referring to convertible debentures that were so far out of the money that they traded as bonds.

If the stock price exceeds the convertible price, the debentures are said to be "in the money" and will trade virtually lockstep with the common.

When the underlying equity is near to the conversion price, the convertible is said to be "at the money". At this level, the convertible debenture will be influenced both by the equity price change as well as the change in interest rates.

Call option

Convertible debenture issues almost always come with a feature which allows the issuer to redeem the debentures prior to maturity at the call price. An issuer would call an issue to possibly refinance at a lower rate or to force conversion.

Risks

Convertible debentures in Canada are typically less-than-investment grade and not rated. Therefore investors with a moderate to high risk tolerance might include them in a well-diversified portfolio. Thus, these debentures have credit risk, interest rate risk and call risk.

What to look for?

When considering investing in convertible debentures, the first step would be to examine the underlying equity of the issuing company. Odlum Brown follows many of the companies which have issued convertibles and may have opinions and recommendations on them.

Next, investors would examine the features of the bond; in particular, the call price is important as is the forced conversion clause. This kicks in when the price of the equity is well above the conversion price. The company in this instance would call the bonds, thereby forcing the debenture holder to convert to the common.

The conversion premium is very important. One of the first things to do is to calculate the cash flow payback period as illustrated earlier. Thus, look for a payback period in years such that the net income gain from owning the debentures versus the equivalent amount of stock pays off the premium before the bond matures. Odlum Brown calculates all of the relevant valuation metrics and they are available from your Investment Advisor on request.

Summary

Convertible debentures will perform well in rising equity markets while adopting more bond-like behaviour during equity market downturns, thus mitigating downside risk.

Thus, they offer investors the upside of equities while retaining the characteristics of a regular fixed income security, namely, a fixed stream of interest payments plus the repayment of principal at a specific date.

They offer some diversification benefits therefore and would also contribute to lower portfolio volatility.

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