

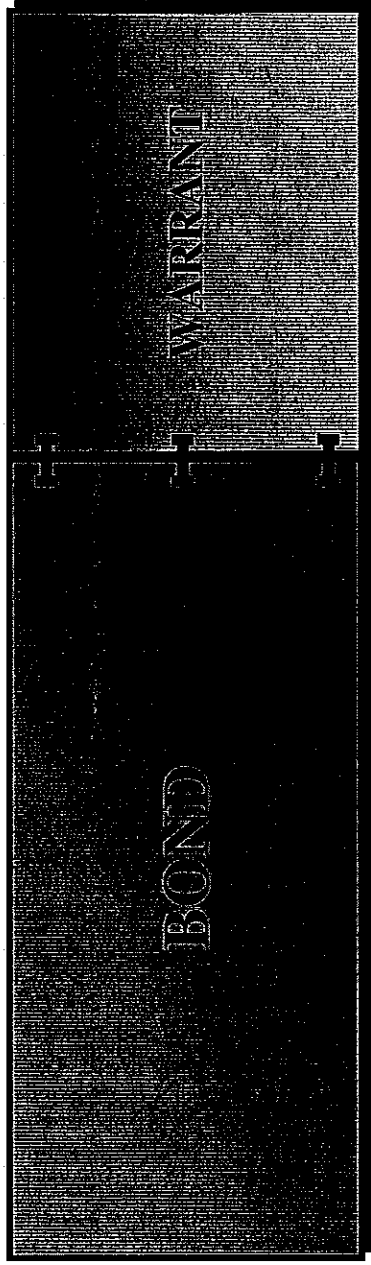
Optimising Capital Structure - The Asset Class Spectrum

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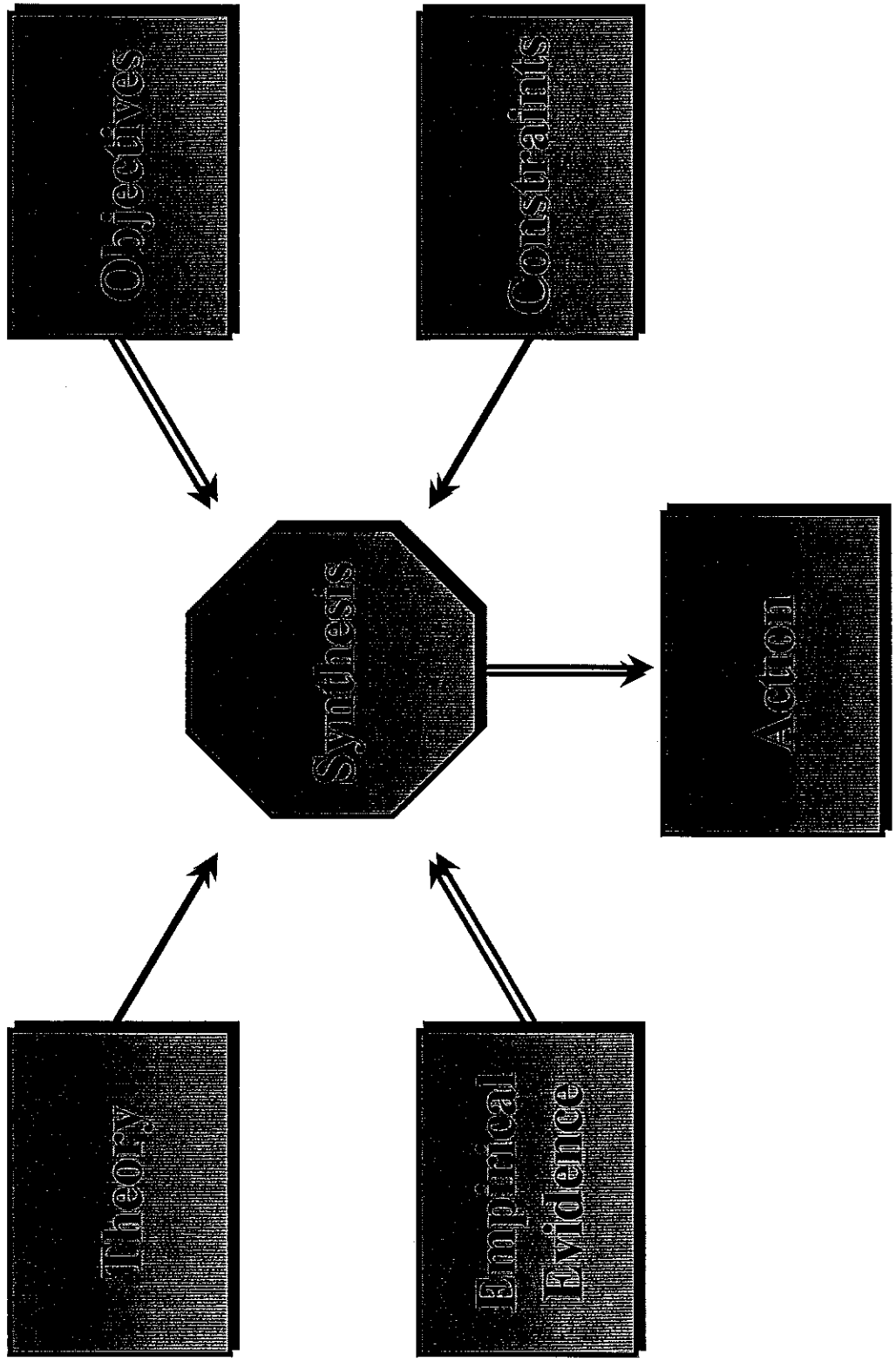
Why Converts?

