Convertible bond investors get cagey, demand covenants

By Innovative Investor

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News

Convertible bond (CB) investors are starting to make more demands of issuers as their outlook becomes more conservative and they have an increasing awareness of credit risks, according to panelists at the SunGard Hong Kong City Day on May 6. Attitudes are also changing towards coupon payouts.

"One thing I think that is interesting is that after the crisis, the terms of the CBs...investors are starting to demand CBs with coupons, compared to before the crisis when the norm seems to be that all CBs get zero coupons. And also, we're beginning to see more and more CBs attached to the type of covenants associated with straight bonds, just like giving more protection on the credit worthiness of the CB. We feel that while people are interested in the CB as an asset class, people are also becoming more conservative and thinking about the worse case scenario," says Wilkie Lai, chief risk officer at Tribridge Investment Partners.

Panelists also note that the appetite of the investment community is driving timing and issuance. Members expressed the opinion that given liquidity in the market at the moment, money is chasing these investment opportunities. They added that if investors agree that the volatility in the equity market will be picking up for the rest of the year, it makes CB is one kind of attractive investment asset class.

Panelists were positive on the outlook for convertible bonds in Asia in general, with Pradeep Swamy, head of Asian convertibles at Barclays Capital, saying "the Barclays view for the asset class is that it will actually outperform equities and credit for the year 2010." Panelists also expected "pretty good" issuance because of the financing needs of Asian corporates, though note it is dependent on the markets holding up.

Delegates on the floor questioned whether or not the rally in convertible bonds last year had left the space too crowded. Swamy responded by saying the market is "a little bit crowded but I don't think that the value has been squeezed out yet. If you look one very basic indicator of valuation, if you look at average yield to maturity or yield to put of the CB, before the crisis it was actually negative...today it is actually about 3%, positive. That's a six percentage point swing in carry. People are looking for more yield and that exists in the CB universe."

One long term trend in the asset class has been the relative shrinking of the Japanese market, against the backdrop of continued growth in the rest of Asia, with Asia leapfrogging Japan. "Fifteen to twenty years ago the Japanese CB market was 75% of the global CB market. Today Japan is 8 or 10% of the global market and Asia ex-Japan is 10 or 12%, so Japan has slipped down...Maybe [in future] Japan stabilizes, but the rest of Asia needs to grow from here on, so you'll see a bigger Asia ex-Japan CB market," said George Long, ceo of LIM Advisors.

"Another interesting things that we saw, that affected the market in Asia was basically the buyback syndrome or buyback phenomenon, both in the Asian straight bond market and the Asian CB market in 2008, which didn't really exist in Europe and the States. In Asia many companies are family owned or have one major shareholder, and either the company or the family stepped in and bought their bonds in late '08, early '09 and that provided the floor. That's quite a different market structure to what I think that exists in Europe and the US - everyone has to pay attention to the family-controlled corporate buy back," says Long.

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