

Why European Firms issue Convertible Debt?

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ABSTRACT

Why convertible bonds are such a popular financing vehicle has been a puzzling phenomenon for financial researchers. In this paper, we examine the characteristics of convertible bonds listed on the European exchanges as well as survey managers of the issuer firms to gain some insights into this issue. Our preliminary analysis shows some interesting findings. Our evidence suggests that while a majority of firms issue convertibles as a “delayed equity”, they also value convertibles for their ability to provide a signal about the future prospects of the firm. Most managers perceive that convertible bond is cheaper than straight debt and value the delayed impact of convertibles on earnings per share dilution relative to the equity alternative. Most managers report that issuing convertibles has significantly positive net benefits compared to the debt or equity alternatives. Overall, our evidence is consistent with theoretical models in asymmetric information framework such as Stein (1992), Mayers (1998), and Brennan and Kravs (1987).

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1. Introduction

Why firms issue convertible debt has both intrigued and puzzled financial researchers. The convertible bonds after all are only a bundle of straight debt and call options on the issuer company's stock. What value does this bundle provide that cannot be replicated in a unit offering combining straight bond debt and warrants which are far less popular? Why should a sophisticated investor be willing to pay more for the convertibles than for separate offerings of straight debt and equity? Yet the popularity of convertibles remains unabated and continues to challenge researchers to come up with rationale explanations. A rich theoretical literature has also developed to explain this puzzling phenomenon but a satisfactory explanation remains elusive. Brennan and Schwartz (1988) observe, "To the perplexity of academics, however, the popularity of convertibles has shown little sign of abating. Consequently, as "positive" financial economists, we have been faced with the task of finding a *convincing* explanation for the corporate use of convertibles – one that is consistent with rational investors and sophisticated financial markets." The goal of this paper is to provide some insights into this puzzling phenomenon by looking at the European experience in convertible bond issues.

The European sample provides us a unique opportunity to gain some insights into this issue for several reasons.¹ First, most of the previous research on convertibles has been undertaken in the U.S. context which is a well developed and mature market. In contrast, the European convertible market gained momentum only in mid-1990s but grew rapidly. By December 1999, the European convertible market grew to \$112 billion and comprised 24 percent of the global convertible market (\$470 billion) compared to U.S market which formed 34 percent of this market. Second, size of the convertible market differs widely across European countries. France and U.K. form about 57 percent of the European market The French market has been the fastest growing market and dominates the European new issues comprising about 47 percent of the

¹ See Noddings et al. (2001) and Hope (2000) for description and special features of European sample.

market.. Finally, European convertible bonds have several unique and distinctive features not observed in the U.S. case. For example, in addition to issuing the standard convertible debt security similar to that in the U.S., many European firms also issue exchangeable bonds where the options are written on securities of other firms. Many French convertibles are also unique: the bond's issue price, par value, and conversion price are all the same. Moreover, the bonds are quoted dirty, inclusive of accrued interest.² The unique features of the European Convertible market provide a rich data set to explore why convertibles are such a popular financing.³

The empirical evidence on rationale for issuing convertibles comprises largely of managerial surveys. The first managerial survey on the use of convertibles was conducted by Piltcher in 1955. Since then several surveys have been undertaken.⁴ In addition, several studies draw inferences about innovations for issuing convertibles by studying issuer characteristics, features of convertibles such as callability provision, and market reaction to announcement of convertibles issues. Despite a preponderance of these surveys and empirical studies, there is no consensus on why firms issue convertibles. In particular, it is difficult to discriminate between alternative theories of rationale for convertibles based on the current evidence. As Mayers (1998) observe, the problem with existing evidence on convertible bonds is that it is consistent with sequential-financing hypothesis as well as with after- issue risk shifting, risk estimation, and asymmetric information theories. In this paper, we attempt to examine two different pieces of evidence from European convertible market to gain some insight into this issue. First, we examine the characteristics of convertible bonds listed on the European exchanges. Second, we also survey managers of the issuer firms on various aspects of the convertible issuance decision.

Our approach is closer to that of Billingsley and Smith (BS, 1996) who combine analysis of market reaction to convertible issues with that of managerial survey data but differs in several dimensions. Our survey spans sixteen European countries compared to their survey of the U.S. managers and is also more comprehensive compared to the previous surveys. We ask managers

² Features of convertibles also vary across countries. See for example, Pablo (1993) De Roon and Veld (1998) and Veld (1994) for distinctive features of Spanish and Deutch convertible bonds respectively.

³ See Noddings et al. (2001) and Hope (2000).

⁴ See for example Brigham, 1966; and Hoffmeister, 1977, and Billingsley and Smith, 1996. Graham and Harvey (2001) and Bancel and Mittoo (2002) also ask questions on factors influencing convertible issues.

questions not only on the rationale for issuing convertibles but also on other aspects of convertible bonds that may provide us indirect evidence on the usefulness of convertibles such as the use of funds, influence of market conditions on issue decision, and callable policy. We also ask managers about the alternatives considered prior to issuing convertibles, the perceived net benefits of convertibles relative to the alternatives considered as well as on the role of investment banker in their decision. In total, we ask over 70 questions and to the best of our knowledge we explore many aspects of convertible issue decisions that have not been examined in the previous surveys.

Our study is useful in providing comprehensive evidence on various aspects of convertible bonds that may influence the issuance decision. Despite its limitations, our approach allows us to collect qualitative data that is normally difficult to obtain. We receive responses from eight European countries. Preliminary analysis shows some interesting findings. A majority of firms issue convertibles as a “delayed equity” but also value convertibles for their ability to provide a signal about the future prospects of the firm. Managers also value the call provision as well as the delayed impact on earnings per share dilution provided by the convertible bonds relative to equity alternative. Most respondents view a combination of low interest rates and high volatility in stock market volatility as an ideal window of opportunity for issuing convertibles.

The rest of the paper is organized as follows. The next section discusses the research design and the sample characteristics. The empirical analysis is presented in the next two sections and summary and conclusions in the last section.

2. Methodology and Sample characteristics

2.1. Survey Questionnaire

The first draft of the survey was developed after a careful review of the theoretical literature pertaining to the U.S. and European countries. While our main focus is on questions pertaining to direct implications of different theoretical models on the rationale of convertibles, we also include questions on several aspects of convertibles that may help us in drawing inferences pertaining to our main enquiry. The draft questionnaire was tested by academics and financial

executives and was revised after incorporating their feedback and suggestions. To increase the response rate, we limited the length of the survey to two pages. The survey was anonymous and tests showed that it took approximately 15-20 minutes to complete.

Our final survey questionnaire is structured around four major topics that have been used in previous studies to examine empirical evidence on convertible issues: (i) rationale for issuing convertibles (ii) evaluating convertibles versus other alternatives (iii) market specific factors and (iv) design of convertibles and role of investment advisor.⁵

2.2. Sample

The initial sample of firms was identified from the list of convertible bond listed on European Stock Exchanges in May 2002. For comparability with the U.S. evidence, we restrict our sample to only those firms that have issued convertibles as a combination of straight debt and a specified number of options on the stock of the issuing firm only.⁶ The final sample consists of 229 firms from 16 European countries. These firms have been identified by combining several databases obtained from BNP Paribas, Exane and Merrill Lynch, financial pages of European newspapers and European stock exchange web sites. The sample represents a good proxy for the whole European convertible market.

Table 1 presents our sample description by country based on number of issues and issuers. Our sample consists of 295 convertible issues with a capitalisation of near 98 billions Euros. France has the largest number of convertibles listed (98), followed by the UK (52) and Switzerland (43). The cross-country variation is also significant in the number of issuers. French firms represent

⁵ Both Stein (1992) and Mayers (1998) use similar categories to discuss the theory and empirical evidence pertaining to convertible bonds.

⁶ Numerous convertibles issued by European firms present an underlying asset which is not the stock of the issuing firm. These convertibles have often been used by European firms to sell forward stakes in firms which do not belong to their core business. This process has to be linked with the increasing pressures in terms of Corporate Governance European firms have had to face the last years. These “non pure” convertibles increase the liquidity and play a key role in the development of the whole market. From the point of view of investors, these assets are part of the market and present the same characteristics as “pure” convertibles. Therefore, the theoretical framework related to the issuing of these assets differs from the one we have analysed in this paper.

33.2% of the total convertible issuing population, followed by British firms (18.8%), Swiss firms (13.5%), Dutch firms (8.3%), German Firms (6.1%) and Italian firms (6.1%). The French market is also the largest in Europe in terms of number of issues representing 32.4% of the total market capitalisation, followed by the UK market (18%), the Swiss market (17.7%), the Dutch market (10.9%) and the Italian market (8.2%). Five countries, France, Italy, Netherlands, Switzerland and UK represent over 80 percent of the convertible bond listings. The average capitalisation is the highest in Ireland (1.1 billion euros) and the lowest in Norway (38 million euros). These convertibles have been issued by a total of 229 firms with many have multiple issues outstanding. The average number of issues per firm varies across countries with the highest in Netherlands (1.58) followed closely by Italy (1.5) and Switzerland (1.38). Overall, our sample represents a broad cross-section of firms from different European countries.