CONVERTIBLE

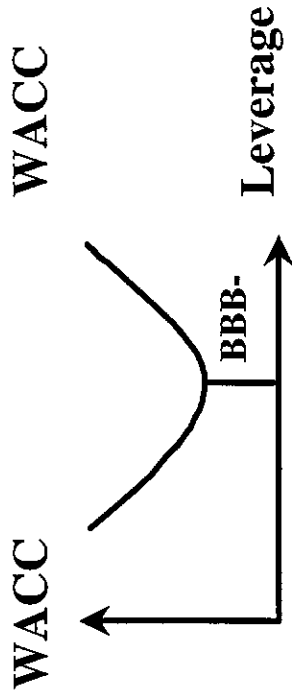


This combination reduces risk for both issuers and investors

Optimal Capital Structure



The Leverage Trade-Off



DEBT

Low Cost
of Capital

CONVERTS?

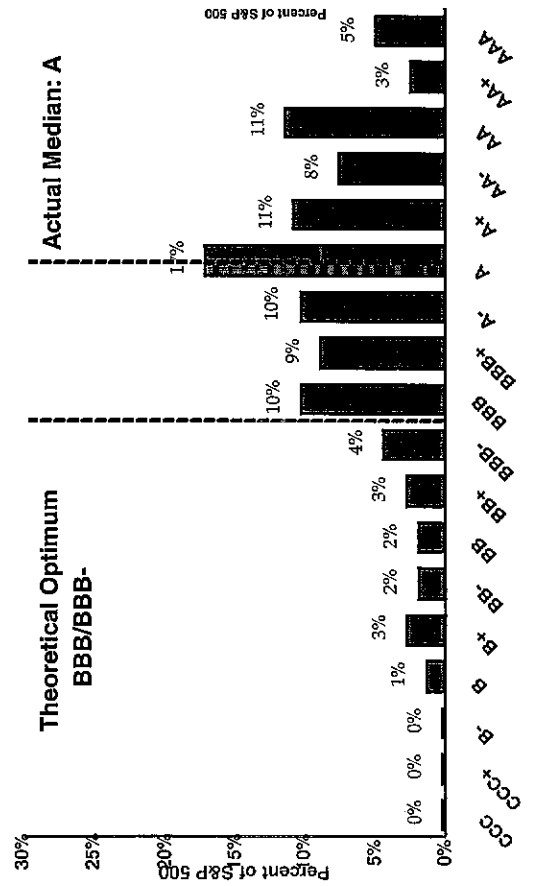
EQUITY

High
Flexibility

The Empirical Evidence

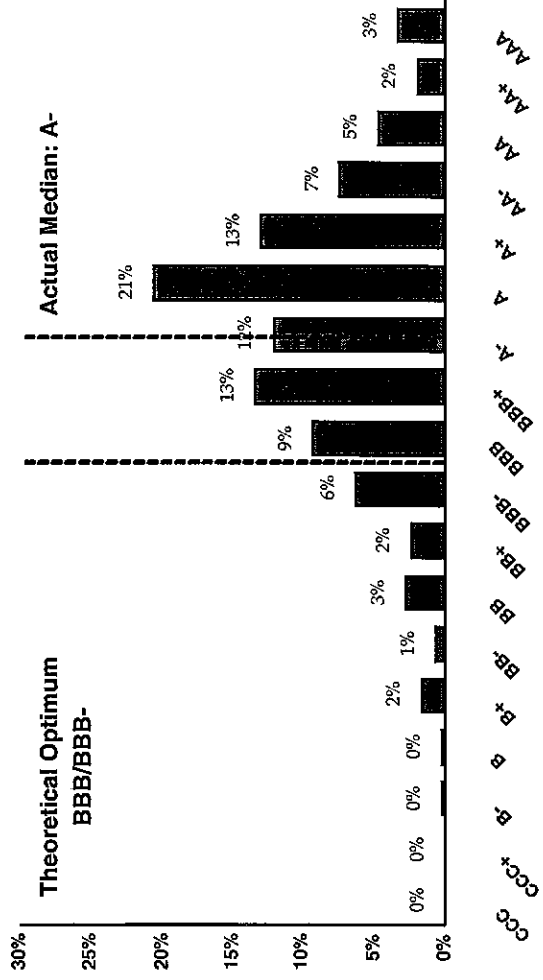
