TWO TECHNIQUES OF CORPORATE FINANCING

Sales of convertible bonds and direct or private placement of conventional debt issues are two long-standing methods of corporate financing that experienced varying degrees of activity in the 1960's. Convertibles were only mildly popular during the first half of the decade, while in the second half their volume attained record levels. Direct placement, on the other hand, followed the opposite pattern. Their volume reached new highs in the early 1960's and in some quarters they were billed as the corporate financing tool of the future. Changing economic and financial conditions, however, discouraged the use of direct placements, in both relative and absolute terms, in the second half of the decade.

Convertible Bonds Bonds that are convertible into equity shares at the option of the bondholder have long been used by U. S. corporations. The earliest widespread use of convertibles came during the railroad boom of the nineteenth century. The convertible feature proved attractive and later was incorporated in a broad assortment of debt instruments. It was particularly popular in the late 1920's and has been a notable feature of corporate financing since the late 1930's.

Two purposes appear to underlie the use of convertible bonds in the corporate financing plan. First, convertibility enhances the marketability of the issue. Second, under certain conditions, the use of convertibles may produce a favorable effect on the financial structure of the firm. Although the advantage of increased marketability has been emphasized traditionally, some empirical evidence suggests that improvement of the financial structure may be a more important reason for issuing convertible securities.[1] Converting an ordinary fixed income security into a common stock whose value is based on the profit potential of the firm adds a speculative attraction to the security. Thus the convertible feature is often looked upon by the market as a "sweetener." Many firms, particularly those with large fluctuations in earnings, find it useful to issue convertible securities to build up their equity buffer over the long run. This technique is especially attractive to firms whose common stock price currently lacks the strength to withstand a direct offering of equity shares. Issuing convertibles may then serve beneficially as a deferred offering of common shares.

The advantages of marketability and financial structure appear to have influenced the rapid increase in the volume of convertibles in the late 1960's, shown in Chart I. This period was characterized by widespread economic expansion, rapid growth in debt financing, extensive merger and expansion activity, and generally firm—on occasion tight—credit market conditions.

The long investment boom of that period, coupled with the increasing appetite of conglomerates for new acquisitions, generated a great demand for external financing among corporations. In the accompanying competition for funds, interest rates soared and the marketability advantage of the convertible bond proved attractive to corporate borrowers. Convertibles offered the investor the right to a fixed income at a time when the firm's earnings were minimal and the prospect of participating in future earnings if the merger were as successful as anticipated.

With the heavy borrowing of the middle and late 1960's, the financial structure of many corporations became overloaded with debt. Moreover, in the tight money episodes of 1966 and 1969, many corporate borrowers relied heavily on short-term funds, avoiding the more permanent high costs of bond financing. Hence for many firms both the debt-equity ratio and the ratio of short-term to long-term debt took unfavorable turns. For firms in this position, the convertible bond offered an opportunity to fund short-term debt while at the same time arranging a deferred improvement in the debt-equity ratio.

Convertibles were widely used in 1968 and 1969, particularly in the latter year, which was characterized by tight credit conditions, falling stock prices, and a high merger rate. Their use declined significantly in 1970, however, as falling interest rates, rising stock prices, and a considerable emphasis on quality by the market encouraged the use of conventional debt and equity instruments. Much of the new financing in 1970 was done by public utilities and communications companies that traditionally have made little use of convertibles.

(Continued on page 8)

[1] C. James Pilcher, *Raising Capital with Convertible Securities* (Ann Arbor: University of Michigan Press, 1955).

TWO TECHNIQUES OF CORPORATE FINANCING

(Continued from page 5)

Direct Placements One of the most important innovations in corporate financing after the early 1930's was the direct placement of securities with large institutional investors. Direct or private placements enable the borrower to deal directly with institutional purchasers such as insurance companies and pension funds. As an increasingly popular method of marketing long-term debt, private placements expanded until 1964 when they accounted for 64 percent of all corporate bonds issued.