Table 2 provides the characteristics of the issuers including book value of assets and sales level as well as their market capitalization as on December 2001, and debt to equity ratio. The average market capitalization of these firms is 5,480 million euros but it varies substantially across countries. The Spanish firms in our sample are the largest in terms of market capitalization (22,343 million euros) followed by the Swiss firms (firms 11,935 million euros). The Polish sample is the smallest with an average market capitalization of 51 million euro. These cross-sectional differences are much less pronounced when sales levels are used for comparisons. The average sales level for our sample firms is 7,986 million euro and it varies from a high of 22,411 million euro (Germany) to a low of 1 million euro (Norway). The average assets are 13,919 million euros. Italian and German firms present the highest average assets (respectively 24,043 and 22,379 million euros).⁷ The debt to equity ratio also varies across countries. While the median gearing (debt divided by market capitalisation) is 80 percent, it varies widely across countries from a low of no debt to a high of 1500 percent.

Table 3 provides industry characteristics of the issuers. A majority of issuers of convertibles belong to manufacturing (15.2% of the market capitalisation), Telecommunication (12.5%), financial (11.2%), and pharmaceutical (10.7%) sectors. The average market capitalization of issues is largest in telecommunication and pharmaceutical sectors with an average size of 1.7 and

⁷ Average assets have been determined excluding banks in order to present homogeneity for data.

1 billion euros respectively.⁸ On the opposite spectrum are the manufacturing and financial sectors with respectively 298 and 268 million euros.

2.3. Summary Statistics of Respondent Firms

The survey was mailed to the Chief Financial Officers (CFO) of those firms whose names and addresses were obtained from the Bloomberg database.⁹ First mailing was undertaken in November 2002. In the mailing a letter was included explaining the objective of the study and promising to send a copy of the findings to those who wished to receive it. A total of 23 responses from eight countries were received by mail or by fax, which represents a response rate of 10%. Our response rate compares favorably with previous surveys of comprehensive nature and multicountry settings. The largest proportions of respondents are from France, followed by Germany and U.K. France is not only the largest convertible market in Europe but had record growth in recent years, doubling in size in 1999 and dominated the European new issues with 47 percent of the primary market. Difference in managerial perspectives of French versus other European firms may provide some insights into factors that spur growth of convertible market. For this purpose, we also compare responses of French managers versus those from other countries.

Figure 1 presents the characteristics of the respondent firms. Our sample is dominated by large and medium size firms. Large firms (sales greater than five billion euros) and medium size firms (sales between one and five billion euros) each comprise about 40 percent of the sample. These proportions are similar when book value of assets is used as a proxy for firm size. A similar

⁸ Noddings et al. (2001) report that the average issue size has been on the rise and increased 2.5 times during 1997-1999 period. They also report that technology – media – telecommunication (TMT) group is the largest market sector by market capitalization and has replaced banks and insurance companies that dominated the market for several years. In the telecommunication industry, European firms have had to invest in UMTS licence and to reorganize and restructure. Convertible bonds have been one the most commonly used financial instrument for this purpose.

⁹ Data have been provided by BNP Paribas. The survey was mailed to the Chief Executive Officer (CEO) when the name of the CFO was not available.

¹⁰ French law countries provide the weakest protection to shareholders and credit holders relative to other legal regimes, See La Porta et al.(1997, 1998).

pattern emerges when market capitalization of equity is used to proxy firm size. The sample is approximately evenly divided between high growth firms, defined as firms with price to earnings (P/E) ratio greater than 14 and low growth firms (P/E ratio less than 14). The respondents have strong international orientation. Foreign sales comprise more than 50 percent of the total sales for about 70 percent of the respondents.

The respondent firms represent a wide variety of industries with a larger concentration in services and transport (about 26 percent) and manufacturing (17.3 percent). Media and technology firms form about 9 percent of the sample. About 68 percent of the firms are widely held public firms with free floating shares averaging about 50 percent of the total shares. An overwhelming majority of them (77 percent) pay regular dividends with payout ratios ranging from 23 percent to 66 percent. Non-utility firms represent about 75 percent of respondents.

3. Survey Results

We organize the discussion of our empirical results around the main question of our study: why firms issue convertibles? For ease of exposition, we first review theoretical models pertaining to the rationale for convertibles and their empirical implications. We then present our survey results relating to the implications of these models. Next, we discuss our survey results that provide indirect evidence relating to different models. These groupings have been used in previous studies to link theory and practice of convertible issues and include (i) evaluating convertibles against other alternatives (ii) market specific factors and (iii) design of convertibles and role of investment advisor.

3.1. Rationale for Convertibles: Theoretical Models:

Several theoretical models have been developed to explain the prevalence and popularity of convertibles. In most of these models, the value of convertibles stems from their ability in resolving a financing or investment problem because of uncertainty or asymmetric information. We divide these broadly into two categories: risk-based and asymmetric information models..

Risk based models emphasize the role of convertibles in resolving risk-shifting or risk measurement problems. Green (1984) develops a model in an agency framework in which managers are agents of the shareholders and have an incentive to engage in riskier project. Bondholders in this model are concerned about the ex-post risk shifting and holding convertible bonds which include an option on the underlying stock reduces their concern. Brennan and Schwartz (BS, 1988) motivate rationale for convertibles in a setting in which investors have difficulty in assessing the risk of assets in place. Issuing convertible debt instead of straight debt in such situations resolves this risk uncertainty. Brennan and Kraus (BK, 1987) consider the case of uncertainty about risk in an asymmetric information framework when managers know about the risk of the proposed investment but investors do not. In this framework, managers can signal the riskiness of the firm by choosing the terms of the convertible contract.

A major empirical implication of the risk based models is that issuers of convertibles are likely to be firms that have high uncertainty about risk measurement such as high growth industries or technology firms. There is also no clear cut role for callability provision in these models as these theories are equally applicable to a debt/warrant package. Further, generally there should be no impact of convertible issues on market prices except in BK (1987) model in which the convertibles provide a signal to the market about the quality of the investment project. An indirect implication of BK model is that design of convertible bonds can be effectively used to provide an appropriate signal by the firm to the market.

Asymmetric information framework models include Constantinides and Grundy (CG, 1989), Stein (1992) and Mayers (1998). These models are developed in Myers and Majluf (1984) framework in which managers have superior information about the risk and cash flows associated with firm's assets in place. In all these models convertible bonds resolve a financing problem but the assumptions and empirical implications are different in each model.

Stein's model is developed on the assumption that financial distress is costly and excessive debt increases the probability of financial distress. Firms issue convertible debt where informational asymmetries about assets in place make conventional equity issues unattractive. In Stein's model, convertible debt is "backdoor equity" financing. Call feature is critical in Stein's model to force investors to exercise their conversion option early and to induce them to swap their bonds

for shares of stocks. In CG's model, on the other hand, callability feature is not important but convertibles must be combined with a publicly observed stock repurchase to have the desired separating equilibrium for different types of issuers.

Mayers' model differs from Stein's model in that asymmetric information in his model is about the value of future investment option rather than about assets in place. In Mayers' model convertible bonds resolve a sequential financing problem associated with an investment option with a future maturity date. Providing funds upfront for both initial project and the investment option sets up an incentive conflict between the investment decision maker (manager) and investors similar to the overinvestment (free cash flow) problem in Jensen (1986). Convertible debt is an attractive alternative to straight debt in such situations since it can economize issue costs as well as control the overinvestment problem. The call option is also valuable in Mayers' model but the purpose of the call provision is different from that in Stein's model. In Mayers' model the main purpose of call provision it is to provide flexibility for future financing as and when the needs for funding profitable investments arise whereas in Stein's model its role is to help avoid possible financial distress.

Overall, while call option and a trigger clause to force conversion are valuable in both Stein and Mayers models, the firms characteristics and the reason for choosing convertibles over other financing alternatives are likely to be different. In Stein's model, firm would like to raise equity but cannot do so whereas in Mayers' model convertibles are likely to be used primarily by high growth firms with future investment opportunities. Also, in Stein's model firm issuing convertibles are likely to perceive that their stock is undervalued whereas in Mayers' model firms may have high stock price at the time of issuance.

3.2 Survey evidence:

A. Direct Evidence on Rationale for Convertibles

We ask managers to rank different factors based on their importance in their decision to issue convertibles. These factors can be divided broadly in three categories. The first set of factors is based on the implications of different risk based and asymmetric information models discussed above. The second set of factors relates to the general literature on capital structure. Since

convertibles are a hybrid of both debt and equity, we should expect that implications of capital structure theories should be applicable to convertibles also. For example, we ask managers questions on the market conditions in issuing convertibles because previous evidence suggests that managers use “window of opportunity” to issue debt or common stock.¹¹ As well, we include questions on commonly held beliefs among managers such as the potential impact of equity issue on earnings per share (EPS dilution) similar to that in GH and BM surveys. The managers were requested to rank the importance of each factor on a scale of 0 to 4 (with 0 as not important and 4 as very important). Finally, we also include some questions on liquidity of convertibles and investor base. In Merton (1987) model investor base and in Amihud and Mendelson (1986) liquidity is an important determinant of asset pricing. We ask firms about holders of their convertible bond and whether the convertible market is well organized in their country.

Figure 2 and Table 4 present the summary of these responses. “Delayed equity” in the expectation that debt would be converted to equity is ranked as the most important factor (mean rank=3.18) and this is consistent with Stein’s model. About 86 percent of the CFOs rate this factor as either important (rating=3) or very important (rating=4). The use of convertible debt as a signal to the market for future growth opportunities is considered important or very important by 65 percent of managers (mean rating 2.57). This factor is generally consistent with both Mayers and BK models. However, a direct implication of Mayers’ model that convertibles provide flexibility in financing uncertain future investment receives less support (mean rank=1.59). The callability provision which is critical in both Stein and Mayers’ model also received modest support as it is considered important only by about 30 percent of managers (mean rank = 1.7). Risk based models receive generally less support. For example, the implication of BS model that convertibles allowed to attract investors that are unsure of the risk of assets receives only modest support (mean rank=1.48) while that of Green’s model that convertibles resolve concern of bondholders receives very little support.

