The Economist

Buttonwood | Why convertible bonds are the asset class for the times

Fast-changing conditions call for flexible forms of capital

IN THE MIDDLE of March last year, as the coronavirus pandemic was taking hold, a private-equity boss in America was asked how his industry would deal with the shock. The businesses owned by buyout firms would first look to raise debt wherever and however they could. Drawing equity from private-equity investors would be a last resort. "I think you'll see the same in public markets—a lot of convertible issues," he said. Sure enough, there was soon a rash of big convertible-bond sales by cruise lines, airlines and retailers..

A convertible is a bond with an option to swap for shares of common equity. Last year $159bn-worth were issued worldwide, according to figures compiled by Calamos Investments, an asset manager. This was around twice the value of convertibles issued in 2019. So far this year around $100bn-worth have been issued. An asset class that had fallen out of fashion is back in vogue. That is because convertibles are well-suited to fast-changing conditions.

To understand why, start with some basics. A convertible bond has the usual features of a garden-variety bond: a principal to be repaid on maturity, an interest-rate coupon paid once or twice a year and so on. In addition the issuer grants the bondholder the right to convert the principal into a fixed number of shares. This number, known as the conversion rate, is typically set so that it would be worthwhile to exercise the option only if the share price rose by 30-40%. The option is thus "out of the money" when the convertible is issued. A company with a share price of, say, $15 might set the conversion rate of a $1,000 bond at 50. At that rate it would begin to make economic sense to swap the bond for equity only if the share price reached $20 (ie, $1,000 divided by 50). In exchange for the equity option, convertibles pay a lower rate of interest. A rule of thumb is that they have a coupon roughly half that of a regular bond.

Convertibles may be complex securities, but in some circumstances they have clear advantages over straight debt or equity for both issuers and investors. This is the case for unproven firms in capital-hungry businesses. (Until recently Tesla was a big issuer of convertibles, for instance.) The founders of such firms are often reluctant to issue equity, because it dilutes their ownership. They would prefer to issue debt. But bond investors might demand a steep interest rate to compensate for the risk of default. Convertible bonds can be an ideal compromise. Investors are willing to accept a lower interest rate in exchange for a piece of the equity upside. For business owners, convertibles are less dilutive than straight equity. New shares are issued later at a much higher price, if at all.

Satoshi Kambayashi

Around 60% of the volume of issues so far this year is by firms that have been listed for less than three years, says Joseph Wysocki of Calamos. But old-economy cyclical firms are issuers, too. Some, like Carnival Cruises and Southwest Airlines, used convertibles last year to raise "rescue" finance at lower interest rates and without immediate dilution. Others are using them to finance investment: Ford Motor sold $2bn of convertible bonds in March, for instance.

This flurry of issuance is quite a shift. The market for convertibles was previously rather moribund, even as high-yield bonds and leveraged loans enjoyed a boom. The absence of meaningful inflation meant that long-term interest rates steadily fell. Bond investors enjoyed healthy capital gains. At an aggregate level, the trend in

American corporate finance was to swap equity for debt, and not the other way round.

Today's challenges are different. A big concern is that inflation and interest rates are at the start of an upward trend. A world of high inflation would be a trickier one in which to raise capital by issuing corporate bonds. The nominal value of the bond at redemption would be a lot lower in real terms. By contrast, convertible bonds offer some protection. They are "nominal assets which come with an embedded call option on a real asset", writes Dylan Grice of Calderwood Capital, an alternative-investment boutique. The option to convert to equity affords the bondholder a degree of indexation to rising consumer prices.

Convertibles have already proved their worth. They were almost tailor-made for the circumstances of spring 2020. Big changes call for flexible forms of capital. And it is easy to imagine further economic dislocations on the horizon. Convertibles are the asset class for the times.

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CALAMOS®
INVESTMENTS

Calamos Advisors LLC
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com | caminfo@calamos.com

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