In the last decade, S&P 500 companies have increased their debt, decreasing their credit ratings

1989 Distribution



Source: Salomon Brothers Inc hz19556.csv

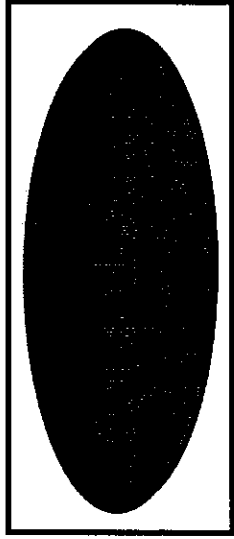
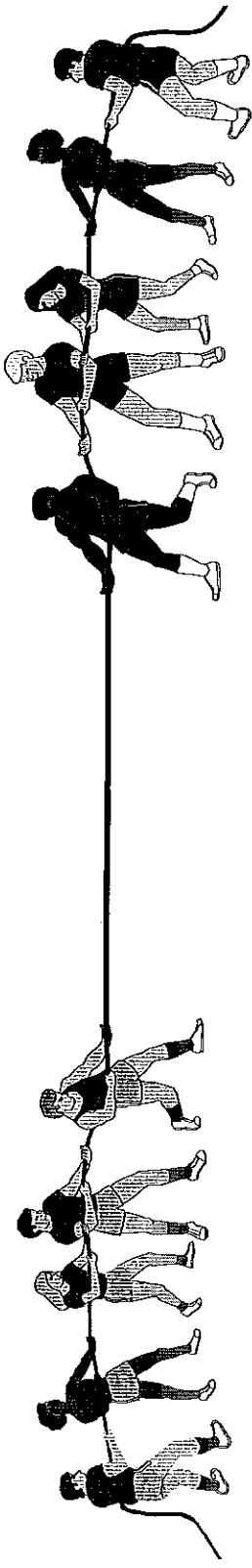
1999 Distribution



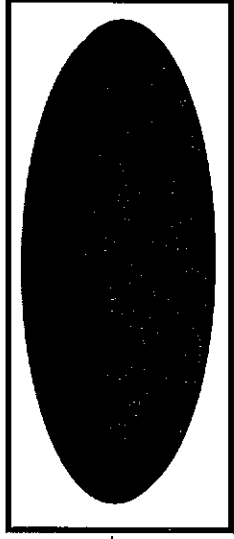
Source: Salomon Brothers Inc hz19556.csv