Other important factors are based on managerial beliefs about capital structure. Over 78 percent of managers agree that convertible bond is less expensive than straight debt (mean rank=2.68)

¹¹ See for example Bayless and Chaplinsky (1996) for window of opportunity hypothesis.

and about 50 percent agree that issuing convertibles avoided short-term equity dilution (mean rank=2.43). Less important factors are the reasons relating to advantages of convertibles such as less covenants, higher book value of equity to debt ratio, and tax advantage of interest tax savings. Factors such as ability to reach international investors, following industry peers, and no need for rating are unimportant.

Our survey findings are largely consistent with result of most previous surveys (Piltcher (1955); Brigham (1966); and Hoffmeister (1977), and Billingsley and Smith (1996)) in that convertibles are considered as “delayed equity”. Our findings about importance of factors based on managerial beliefs are also consistent with those in GH and BM surveys of capital structure. We also examine differences in responses based on several firm characteristics but the differences are not significant in most cases. Interestingly, tax deductibility of convertibles is valued less by French firms (See Table 4).

B. Indirect Evidence

(i) Evaluating Convertibles versus Other Alternatives

We also ask managers questions on other alternatives considered prior to issuing convertibles. This question is relevant since in Stein’s model firms wish to issue equity but cannot and choose convertible instead. In Mayer’s model, on the other hand convertible is issued as an alternative to debt financing because of asymmetric information about future investments. We find support for both models in managerial responses. Figure 3 provides information on these alternatives and shows that all respondents do consider straight debt as an alternative to convertible debt, with about 65 percent seriously (mean rank > 2). About 87 percent of respondents also consider equity as an alternative but only 25 percent of those consider it seriously. About half of them also consider other synthetic securities as alternatives and of them only about 42 percent considered it seriously as an option.

In another question we asked respondents about major reasons for selecting convertibles over other alternatives. This was an open ended question and the respondents provided their main reasons which were then coded in five broad categories (Figure 3, B). Over 60 percent of managers cited attractive features of convertibles such as lower coupon than straight debt,

callability provision etc. as major reason for their decision in choosing convertibles over other options. Other reasons cited included favorable market conditions, financial constraints, growth opportunities, and good investor base. We also asked respondents to compare their perceived net benefits in issuing convertibles relative to the alternative considered. About 83 percent of respondents reported positive or significantly positive net benefits compared to the alternative considered.

Another open ended question related to the use of funds raised through convertibles. As Figure 3 shows the funds raised through convertibles were used for a variety of purposes but primarily for refinancing (35 percent) and capital budgeting (25 percent) activities. Other uses included merger and acquisitions (20 percent) and financing growth activities (10 percent). Our results on use of funds are similar to that of Mikkelson and Partch (1986), Mikkelson (1984), and Eckbo (1986) and Billingsley and Smith (1991).

(ii) Market Specific factors

Previous evidence suggests that managers try to time the market in issuing debt and equity. For example, both GH and BM provide evidence to support this. To examine whether this is the case for convertible issues also, we ask managers about the market conditions that may have influenced their decision. Summary of these responses is provided in Table 5 and Figure 4. About 60 percent of respondents report that low interest rate environment and high stock market volatility were important or very important in their decision to issue convertibles. Surprisingly, the percentage of managers who felt that their stocks was undervalued (38.1 percent) at the time of convertible issue is the same as those who felt it was overvalued. Thus, we find support for both Stein's and Mayer's models.¹² Further, about one third of respondents also considered liquidity of convertible market as important or very important factor in issuing convertibles. Interestingly, this factor was valued much higher by French respondents compared to those from other countries. This evidence is consistent with Amihud and Mendelson (1986) model of asset pricing in which asset liquidity is a major determinant of asset pricing.

¹² Another difference between Stein's and Mayer's models is that in the former issuers are more likely to perceive their stock to be undervalued while in Mayer's model firms could issue convertibles even when their stock is overvalued.

In Merton (1987) model, investor base is an important determinant of asset pricing. Noddings et al. (2001) argue that growth in European new issue convertible market has been partly spurred by growing investor demand as fixed-income investors sought higher returns, funds dedicated to European convertibles as an asset class increased, and demand from private client and market – neutral hedge funds expanded. To examine, the importance of the demand side factors, we ask managers questions on the holders of their convertible bonds at the time of the issue. Figure 5 summaries this information. An overwhelming majority of convertibles (over 80 percent) are held by institutional investors, with average holding of about 58 percent. Hedge funds are other major investors in convertible bonds with about 40 percent of the average holding. In comparison, banks, private investors hold relatively small percentages of these bonds. Overall, institutional holders including hedge funds appear to be major investors of convertible bonds.

In asymmetric information framework models, market reaction to equity issues is predicted to be negative. Since convertible bonds are ranked between bonds and equity in pecking order hypothesis, the convertible bonds also are expected to have negative reaction, although less pronounced than equity. We asked managers about market reaction to convertible issues. Over 68 percent of managers report that the market reaction to convertible issue was negative consistent with empirical evidence reported in most previous studies. For example, Dann and (Mikkelson) 1984 document a negative reaction to convertible announcement in U.S while Abhyankar and Dunning, 1999 document a negative reaction in U.K.

(iii) Design of Convertible Securities and Role of Investor Banks:

A major advantage of a convertible bond is that its design can be adjusted to make it look more like debt or equity type security by incorporating features such as call protection, maturity, conversion price, and call price. Several recent studies focused on this aspect of convertibles by extending the Stein and Mayers models Lewis, Rogalski and Seward (1998a) extend Stein's model to incorporate the case in which firms that are more confident about their future prospects issue convertibles with shorter call protection periods relative to others. Lewis, Rogalski, and Seward (1998b) find evidence that firms that are predicted to issue equity are likely to issue convertibles that are more equity-like, and those that are predicted to issue debt issue more debt-like convertibles. These adjustments are done by balancing between the debt and equity like

features by setting contract terms such as coupon rate, maturity, conversion price, call price, and call protection on their convertibles. Korkeamaki and Moore (2002) extend Mayers' model by studying the implications of his model on call protection terms and find evidence of a connection between issuers' investment patterns following the convertible issue and call protection terms on their issues. Korkeamaki (2002) examines whether call protection terms of convertibles issues vary across different legal regime countries defined by La Porta et al. (1997, 1998) and they find support for this hypothesis.

We ask several managers questions about different features of their convertible issues. Figure 7 provides information on characteristics of the latest convertible issue of the respondent firms. The size of the convertibles varies widely across firms with a majority (about 55 percent) of issues between 100 and 500 million euros. The average issue size is 478.6 million euro (median 359 million) while the average (median) issue size as a percentage of assets is 12.9 percent (10 percent). A majority of the convertibles (about 67 percent) have a trigger clause to force conversion, the trigger premium varying from 120 percent to 150 percent of stock price. Very few convertibles have any preemptive rights or other covenants. The cross sectional variation in the convertible features supports that firms tailor convertible bonds to fit their special needs by adjusting various features.

We also ask CFOs about their call policy. Figure 6 and Table 6 summarize the responses on convertible call policy. About 37 percent of the managers are concerned about the dilution of equity as a major factor in conversion policy while about 35 percent agree that forcing the conversion would be done when future investment opportunities occur. About 20 percent of respondents also report that conversion feature is not important. Overall, the evidence on call policy is more supportive of Mayers model relative to Stein' model.

We also ask CFOs about their capital structure. About 63 percent of respondents have a target debt to equity ratio, and about half of them maintains a target debt to equity ratio of one. Most of the firms have a credit rating and about half of them have rating of A and above. This is consistent with Noddings et al (2001) who report that over two-thirds of European convertibles are rated investment grade by Moody's or S&P, and a majority of non rated convertibles are from financially strong companies. As Figure 7 shows, many issuers have raise funds in capital

markets during the last 10 years. About 80 percent of them have issued debt and/or equity in the last ten years. Most respondents are also heavy users of convertibles. An overwhelming majority of them (95 percent) have issued convertible debt in the past ten years and about 50 percent of them have issued it more than twice. A small percentage of them have also issued other synthetic securities.

Since convertible bond designing can be a complex task, the investment advisor is likely to play a key role in this aspect. While previous research has not focused on this issue, this may be important in recent models in which security design is hypothesized to be a major determinant of the use of convertibles. We ask managers several questions about role of their investment advisor in their decision to issue convertible bonds. A majority of them stated that investment advisor played a medium level role in the decision to issue convertibles but provided help in designing. Further, we also asked CFOs how they selected their investment advisor and what help did the advisors provide. The summary of responses is provided in Figure 8 and Table 7. Good relationship (mean rank=3) and reputation (mean rank=2.6) are cited as the most important criteria in selecting the investment bank. Other important factors included banking relationship and pricing (mean rank >2). The major help provided by investment banks is in pricing and designing the convertibles. Over 50 percent of the respondents consider these as important or very important (mean rank=2.68). Investment banks also helped firms in evaluating other alternatives and their advice to issue convertibles was based largely on favorable market conditions. There are significant differences in small and large firms responses; large firms rely less on investment bankers compared to their smaller counterparts. Overall, the responses support that investment bankers play a major role in designing and pricing the security to make it look like more equity or debt like security.

