Ground zero?

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Abstract:
Zero-coupons convertible bonds offer an easy way for companies to raise their much-needed capital. Originally devised by Merrill Lynch in 1985, the zero-coupon convertibles can be turned into common stock at a certain amount which offers investors some upside and downside potential depending on the bond's return. The only negative side to zero-coupon convertibles is that the amount of capital that can be raised is only half of the issue's face amount which turns into an advantage considering that the conversion premium increases as it matures.

Full Text:
Issuance of zero-coupon convertible bonds is booming. And that makes them a juicier target for the IRS.

The high-flying market for wireless communications offers as much risk as it does growth opportunities. But when Indianapolis-based Brightpoint Inc. needed to raise capital earlier this year, the $1 billion (in revenues) supplier of wireless services was able to take advantage of one of the best deals around: a zero-coupon convertible bond.

This complex security, first created in 1985 by Merrill Lynch, enabled Brightpoint to raise $172 million at very little cost. And given the heightened scrutiny zero-coupon convertibles have been receiving from the Clinton Administration, Brightpoint may have acted none too soon.

Like other convertibles, zero-coupon converts are bonds that can be converted into a fixed amount of a company's common stock at a certain price. That gives investors some of the upside potential of the underlying stock, as well as downside protection based on the bond's return. And with the stock market reaching dizzying heights, investors looking to hedge their bets have been snapping up convertibles of all kinds.

But issuers like Brightpoint are finding it particularly advantageous to combine the features of straight convertibles with those of zero-coupon bonds. Unlike traditional bonds, zeros don't pay out any interest until maturity. That appeals to investors that don't need the income until then and would prefer not to have to reinvest it. Issuers of zeros are able to offer investors lower yields compared with straight debt because of the "equity kicker" embodied in the convertible. Conversely, because of the wait, the yield on a zero-coupon convertible will exceed that of a current coupon convertible. The difference is more than offset by the tax deduction that issuers can take each year for a portion of that eventual payout.

"These products entail a tax deduction without an outlay of cash," says Robert Willens, a tax and accounting analyst for the New York investment firm Lehman Brothers Inc. "So the effective cost of these instruments is below the nominal cost. It's one of the cheapest forms of debt ever developed."

Too cheap to be true? Not to Brightpoint CFO Phillip Bounsall. For starters, the company was able to offer a yield to maturity of 4 percent on the bonds, not much more than it would have had to pay on a traditional convertible. More important, Brightpoint gets tax deductions each year for interest it won't have to pay for up to 20 years. As a result, says Bounsall, "you're saving the cash interest plus an additional 40 percent [in taxes]. From a cash-flow perspective, it's very, very positive."

* UNCONVERTIBLES?

The only drawback is that the securities are issued at a deep discount to face value - in Brightpoint's case, a 45 percent discount, which means the amount of capital the company raised represented less than half the issue's $380 million face amount.

But even that drawback may be an advantage. Reason: It makes the bond exceedingly difficult for investors to ever turn into stock. As with any convertible, the price of the underlying stock must exceed the so-called strike price by a certain amount - known as the conversion premium - before it's worthwhile to convert the bond. And because the bond was issued at a discount, its conversion premium rises as it matures.

"You might start off with a 15 percent conversion premium, but if the stock remained flat, the conversion premium would expand."

The premium on Brightpoint's zero, for example, was 20 percent when issued. And even if the stock stays where it is, the premium will expand to 46 percent in five years.

"The strike price is running away," adds Thomas Patrick, executive vice president at Merrill in Chicago. "Even though you're starting with a premium the same as any other convertible, the holder never gets the stock."

That, needless to say, isn't great for holders of the bonds. But it's good for shareholders, who are protected from the dilution that conversion of debt into equity produces. No wonder such companies as HewlettPackard, Disney, Marriott, Motorola, News Corp., and Time Warner have all taken advantage of zero converts. And despite the difficulty of converting these bonds to equity - and the fact that some are more sensitive than traditional convertibles to interest-rate changes - demand from investors has been so strong that a growing number of smaller, lower-rated companies like Brightpoint have also been able to tap it. Even companies in as bad shape as appliance maker Sunbeam have recently managed to sell zero-coupon converts.

* A SELLER'S MARKET

One of the biggest buyers of zero-coupon converts is Nick Calamos, senior portfolio manager for Calamos Asset Management, which holds more than $3 billion in convertibles of various kinds. But Calamos notes that "there are a lot of very unattractive zeros, where the stock moves up 30 percent to 40 percent and the zero does almost nothing." In the current market, this hasn't been true of those issued by bigger-cap, more-stable companies, which is where Calamos has put about 15 percent of his portfolio. If less attractively termed bonds are being sold despite their problems, that's because "issuers have the upper hand" in a seller's market.

That's evident in the amount of capital raised. Through 1997, roughly $22.7 billion worth of zero converts had been issued since Merrill first brought one to market in 1985. The total rose by $2.8 billion, or nearly sixfold, last year alone, according to Securities Data Corp., a New York firm that tracks securities issuance.

But the boom has also heightened interest in the securities on the part of the U.S. Treasury, which has long viewed them as a tax dodge. This year, for the third time since 1995, the Clinton Administration budget proposes to curb the ability of issuers to deduct interest on the bonds. The government argues that because issuers don't pay any interest until maturity, they should get a tax deduction for interest only at that time. "There's always been a cloud over the product from a tax point of view," says Willens.

Critics of the Treasury proposal contend that the difficulty in converting these bonds to stock undermines that argument. Merrill's Patrick also claims that the Treasury's proposal "is at odds with the tax law's general treatment of expenses paid in stock," which are deductible. And finally, he claims that the proposal would "destroy the symmetry between issuers and holders of debt with original issue discount, which has been the pillar of tax policy regarding [zero-coupon convertibles]."

But that pillar looks increasingly shaky. Theoretically, buyers pay tax each year on a portion of the income they eventually receive from the zeros - creating the symmetry. But Willens notes that "the reality is that for zero coupons, the principal purchasers are tax-exempt organizations, deferred tax accounts, and foreigners." As a result, he says, "it's a revenue loss to the IRS." Since the product's inception, he says, the loss has clearly been "substantial."

Willens's point is borne out by Calamos, who says he buys zero-coupon converts primarily for tax-exempt accounts. And while the Treasury's past efforts to curb the tax break have failed, the bigger the drain on IRS coffers, the harder the Administration is likely to push to eliminate the tax break, and the harder it will be for Congress to push back. Granted, the IRS issued a private-letter ruling that okayed the product's tax status in 1991, but the service has been backtracking ever since. In 1995, the Treasury stated in its budget proposal that "the line between debt and equity is uncertain, and taxpayers have exploited this lack of guidance."

This February, its proposal added that "in many cases, the issuance of convertible debt instruments is viewed by market participants as a de facto issuance of equity," and that allowing issuers to deduct accrued interest and the original issue discount is "inconsistent with the market view." So now the IRS wants to defer the deduction until actual payment.

It's impossible to predict, of course, whether the proposal will in fact become law. But the longer the zero-convert boom lasts, the likelier that prospect becomes. And issuers who want to take fresh advantage clearly have reason to make hay while the making is good.

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