Bond vs Equity Holders

◆ Political Economy starts when Robinson Crusoe meets Friday



- conservative
- basis point driven
- calculators in their pockets

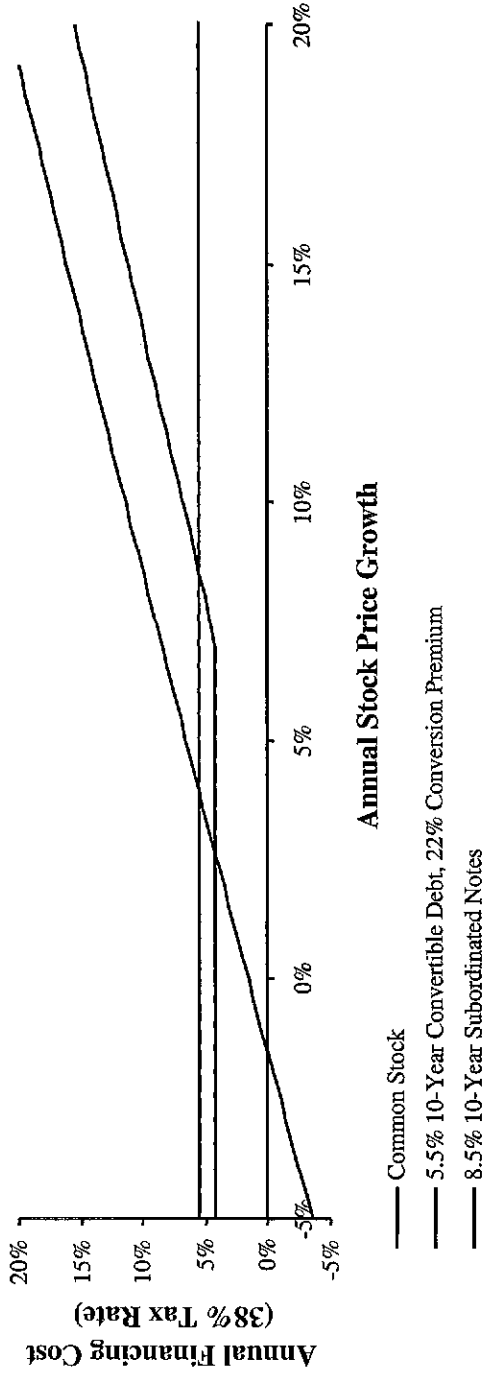


- aggressive
- dream driven
- twinkles in their eyes

◆ Are converts the solution?

Why Converts?

- ◆ There is no free lunch
- ◆ Some lunches, however, are more digestible



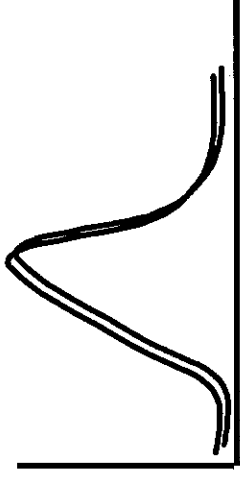
Lean Times

- costlier than equity
- cheaper than debt

Fat Times

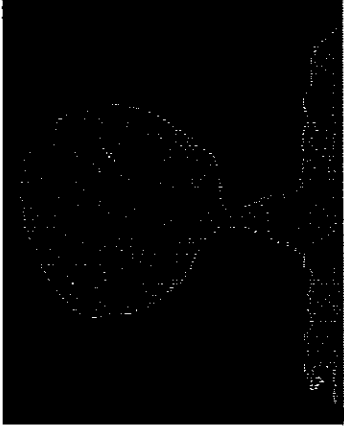
- costlier than debt
- cheaper than equity

Risk vs Uncertainty



RISK

- ◆ The probability that a 50-year old male dies of a heart attack.
- ◆ Well defined probability distribution.



UNCERTAINTY

- ◆ The probability that World War III will break out.
- ◆ Not a well defined probability distribution.

Regret Minimising Strategies

◆ Do not know how infective mad cow disease is?

◆ What percentage of the cows do you cull?



High Infectivity Low Infectivity

Cull All	No Regret	High Infectivity
Cull None	High Regret	Low Infectivity
Cull Some	Some Regret	Low Infectivity

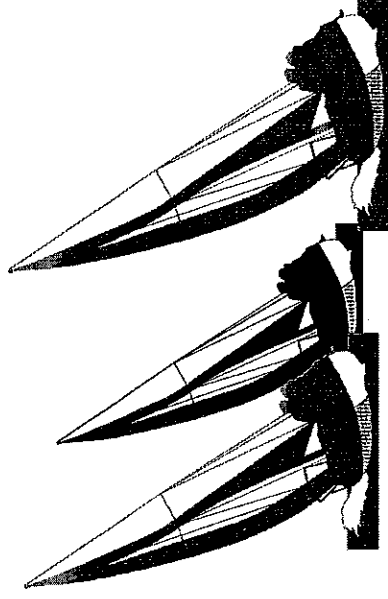
Regret Minimising and Converts



Debt	High Regret	High Regret
Equity	No Regret	High Regret
Converts	Some Regret	Some Regret

Converts may not offer a free lunch, but they may minimise regret for risk averse issuers.