4. Conclusions and Further research

Why convertible bonds are such a popular financing vehicle has been a puzzling phenomenon for financial researchers. In this paper, we examine European convertible sample to gain some insights into this issue by studying two different pieces of evidence. First, we examine the characteristics of convertible bonds listed on the European exchanges and second, we also survey managers of the issuer firms on various aspects of the convertible issuance decision. Our preliminary analysis shows some interesting findings. Our evidence suggests that a majority of firms issue convertibles as a “delayed equity” but they also value convertibles for their ability to provide a signal about the future prospects of the firm. Managers also view convertibles as cheaper than straight debt and care about the delayed impact of convertibles on earnings per share dilution. The call provision is also considered modestly important by managers. Most CFOs also report a negative market reaction at the issuance of convertibles consistent with previous empirical studies on stock market reaction. Most managers do consider debt or equity as an alternative to issuing convertibles and perceive that net benefits of convertible issue are positive or significantly positive compared to alternatives evaluated by them prior to issue. Managers also consider combination of low interest rates and high volatility in stock market as good “window of opportunity” for issuing convertibles.

Our results should be interpreted with some caution since they are based on a small number of respondents and may not be representative of the population. Further, we have also not examined the population of firms that do not issue convertibles. Despite these limitations our study provides some useful evidence on European convertibles. Although our survey sample is small, our survey questionnaire is more comprehensive than that in previous studies. We not only ask questions on rationale of issuing convertibles but also ask questions on all different aspects of convertible issues including on characteristics of convertible bonds and of issuers, on call policy and regarding net benefits of convertibles. We also explore whether flexibility in designing convertibles is valuable and examine the role of investment advisor in the convertible issue decision. To our knowledge, these aspects have not been examined in previous surveys on convertibles. Overall, our evidence is consistent with the models in the asymmetric information framework. We find partial support for both Stein (1992) and Mayers (1998) and Brennan and

Kravs (1987) models but less support for risk based models by Green (1984) and Brennan and Schwartz (1988). Evidence is also generally consistent with the survey evidence by Graham and Harvey (2001) and Bancel and Mittoo (2002) who report that financial flexibility and EPS dilution are the most important factors in debt and equity policy for firms. We also find support that flexibility in adjusting a convertible bond to look more like debt –like or equity-like security may be valuable for firms. These conclusions are, however, based on preliminary investigation only and we propose to undertake more indepth analysis in future.

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Table 1: The European convertibles market

	Convertibles:Market cap (mil euros)	%	Number of issuing Firms	%	Number of convertibles listed	%	Average convertible Market cap (mil euros)
AUSTRIA	73	0,1%	1	0,4%	1	0,3%	73
BELGIUM	2 113	2,2%	6	2,6%	8	2,7%	352
FINLAND	965	1,0%	6	2,6%	7	2,4%	161
FRANCE	31 774	32,4%	76	33,2%	98	33,2%	418
GERMANY	4 136	4,2%	14	6,1%	14	4,7%	295
GREECE	319	0,3%	1	0,4%	1	0,3%	319
IRELAND	1 104	1,1%	1	0,4%	2	0,7%	1 104
ITALY	8 013	8,2%	14	6,1%	21	7,1%	572
NETHERLANDS	10 669	10,9%	19	8,3%	28	9,5%	562
NORWAY	38	0,0%	1	0,4%	2	0,7%	38
POLAND	354	0,4%	1	0,4%	1	0,3%	354
PORTUGAL	1 610	1,6%	3	1,3%	4	1,4%	537
RUSSIA	100	0,1%	1	0,4%	1	0,3%	100
SPAIN	863	0,9%	3	1,3%	4	1,4%	288
SWEDEN	868	0,9%	8	3,5%	8	2,7%	109
SWITZERLAND	17 330	17,7%	31	13,5%	43	14,6%	559
UK	17 605	18,0%	43	18,8%	52	17,6%	409
Total	97 933	100,0%	229	100,0%	295	100,0%	428

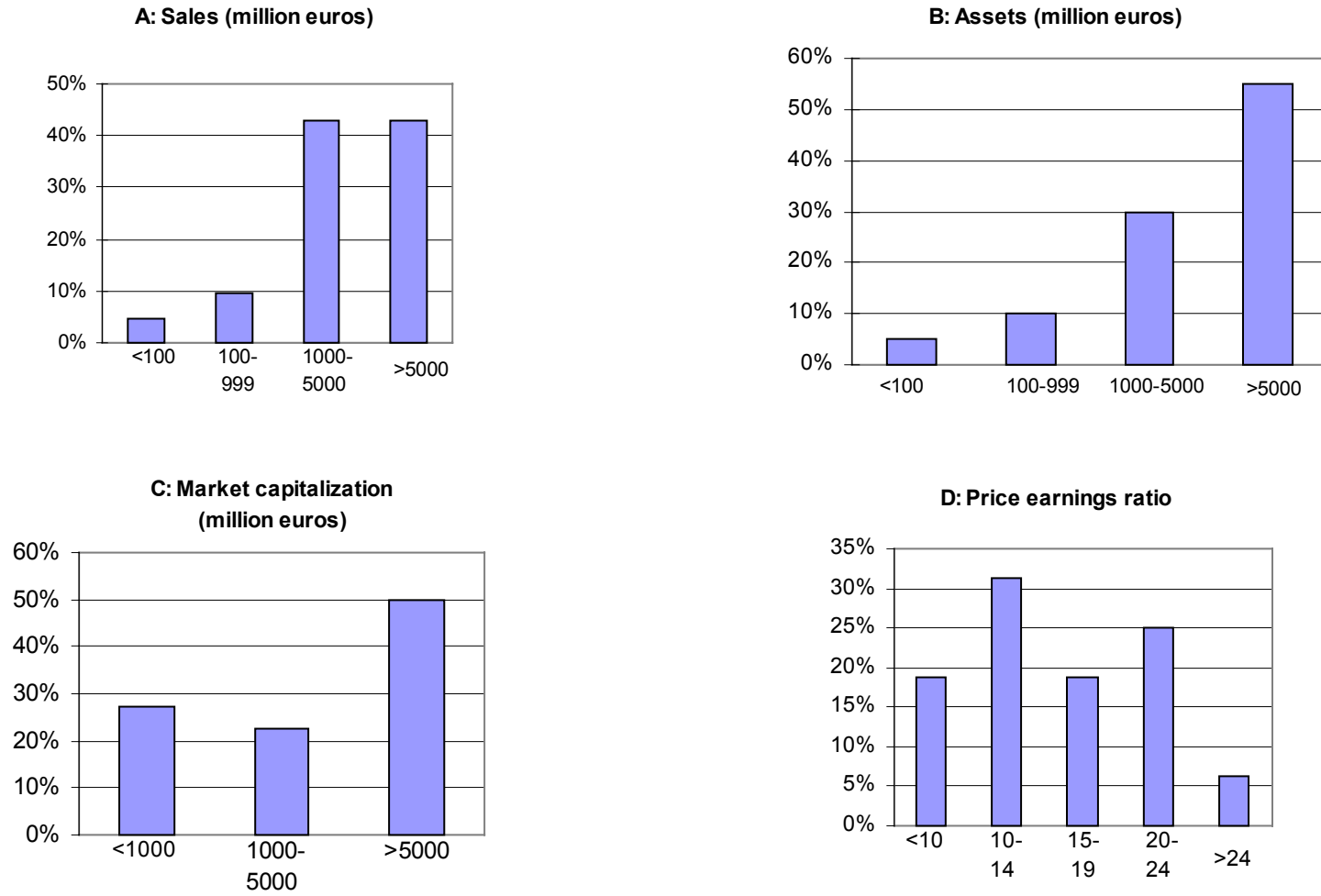
Table 2: Characteristics of sample firms

	Number of firms	Average Market capitalisation (mil euros)	Average sales (mil euros)	Total assets (mil euros)	Median Vd/Ve
AUSTRIA	1	143	1 867	1 409	4,7
BELGIUM	6	10 389	7 185	2 900	0,8
FINLAND	6	754	2 827	2 893	1,3
FRANCE	76	4 235	7 723	16 809	0,8
GERMANY	14	7 076	22 411	22 379	1,5
GREECE	1	3 995	1 789	19 585	0,3
IRELAND	1	239	154	422	7,0
ITALY	14	2 418	5 125	24 043	1,6
NETHERLANDS	19	3 790	8 943	6 646	0,9
NORWAY	1	58	1	1 025	10,4
POLAND	1	51	420	331	15,1
PORTUGAL	3	5 336	4 920	17 135	0,9
RUSSIA	1	924	439	973	0,3
SPAIN	3	22 343	21 146	2 921	1,2
SWEDEN	8	4 262	6 782	8 897	0,5
SWITZERLAND	31	11 935	8 974	14 172	0,3
UK	43	4 087	4 829	12 645	0,7
Total	229	5 480	7 986	13 919	0,8

