



I never hesitate to tell a man that I am bullish or bearish. But I do not tell people to buy or sell any particular stock. In a bear market all stocks go down and in a bull market they go up – Jesse Livermore

Index:	21,491.11	7.0%
Cap:	N4.88trn	+0.76%
Volume:	1.7 bn	-37.86%
Value:	N9.75bn	-28.0%

## Convertible Bonds: Are they bonds or stocks

New players to the investing game often ask what convertible bonds are, and the confusion usually lies on the issue of determining whether they are bonds or stocks. Over the last few weeks, we have discussed extensively on bonds and the different forms in which they are issued and how beneficial they can be to investors particularly at this time when activities in the stock market has somewhat slowed down.

This week, we'll cover the basics of this twin-faced security as well as their upsides and downsides.

### What is a Convertible Bond?

Essentially, a convertible bond is a form of debt that features an embedded stock option allowing the convertible bondholder to convert his/her bond into a predetermined number of shares in the issuing company at some future date.

As the name implies, convertible bonds, give the holder the option to exchange the bond for a predetermined number of shares in the issuing company.

Accordingly, investing in convertible bonds appeals to investors since it offers them the better of two worlds of investments – stocks and bonds at the same time – the safety of a fixed income security, plus the appreciation potential of equity.

### Features of Convertible Bonds

When first issued, they act just like regular corporate bonds, albeit with a slightly lower interest rate. Because convertibles can be changed into stock and thus benefit from a rise in the price of the underlying stock, companies offer lower yields on convertibles.

There are many different kinds of convertible bonds, each with its own conversion features. Usually, convertible bonds are converted when the bondholder chooses to do so - that is, the bondholder has the right, but not the obligation, to convert the bond on or before a set date. The terms of the bond's indenture detail the specific conversion clauses, such as how many and what kind of shares the bonds convert into.

Convertible bonds usually have no voting rights until they are converted. Even after conversion, they may not be granted voting rights unless they are converted to ordinary shares of the company. However, if they are converted to preference shares, they would still not have voting rights.

The convertibility factor, like many special bond features, lowers the interest rate that the corporation would otherwise have to pay without this feature, and it appeals to investors who want current income, but would like to take advantage of any growth in the corporation. The yield is usually more than any stock dividend—the yield advantage of the convert—but less than a straight bond from the same issuer. The premium over bond value is the difference in price between the convertible bond and a straight bond without the convertibility feature from the same issuer.

Because convertible bonds are callable, the conversion can be forced by the company if bond prices drop. This eliminates debt and interest payments for the company.

### How Conversion Works

The conversion ratio (also called the conversion premium) determines how many shares can be converted from each bond.

State Bonds Issued in the last 10 years			
Year	Amount	State	Purpose
1999	N1bn	Edo	Housing
2000	N3.5bn	Delta	Various Projects
2001	N2.5bn	Yobe	Various Projects
2002	N4bn	Ekiti	Various Projects
2002	N15bn	Lagos	Various Projects
2003	N4bn	Cross River	Tourism (Obudu Ranch)
2004	N6bn	Akwa Ibom	Various Projects
2006	N2.5bn	Kebbi	State University and irrigation project
2008	N275bn	Lagos	Roads etc

“ One benefit of convertible bonds to an investor is that it offers appreciation potential if the company does well, and its stock rises; but, if the company suffers, and the stock price declines, the investor can still keep the bond as a bond, and collect interest and principal, or sell it, based on the interest that it pays. ”

This can be expressed as a ratio or as the conversion price, and is specified in the indenture along with other provisions.

When a convertible bond is purchased, it is given a conversion ratio. This simply states how many shares of stock the bond can be converted into per the bond value (assuming it is N10,000). If the conversion ratio is

2,000:1 (2,000 to 1), then the bond can be converted into 2,000 shares of the stock at a price of N5 each. However, the conversion price is often valued above (also called “premium to”) the current stock price by 10-30%. This means that the stock may be trading at N7 or N8 per share. Therefore, the stock would have to go up until it reaches N8 before a reasonable conversion can take place. If the stock kept going up and reached N10/share, then the bond could be converted into N20, 000 worth of stock.

As we mentioned earlier convertible bonds are rather complex securities for a few reasons. First they have the characteristics of both bonds and stocks, which can be confusing to new investors. Then you have to weigh in the factors affecting the price of these securities. These factors are a mixture of what is happening in the interest-rate climate (which affects bond pricing) and the market for the underlying stock (which affects the price of the stock).

Then there's the fact that these bonds can be called by the issuer at a certain price that insulates the issuer from any dramatic spike in share price. All of these factors are important when pricing convertibles.

### Advantages

The advantages of convertible bonds to an investor is that it offers appreciation potential if the company does well, and its stock rises; but, if the company suffers, and the stock price declines, the investor can still keep the bond as a bond, and collect interest and principal, or sell it, based on the interest that it pays.

Convertible bonds offer a way to cushion the market fluctuations while providing you with a very nice annual gain.

Another advantage is that many convertible bonds are offered by small and medium-sized companies which allow investors a slightly safer approach to getting into the small and mid-cap sectors.

These bonds are a great way to provide a nice long-term return with a little less risk. Through mutual funds, a young investor can diversify their portfolio while not missing out on the excellent gains associated with a bull market.

The demand from institutional investors (especially pension fund managers) who may be restricted by law from buying stock. Buying converts allows these institutional investors to possibly earn considerable more than just the yield, while having downside protection.

Transaction costs for buying the bond and converting it into stock are lower than buying the stock itself.

The longer the duration of the conversion option, the greater the premium – Higher common stock dividends diminish the yield advantage, thus diminishing the premium over bond value.

### Disadvantages

These bonds do have disadvantages.

First of all, one downside is that the issuing company has the right to call the bonds. In other words, they have the right to forcibly convert them. Forced conversion usually occurs when the price of the stock is higher than the amount it would be if the bond were redeemed, or at its call date. This does happen but not very often. The company does this to limit their debt. Bonds are referred to as debt because the money is lent to the company by the bondholder and the company has the obligation to pay them back plus interest. This attribute restricts the capital appreciation potential of the convertible bond.

Also if interest rates should decline significantly after the convertible bond is issued, most companies can and will call their bonds, in which case one loses the source of what had been a relatively attractive income, and must then reinvest the proceeds in another vehicle at the then lower rates of interest.

On the other hand, if interest rates go up, there is no chance that the bond will be called, and so the investor is stuck with a lower-than-market rate of interest on the bonds. However, this downside can be mitigated if the convertible bonds have a fixed tenor, this means that regardless of the situation, the bonds are converted or redeemed when the tenor matures.

Convertible bonds, too, are typically subordinate debentures which mean that their standing, in the event of default, is lower than that of any other of the company's debt or even its bank loans.

### Conclusion

Getting caught up in all the details and intricacies of convertible bonds can make them appear more complex than they really are. At their most basic, convertibles provide a sort of security blanket for investors wishing to participate in the growth of a particular company they are unsure of. By investing in converts you are limiting your downside risk at the expense of limiting your upside potential.