Convertible bonds: The best of both worlds?

Investors will sometimes question whether convertible securities are stocks or bonds. Interestingly, they can be both, but not at the same time.

What are convertible bonds?

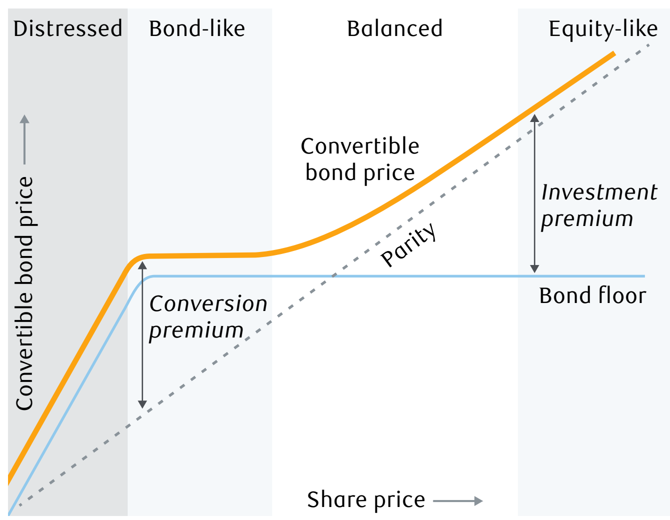
At issuance, convertible bonds tend to behave very similarly to traditional corporate bonds because they're considered debt instruments with a final maturity and coupon rate. Yet as the name implies, convertible bonds give investors the option to exchange their securities for a predetermined quantity of common stock shares from the issuing company. As a result, unlike a traditional corporate bond whose price typically reflects interest rate fluctuation, a convertible bond's price is more strongly correlated to the company's stock price. As such, investors must be comfortable with the company's credit characteristics and stock valuation.

Why do investors purchase convertible bonds?

The bottom line is that convertible bonds give investors the ability to participate in the growth of a company, but they also generate baseline interest income. From a cash flow perspective, bondholders initially benefit more than equity investors because the bondholders receive interest whereas the equity holders typically are not receiving dividend payments. Therefore, bondholders must be content at the outset of solely receiving interest payments.

Nonetheless, a rising stock price is positive from a valuation standpoint because the price of the convertible bond mirrors the company's stock price. At issuance, the convertible bond's conversion price is always higher than the company's current stock price. Yet once the company's stock price exceeds the conversion price, say a conversion price of $100, the option for converting bonds into stock shares results in a profit for investors. Alternatively, if the stock price falls to $50, the price of the bonds will also decline mirroring the stock price. However,

Convertible bond valuation



Source - RBC Wealth Management

the bondholders will still receive face value of par at maturity absent a credit event should the bonds fail to convert during the life of the security.

The downside with convertible bonds is that the upside potential is less compared to an investor that purchased the equity well below the conversion price. While a rising stock price is positive from a valuation standpoint, a company may force conversion if the stock price climbs beyond the conversion price. Again from the previous example, the investor will still profit if the company forces conversion beyond the $100 conversion price, but the original bondholders no longer own interest-paying debt securities with limited downside risk. Positively, the investor now owns equity shares with theoretically unlimited growth potential. However, downside risk is

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higher because equity investors no longer have protection if the stock price plummets, or have legal protection associated with debt instruments.

Why do companies issue convertible bonds?

Companies issue convertible bonds for two primary reasons. First, convertible bonds can be sold at a lower interest cost compared to traditional corporate debt because of the greater upside potential created by the exchange feature. Investors are often willing to accept the convertible bond's lower interest rate in exchange for the potential of greater total return on their investment if the investor projects that the company's stock price will exceed a certain threshold. As a result, a company can reduce its interest expense when raising capital.

Second, convertible bonds can help optimize the company's weighted average cost of capital. If management anticipates higher longer-term revenue growth and stock valuations, convertible bonds may be the optimal solution to raise cash while the stock price is believed to be undervalued. As such, the company benefits from both issuing debt at a lower cost of capital compared to traditional bonds and delaying dilution of the company's presently undervalued equity price. Furthermore, the company's interest expense on the convertible bonds is tax deductible, which provides another crucial benefit.

Conversion price and ratio on convertible bonds

The conversion ratio determines the quantity of stock shares that the investor or issuer can convert for each individual convertible bond. For instance, a conversion ratio of 10:1 means one convertible bond ($1,000 par value) can be converted into 10 shares of stock at the predetermined conversion price set at issuance. The conversion price is a convertible bond's par value divided by the quantity of stock shares that can be exchanged.

Pros and cons of convertible bond investing

Pros

- Convertible bonds can add diversification to portfolios while offering flexibility since investors have the ability to convert these instruments into equity shares.
- For fixed income portfolios, equity exposure from convertible bonds can unlock greater returns over traditional corporate bonds due to a high correlation to stock price movement versus interest rate fluctuation.
- For equity portfolios, convertible bonds can help reduce downside risk without sacrificing upside growth potential.
- Convertible bonds can generate a steady stream of income for portfolios should the investor or issuer decide not to force conversion and/or the bond never reaches the conversion price.
- Prior to conversion, convertible bonds can provide protection against default risk, since bondholders receive priority of payment before stockholders.

Cons

- Convertible bonds are more vulnerable to price depreciation versus traditional corporate bonds because of their high correlation to the underlying equity share price.
- Convertible bonds are issued with lower coupon rates compared to traditional corporate bonds due to the conversion option.
- Issuers typically have a smaller market capitalization and weaker credit ratings compared to traditional corporate bond issuers.
- Issuers can force conversion if the stock price climbs beyond a particular point, causing investors to no longer own interest-paying debt securities with less downside risk.

Conclusion

In our view, purchasing convertible bonds can be a sound strategy for investors wanting to participate in the growth of a company while also receiving interest income. Depending on an investor's objective and risk tolerance, introducing convertible bonds in portfolios can potentially generate equity-like returns, enhance diversification, and reduce downside risk due to their debt obligation features prior to conversion.

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