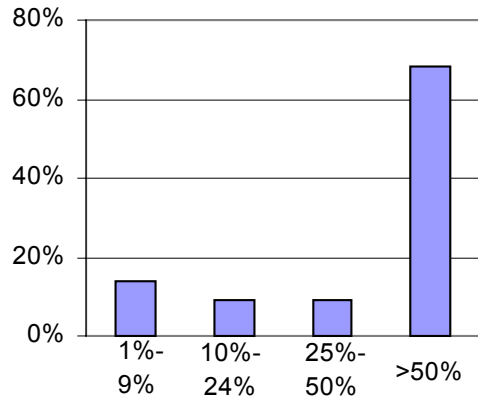
Table 3: Industry of issuing firms

	Number of issuing Firms	%	Convertibles:Market cap (mil euros)	%	Average convertible Market cap (mil euros)
Insurance	8	3,5%	5 544	5,7%	693
Manufacturing	50	21,8%	14 912	15,2%	298
Banks/diversified financial	41	17,9%	11 000	11,2%	268
Consumer goods	11	4,8%	6 664	6,8%	606
Services/Transport	24	10,5%	4 929	5,0%	205
Construction and building	14	6,1%	6 477	6,6%	463
Retailers & Distributors	8	3,5%	5 777	5,9%	722
Energy/Utilities	9	3,9%	3 139	3,2%	349
Media	15	6,6%	8 314	8,5%	554
Pharmaceuticals & Healthcare	10	4,4%	10 434	10,7%	1043
Technology	32	14,0%	8 502	8,7%	266
Telecommunication	7	3,1%	12 241	12,5%	1749
Total	229	100,0%	97 933	100,0%	428

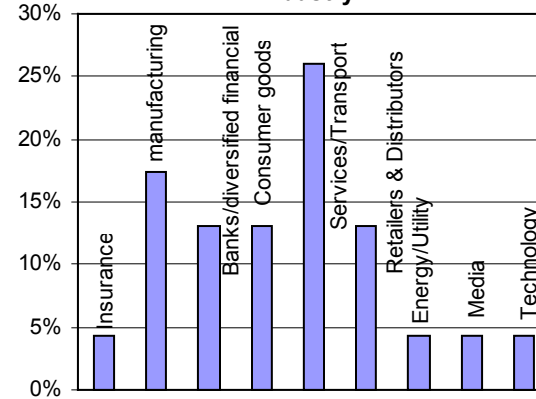
Figure 1: Firm Characteristics



E: Foreign Sales (% of Total)



F: Industry



G: Other characteristics

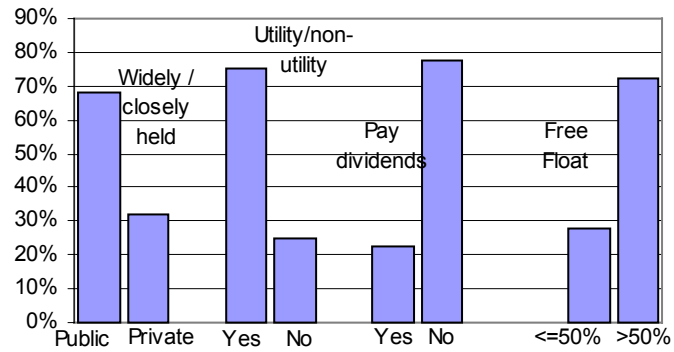


Figure 2: Convertible Policy Factors

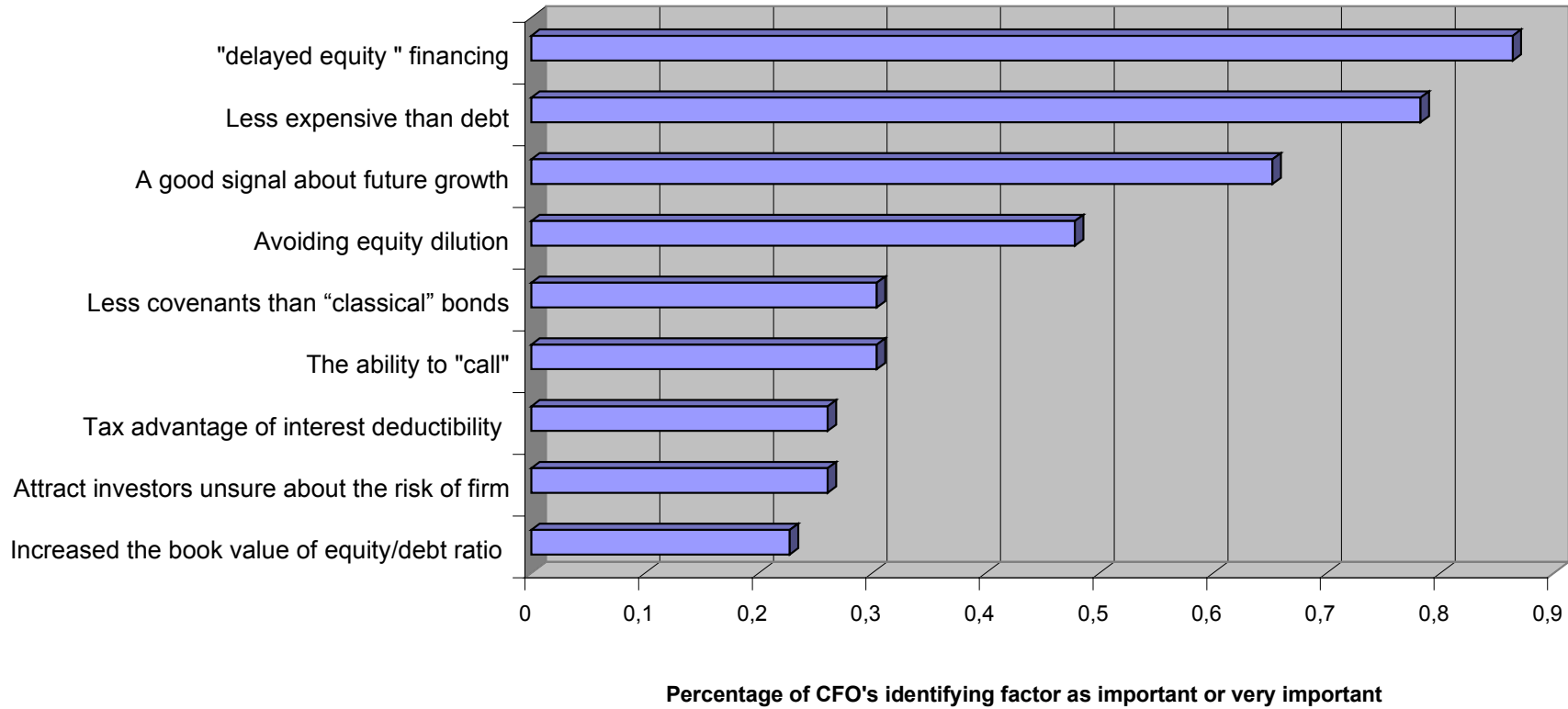


Table 4: Survey response to the question: What factors have affected your firm’s decisions about issuing convertible debt?

	% Important or very important	Mean	French		Size		P/E		Dividend		Trigger		Converttusers		Use of funds		Foreign Sales	
			Yes	No	Small	Large	Growth	Non-G	Yes	No	Yes	No	Low	High	Normal	Special	<50%	>50%
1) Convertibles were "delayed equity " financing, expecting that the debt would be converted	86.36%	3.18	3.5	2.8**	3	3.6	3.3	3	3.25	3	3.13	3.2	2.78	3.45*	3.09	3.25	3.5	3.07
7) Convertibles were less expensive than debt	78.26%	2.78	3.25	2.27*	3	2.45	2.88	2.5	2.71	2.8	2.44	3	2.4	3	2.67	2.63	2.43	2.87
15) Convertibles provide a good signal to the market about our future growth opportunities	65.22%	2.57	2.58	2.55	2.82	2.27	2.5	2.38	2.53	2.6	2.44	2.64	2.3	2.82	2.67	2.63	2.71	2.47
2) Issuing convertibles avoided short-term equity dilution	47.83%	2.43	2.42	2.45	2.6	2.27	2.13	2.75	2.59	2	2.22	2.57	2	2.91*	2.67	2.38	3.14	2.13*
3) Convertibles gave us the ability to "call" or force conversion of debt if/when we needed to	30.4%	1.7	1.67	1.73	2.09	1.27*	1.25	1.75	1.53	2.2	1.33	1.93	1.6	1.45	1.83	1.75	1.71	1.67
12) Convertible debt could be issued with less covenants than "classical" bonds	30.4%	1.57	1.83	1.27	2.18	0.82**	1.25	1.63	1.41	1.8	0.78**	2.07	1.3	1.73	1.58	1.75	1.29	1.6
4) Convertibles allowed us to attract investors unsure about the risk of our firm	26.09%	1.48	1.33	1.64	1.81	1.27	2	1.38	1.65	1.2	1.33	1.57	1.5	1.45	1.58	1.25	2.14	1.27
8) Convertibles induced tax advantage of interest deductibility	26.09%	1.52	0.83	2.27***	1.64	1.45	1	2.25**	1.47	1.8	1.33	1.64	1.6	1.36	1.42	2	1.43	1.6
5) Issuing convertibles increased the book value of equity/debt ratio	22.73%	1.41	1.08	1.8	1.55	1.3	1.75	1.14	1.31	1.8	1.44	1.38	1.6	0.9	1.33	1.57	1.67	1.33
9) Other firms in our industry successfully used convertibles	17.39%	0.96	1	0.91	1.36	0.55*	0.75	1.25	0.76	1.6	0.6	1.14	0.9	0.82	1	0.88	0.86	1
11) Convertible debt was a debt funding that did not require a rating	13.64%	1.09	1.45	0.73	1.36	0.6	1	0.75	0.94	1.2	0.22***	1.69	0.9	1.2	1.17	0.86	1.14	0.93
13) Compared with debt, convertibles gave us the ability to reach an international investor basis	13.64%	1.14	1.09	1.18	1.73	0.5**	1	1.13	1.19	1	1.11	1.15	1.1	1.1	1.58	0.57*	1.86	0.79*
14) Convertibles provide us flexibility in financing uncertain future investments as and when we need	13.64%	1.59	1.89	1.36	1.45	1.7	1.5	1.25	1.38	2.2*	1.44	1.68	1.3	1.5	1.5	1.86	1.28	1.71
6) Convertibles protected bondholders against unfavourable actions by managers or stockholders	4.35%	0.74	0.92	0.55	0.64	0.82	0.63	0.38	0.53	1.4*	0.78	0.71	0.8	0.64	1	0.38	1.29	0.47*
10) Issuing convertibles has helped us to reduce the risk of an hostile takeover	0%	0.64	0.54	0.73	0.55	0.7	0.38	0.63	0.44	1.2***	0.56	0.69	0.8	0.4	0.58	0.86	0.57	0.64

Respondents are asked to rate on a scale of 0 (not important) to 4 (very important). We report the overall mean as well as the % of respondents that answered 3 and 4 (very important).

