Swaps: Debt-equity swap

INTRODUCTION

Debt-equity (respectively equity-debt) swap allows a company, government, or municipality to swap debt for equity (respectively equity for debt). Debt and equity are the two main sources of financing. Debt-equity and equity-debt swap enables to change the liability profile from one to the other type, to create a more optimal capital structure Debt-equity and equity debt results in what is called a recapitalisation. The two characteristics of a recapitalisation are that there is no change of capital within the entity[1] and the capital structure is modified between debt and equity. As a result, two important financial indicators are modified:

- the debt-equity ratio, defined as the ratio of the entity's total liabilities over its total equity. Management of the debt-equity ratio is an important element for optimal capital design. There is a trade-off between a high debt-equity to get a high leverage but also a soaring cost of financing and a low debt-equity ratio with less risk but also less leverage and potential growth resulting from it.
- The debt service defined as the amount of funds necessary for or used in the payment of interest and amortization charges of a debt.

In brief, swapping debt for equity (respectively equity for debt) reduces (respectively increases) the leverage.

[1] Apart form transaction costs in the exchange and advisory fee for the swap.

RATIONAL

There are several motivations for a company, government, or municipality to swap debt for an ownership, or equity, stake in a company:

- To avoid a Chapter 11 (bankruptcy) filing, which would take years to resolve, a company in financial distress may offer to its bondholder to get a negotiated amount of equity in exchange for their debt holding. The exact amount would be the result of negotiation between company management and bondholders
- High stock market valuation or increasing debt agency cost may also make a debt-equity swap attractive as a way to buy back existing debt against new issued stocks. The final swap would be the result of negotiation between management and bondholders. In case of disagreement, often bond indenture has terms and covenants to prevent the swap to occur.
- Bondholder or third party person may be interested in taking a direct stake in the company using a debt-equity swap. If it is not the bondholder but rather a third party who wishes to own equity or if the bond holder is disallowed to get direct ownership of the company, the bondholder may sell the bond in the secondary market to the third party who would then be able to make the swap.
- The debt-equity swap may be the result of a conversion of a convertible bond, of a leverage buy out.
- Last but not least, debt-equity swap may be the result of regulatory capital constraints. This is very much the case of banking institution subject to specific regulatory capital target.

From an investor point of view a debt-equity swap may be attractive for the following reasons:

- Equity provides more corporate tax shield as dividends are usually taxed at a lower rate compared to coupon payment on bonds
- The investor may have some favourable views on existing and future projects. Asymmetric information between management and investor is partially limited by insider trading law.

MARKET REACTION

Usually, one observes that stock market reacts strongly to recapitalisation:

- If leverage increases, stock price commonly increases often because of anticipated growth of the entity and because of corporate tax shield for common stocks.
- If leverage decreases, stock price in most cases decreases. Markets think that the exchange of equity for debt reveals some bad news about the firm. There is therefore a trade-off between a drop in price due to recapitalisation and higher expected bankruptcy, renegotiation and litigation costs when delaying the equity-debt swap.

EXAMPLE

Here are some school cases of debt/equity swaps

- Debt-equity swap by a government or municipal entity. The government of a developing country may be unable to service its debt, usually denominated and payable in U.S. dollars. The holder of a loan may offer to sell it back in exchange for a stake in a government-owned company being privatised. Alternatively, the government may offer to swap the debt into local currency. This currency conversion may be useful for the debtor to build local operations or invest in local companies.

- Equity-debt by a large corporation: A Corporation is overwhelmed by its debt charge and may not be able to meet its payment. But the company may think that this payment crisis is only temporary as it is waiting for a promising product line to kick off in the coming two years. The company may renegotiate its debt and agree to swap debt for equity. The bank owning the loan may accept to take some participation in the future benefit of the product in exchange for a full or partial write-off of the loan. The swap would make both better off as the large company would be in better shape to handle its debt service while the bank would avoid adding some risky debt to its trade book and hence avoid some costly reserve capital requirement.

- A new-economy company specialising in providing financial information on-line see its debt rapidly mounting due to the development of new services on-line which are expected to generate great revenues when users switch from the free to the monthly rented services. Most of its debts are with some financial information suppliers. The supplier may accept a stake in the new service revenues in return for a write-off of the debt. That way, the supplier has greater chance of recovering part of its debt, while the new-economy company can manage to develop the new service to generate even more revenue to the financial data supplier.

Entry category: swaps

Scope: nature of debt equity swap; reasons for; implications for financial risk of firms.

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