Hedging - High and Indeterminate Risk



Risk ↑

cost of debt ↑

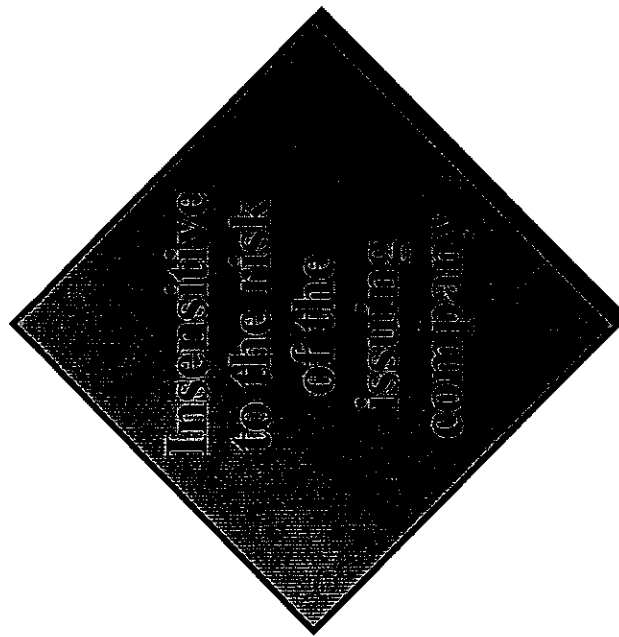
bond value ↓ warrant value ↑

Risk ↓

cost of debt ↓

bond value ↑ warrant value ↓

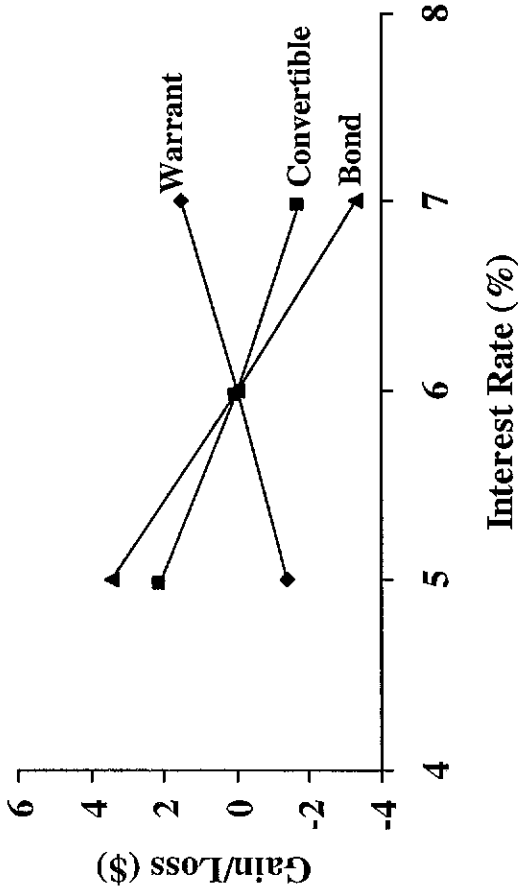
Why Convertibles?



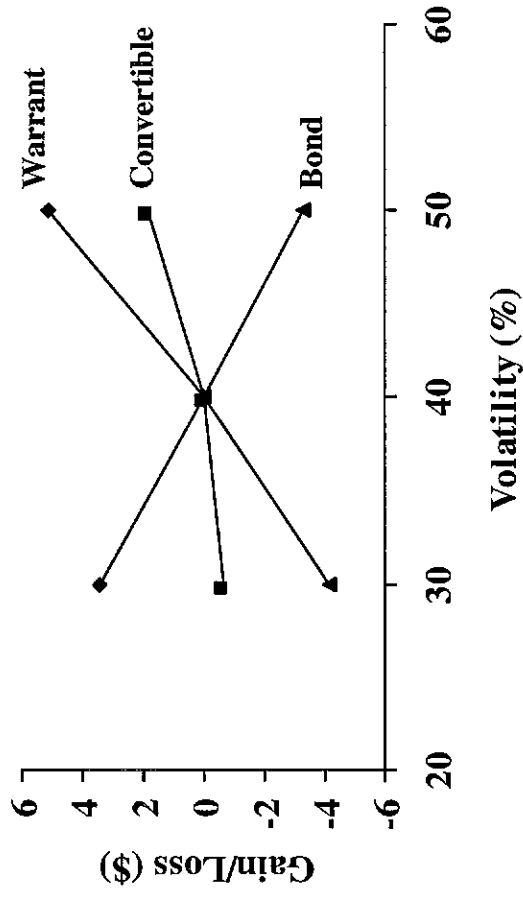
Sensitivity to Interest Rates and Volatility