***, **, * denotesa significant difference as the 1%, 5%, and 10% level, respectively.

Figure 3: Alternatives for Convertibles

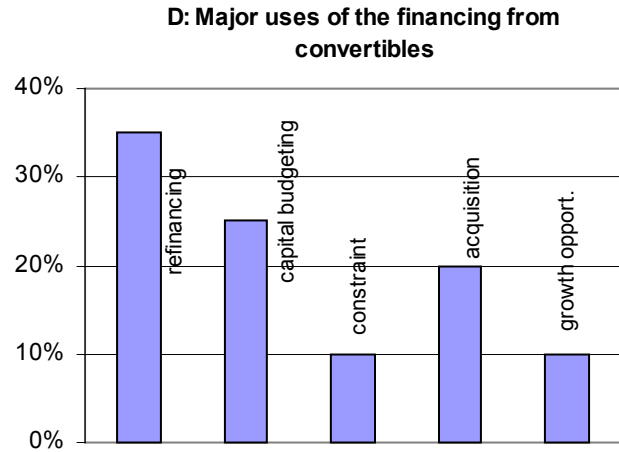
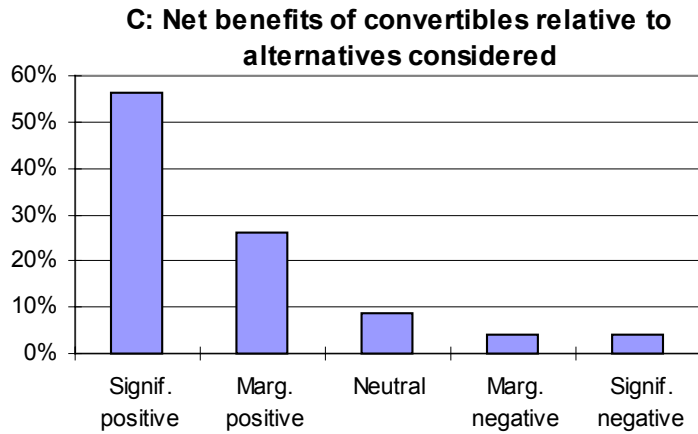
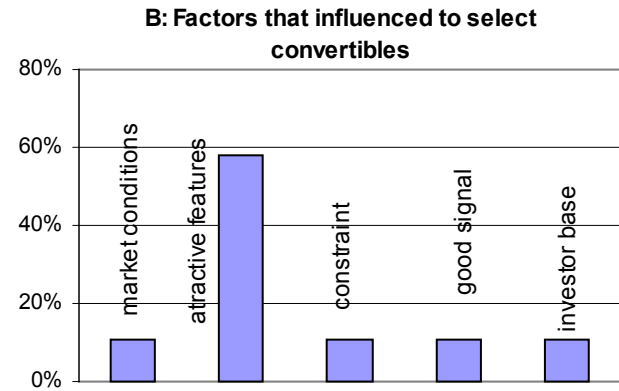
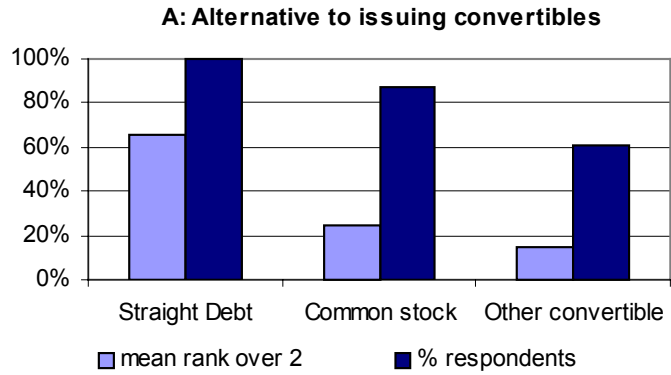


Figure 4: Decision of issuing convertibles debt been affected by market conditions

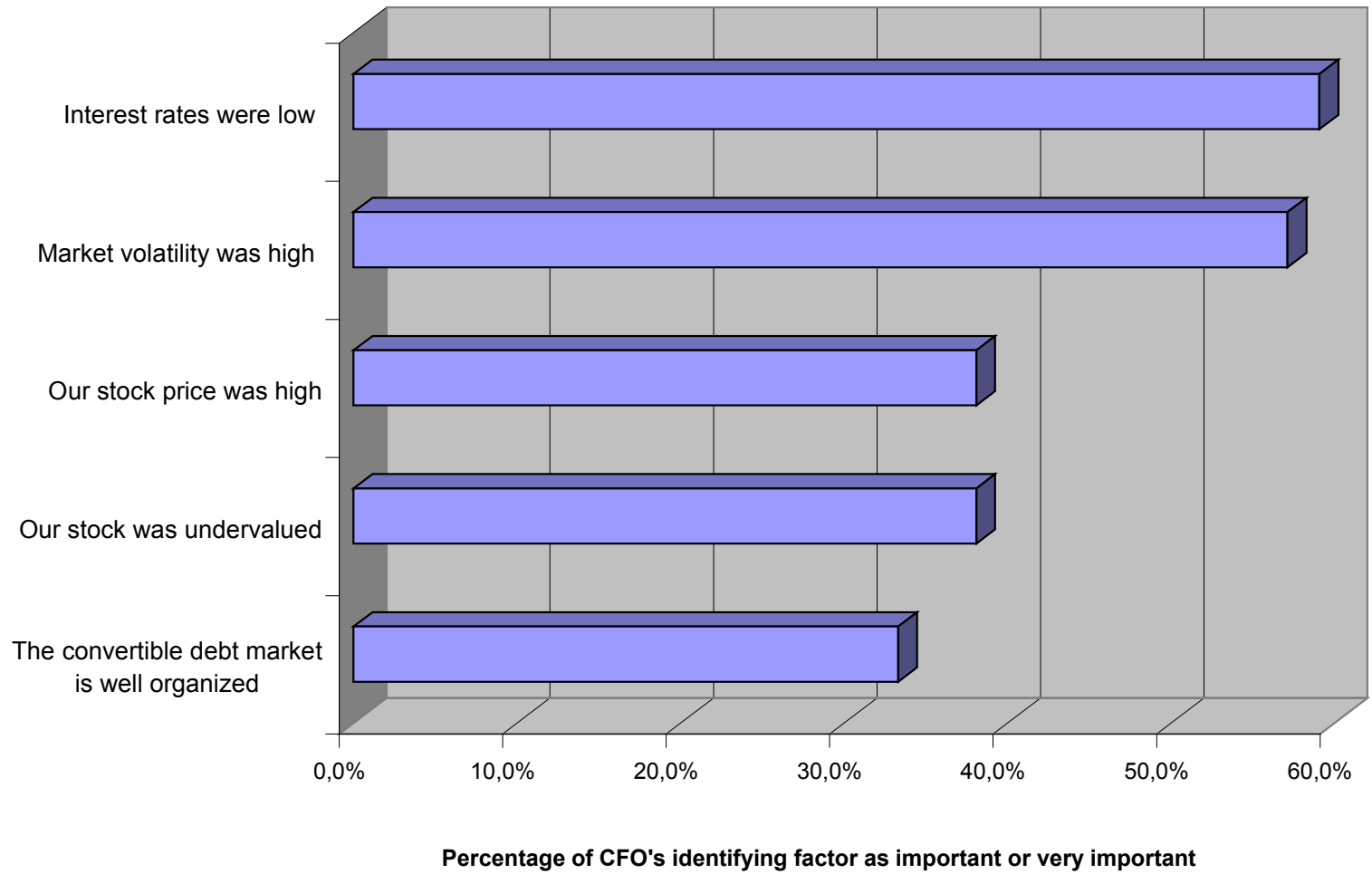


Table 5: Survey response to the question: How has your decision to issue convertibles been affected by market conditions?

	% Important or very important	Mean	French		Size		P/E		Dividend		Trigger		Converttusers	
			Yes	No	Small	Large	Growth	Non-G	Yes	No	Yes	No	Low	High
1) Interest rates were low	59.09%	2.68	2.67	2.7	3	2.27	3.25	2.43	2.71	2.25	2.57	2.88	2.56	2.73
2) Stock market volatility was high	57.14%	2.48	2.58	2.33	2.8	2.36	3	2.57	2.88	1.25***	2.29	2.86	2	2.91
4) Our stock was currently undervalued and issuing convertibles was a better choice	38.1%	1.95	1.55	2.4*	2.2	1.7	2.5	1.86	2.19	1.0*	2.15	1.63	2.1	2.1
5) Our stock price was currently high and with convertibles we locked in a favourable premium	38.1%	1.9	2.25	1.44	1.44	2.45	1.71	1.86	1.94	2.25	1.93	1.86	1	2.54**
6) The convertible debt market in our country is well organized and highly liquid	33.33%	2.19	2.64	1.7	2.3	2	2.25	2.14	2.06	2.5	2.36	1.88	2.1	2.2
3) We could not issue new debt or shares (because of market conditions, legal constraints, etc.)	15%	1.15	1.09	1.22	1	1.1	1	0.88	1.13	0.75	1.46	0.57*	0.88	1.4

Respondents are asked to rate on a scale of 0 (not important) to 4 (very important). We report the overall mean as well as the % of respondents that answered 3 and 4 (very important).

***,**, * denotes a significant difference as the 1%, 5%, and 10% level, respectively.

Figure 5: Major Holders and market reaction

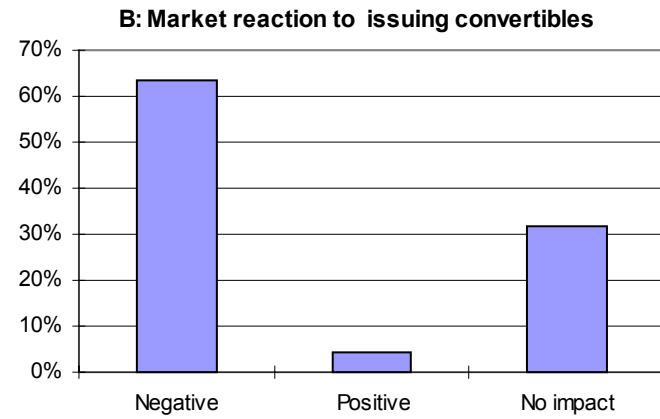
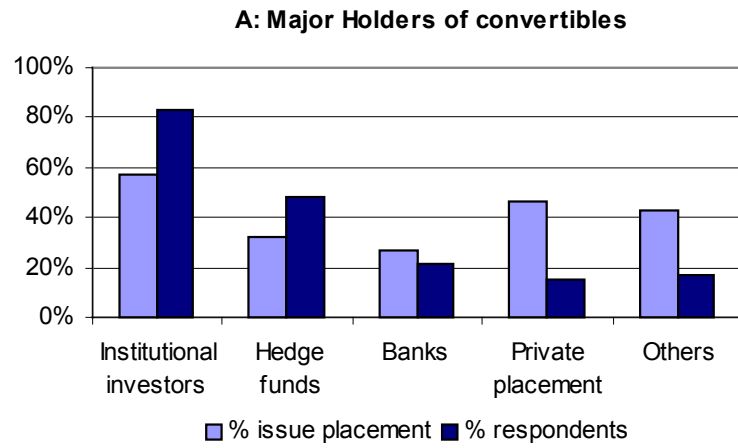


Figure 6: Factors in determining conversion policy

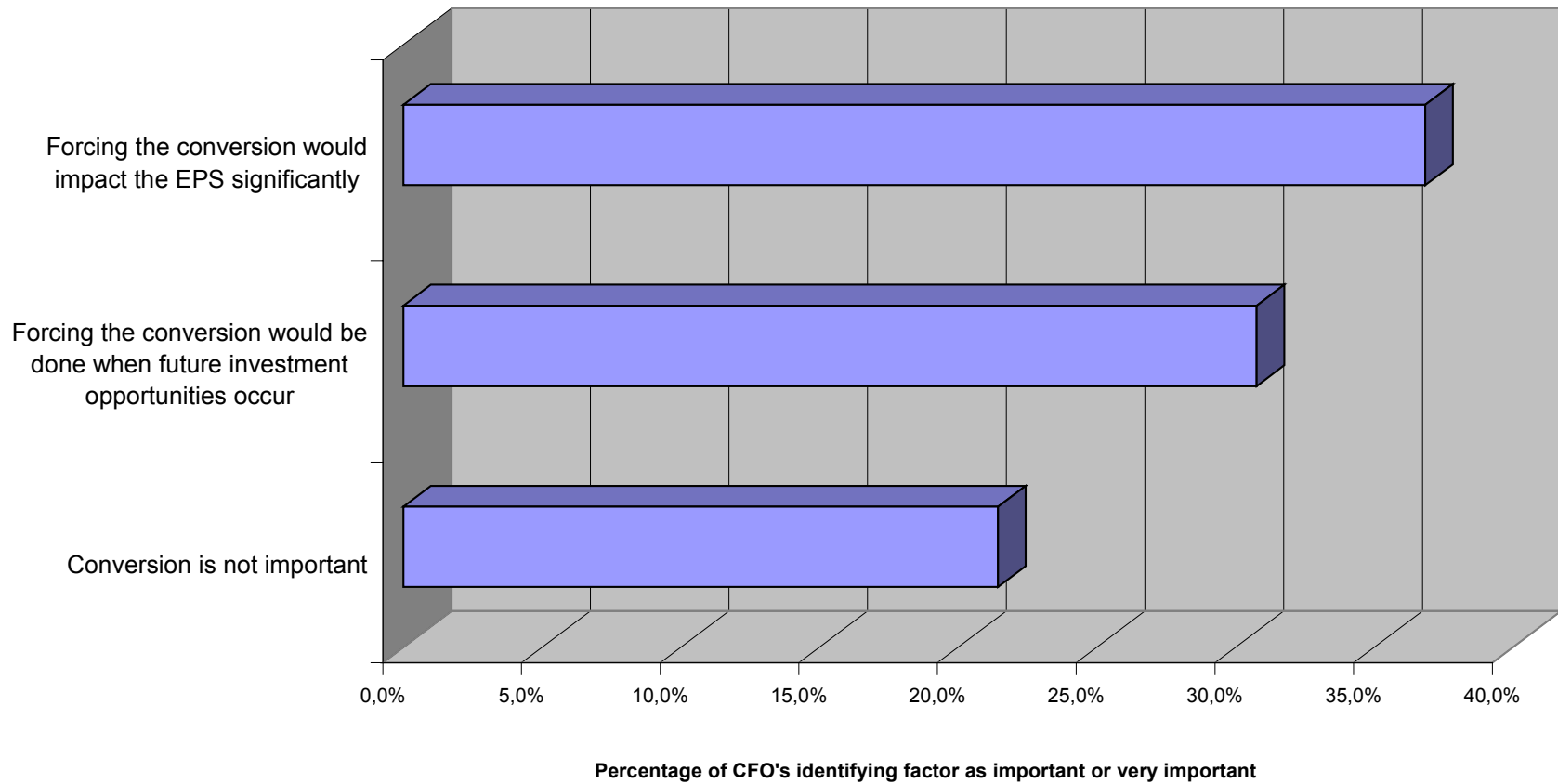


Table 6: Survey response to the question: What factors are important in determining your conversion policy?

	% Important or very important	Mean	French		Size		P/E		Dividend		Trigger		Converttusers	
			Yes	No	Small	Large	Growth	Non-G	Yes	No	Yes	No	Low	High
1) Forcing the conversion would impact significantly the EPS	36.84%	2.05	2	2.13	1.4	2.67**	2	2.14	2	2.33	2	2.2	1.67	2.27
5) Forcing the conversion would be done as and when future investment opportunities occur	30.77%	1.31	2	0.71*	1.63	0.8	2	0.2***	1.27	1.5	1.25	1.4	0.8	1.57
6) Conversion of the issue is not important to us	21.44%	1.86	2	1.71	1.75	2	1.8	2.2	1.73	2.33	1.88	1.83	2	1.71
3) Forcing the conversion close to the call premium would be unpopular with the investors	12.5%	1.06	0.67	0.57	0.75	1.38	1.17	1	1.15	0.67	0.64	2***	1.6	0.9
2) Forcing the conversion would mean loss of tax deductibility of interest	11.11%	1.11	0.81	1.57	1.22	1	1	1.83	1.29	0.33	0.92	1.6	1.67	1
4) Forcing the conversion indirectly through raising dividend is better	0%	0.94	0.67	1.29	1.13	0.75	1	1.2	1.08	0.33	0.6	1.6**	1.6	0.78*

Respondents are asked to rate on a scale of 0 (not important) to 4 (very important). We report the overall mean as well as the % of respondents that answered 3 and 4 (very important).