Converts are a natural hedge against interest rate and volatility uncertainty

40% Volatility



6% Interest Rate



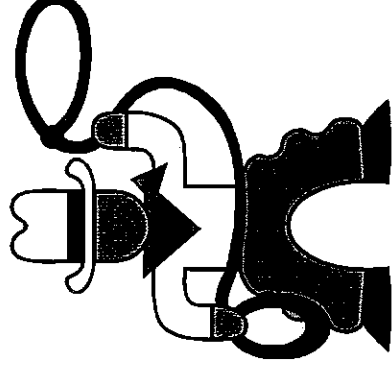
- Assumes \$100 initial theoretical value for the convert

- Assumes interest rates increase by 100 basis points for every 10 percentage point increase in volatility.

The Empirical Evidence

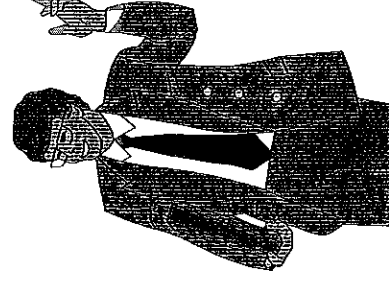
Characteristics of Convert Issuers in the United States

- ◆ Highly-levered
- ◆ High-growth
- ◆ High market volatility
- ◆ High earnings volatility
- ◆ Small capitalization
- ◆ Young corporate age



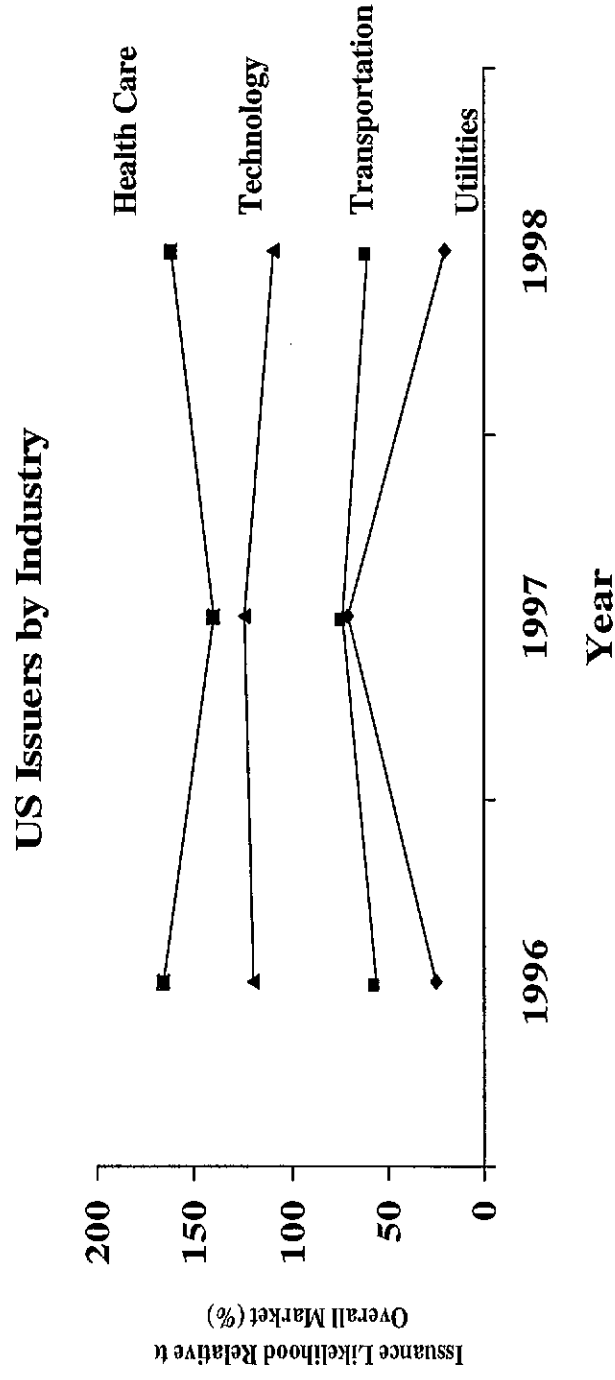
Characteristics of Convert Issuers in Europe

- ◆ Relatively unlevered
- ◆ Mature
- ◆ Stable, blue-chip



The Empirical Evidence

In the United States, high growth, high-risk industries favor converts.



Rating Agency Treatment of Convertibles

Issuance by industrials and utilities