***. **. * denotes a significant difference at the 1%, 5%, and 10% level, respectively.

Figure 7: Characteristics of Convertibles

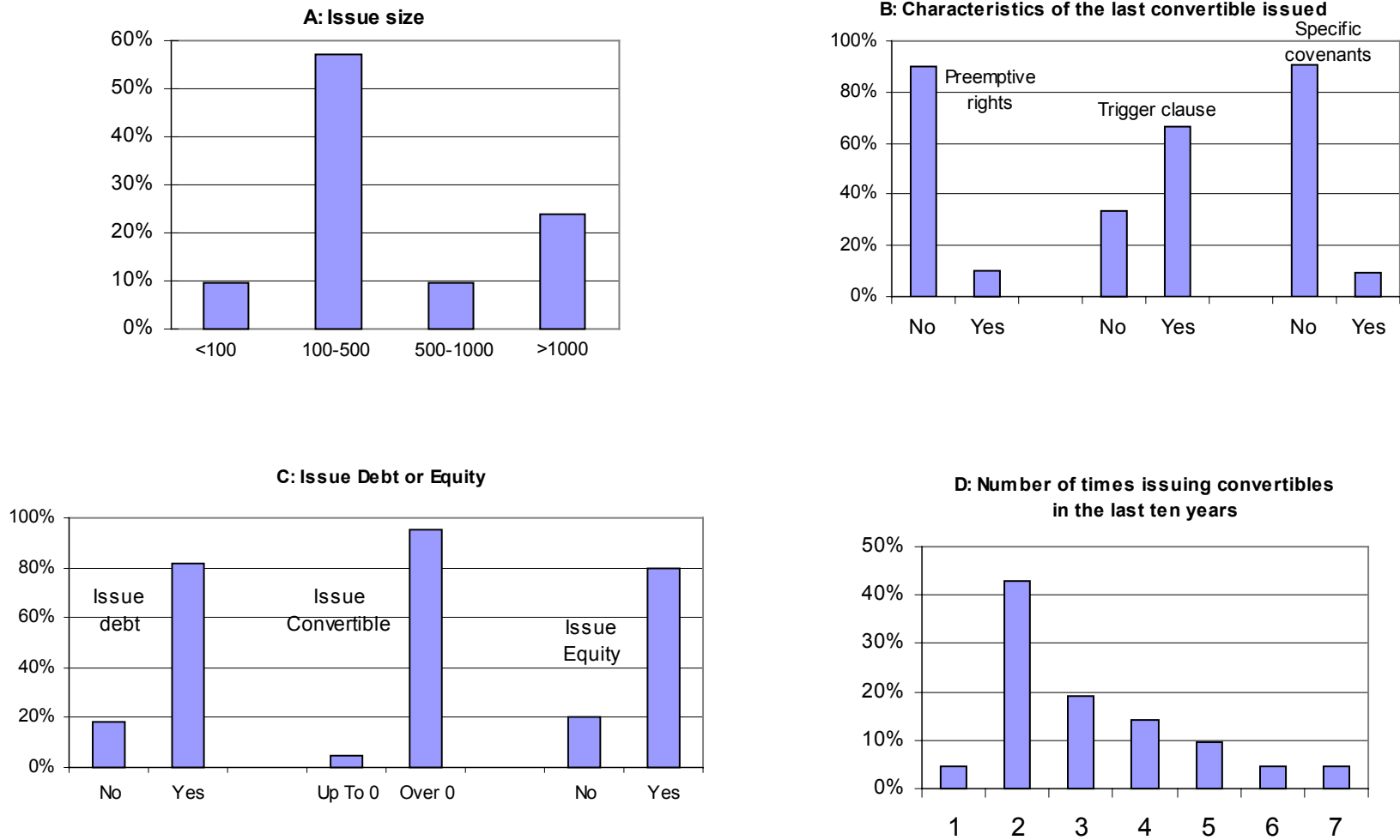


Figure 8: How did you select your investment advisor and what was the major help/advice by your investment bank?

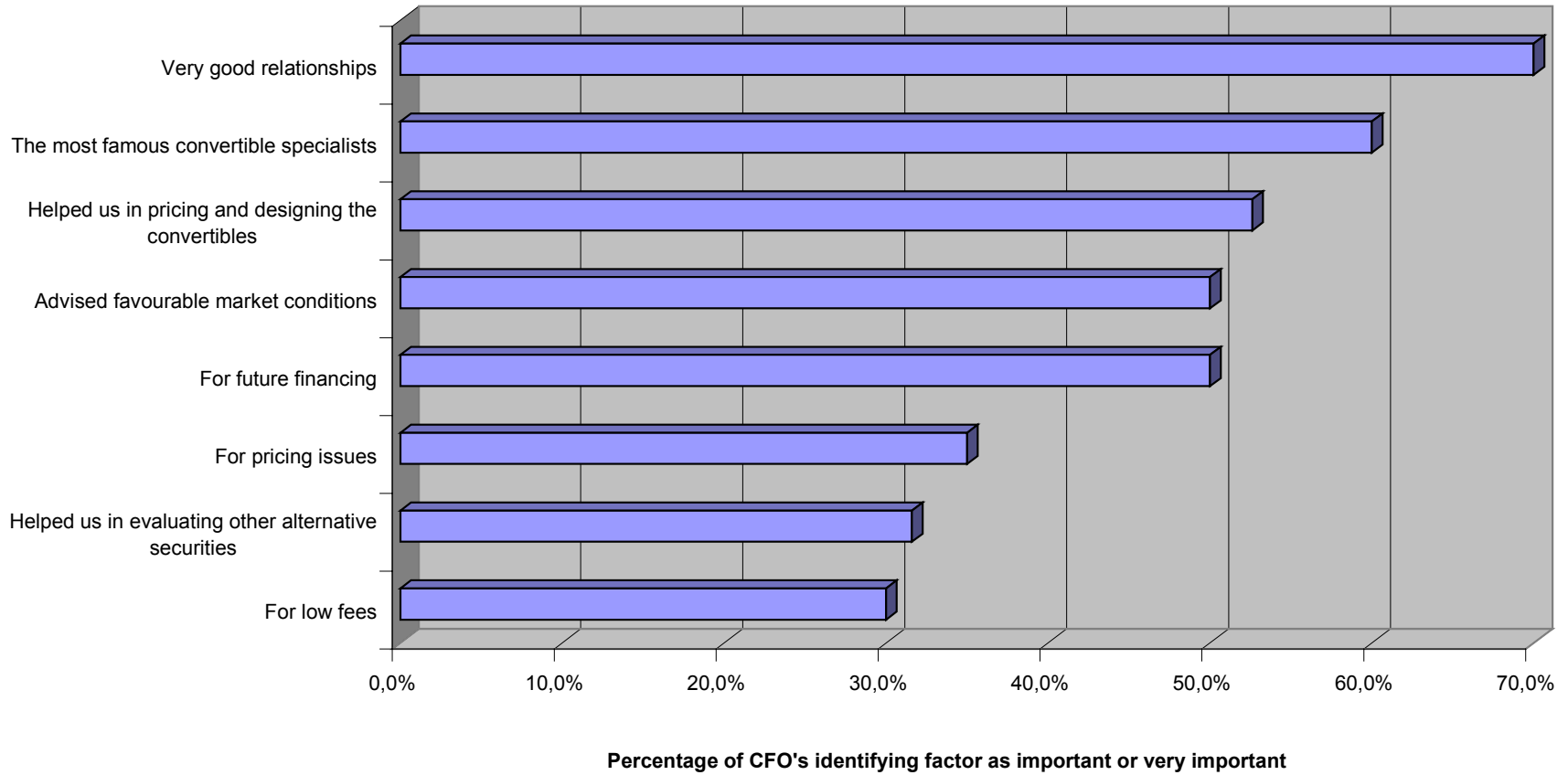


Table 7: Survey response to the question: How did you select your investment advisor and what was the major help/advice given by your investment bank?

	% Important or very important	Mean	French		Size		P/E		Dividend		Trigger		Converttusers	
			Yes	No	Small	Large	Growth	Non-G	Yes	No	Yes	No	Low	High
1) We had very good relationships with the investment bank that advised us	70%	3	2.6	3.4	3.3	2.78	2.67	3.25	3	3.25	3	3	3.13	2.9
3) We have chosen the investment bank that was the most famous convertible specialist (reputation)	60%	2.6	2.6	2.6	2.7	2.56	2.5	3	2.73	2.25	2.61	2.57	2.5	2.7
8) The investment bank has helped us in pricing and designing the convertibles (call policy, etc.)	52.63%	2.68	2.4	3	3.2	2.22**	2.4	3	2.64	3	2.62	2.83	3	2.5
2) We have selected as adviser a bank that was also able to finance us (lending money)	50%	2.35	2.6	2.1	2.4	2.33	2.17	2.25	2.27	2.75	2.69	1.71*	1.88	2.6
6) The investment bank has advised us to issue convertibles because of favourable market conditions	50%	2.33	2.67	2	3	1.5***	1.8	2.25	2.08	3	2.58	1.83	2.6	2
4) We have chosen our investment bank for pricing issues (the bank that offered the best pricing)	35%	2.1	2	2.2	1.6	2.44	2	1.75	2	2	2	2.29	2	2.1
9) The investment bank has helped us in evaluating other alternative securities versus convertibles	31.6%	1.74	1.5	2	2.1	1.11*	0.6	2.12***	1.5	2	1.92	1.3	2.29	1.4
5) We have chosen our investment bank for fees conditions (low fees)	30%	2.05	1.7	2.4	1.8	2.11	2.3	1.88	1.93	2	1.77	2.57	2.5	1.6*
7) The investment bank has explained to us the advantages of convertibles and has influenced us	11.11%	1.6	1.44	1.67	2.1	0.8***	0.6	2.0**	1.31	2.05	1.5	1.67	2.29	1**

Respondents are asked to rate on a scale of 0 (not important) to 4 (very important). We report the overall mean as well as the % of respondents that answered 3 and 4 (very important).

***, **, * denotes a significant difference as the 1%, 5%, and 10% level, respectively.