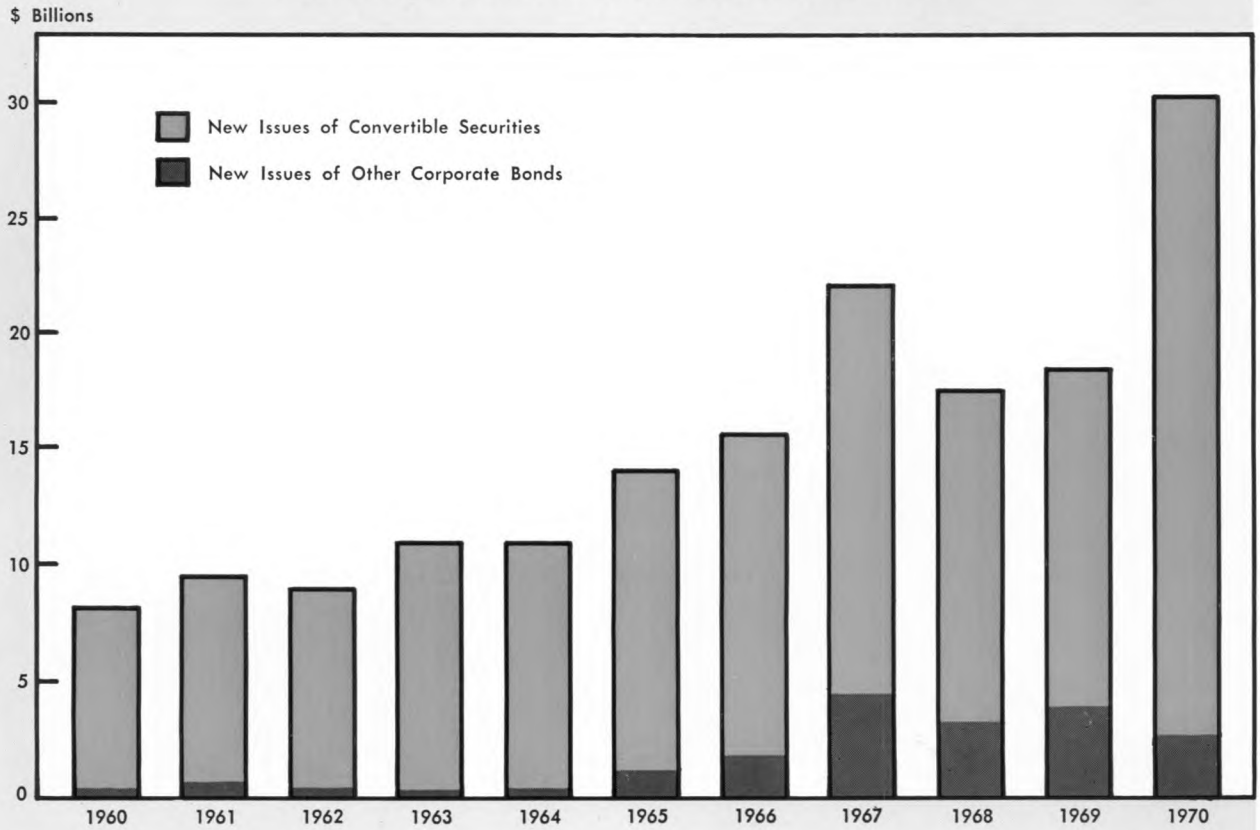
Several factors contributed to the rise of private placements after the early 1930's. Changes in legal codes after 1928 allowed insurance companies for the first time to invest in unsecured loans, including corporate debentures. Equally important was the tremendous increase in the resources of insurance companies, much of which took place in the 1930's, when the total volume of corporate borrowing was at a low ebb.

The reduction in time and expense involved in direct placements was a third factor. Long delays in the registration of a public issue are unavoidable. The possibility of basic changes in market conditions during such delays introduces an element of uncertainty in the financial planning of corporate treasurers. By comparison, private placements can be negotiated in relatively little time.

One of the most important reasons for the popularity of direct financing, however, has been the close relationship of the issuer to the lender. Because there is only one or a limited number of bondholders, the terms of indenture are easily negotiated, and if these terms become burdensome to either party, the indenture could be renegotiated more easily if only two parties are involved.

Chart 1

CONVERTIBLE SECURITIES IN CORPORATE DEBT ISSUES



Source: **Statistical Bulletin**, Securities and Exchange Commission, March 1971.

At the same time, however, there are disadvantages associated with direct placements. The creditor assumes greater risk because of the length of his commitment and the reduced ability to diversify his portfolio. Costs of investigating the financial position of the borrower are relatively high. The issuer may have to borrow at somewhat higher rates of interest, be of higher credit standing than otherwise necessary, and submit to substantial financial restrictions and often management control.

Unlike convertible bonds, directly placed bonds became less attractive during the second half of the 1960's. (See Chart II.) During this period life insurance companies, by far the largest suppliers of direct placement of funds, were not sufficiently liquid to continue to purchase securities as rapidly as they had in earlier years. The reduced supply of lendable funds among life insurance companies was traceable to the generally tight credit conditions and to the sharp upsurge in requests for loans by policyholders. On the demand side, tight credit conditions discouraged many corporations from using long-term debt in favor of temporary short-term funds, thus curtailing the demand for direct placement of funds.

Although the chief characteristic of the bull market in bonds after mid-1970 was the rising prices at which huge quantities of new securities were marketed, there was also considerable emphasis on the quality of issues. The Penn Central debacle caused many insurance firms, as well as other institutional investors, to be unusually quality-conscious in their investment planning. Most insurance companies shied away from direct placements unless the borrower had a high credit rating.

As the credit markets became characterized by less frantic conditions, direct placements may regain their earlier popularity. They offer considerable advantages for both large firms and large institutional investors.

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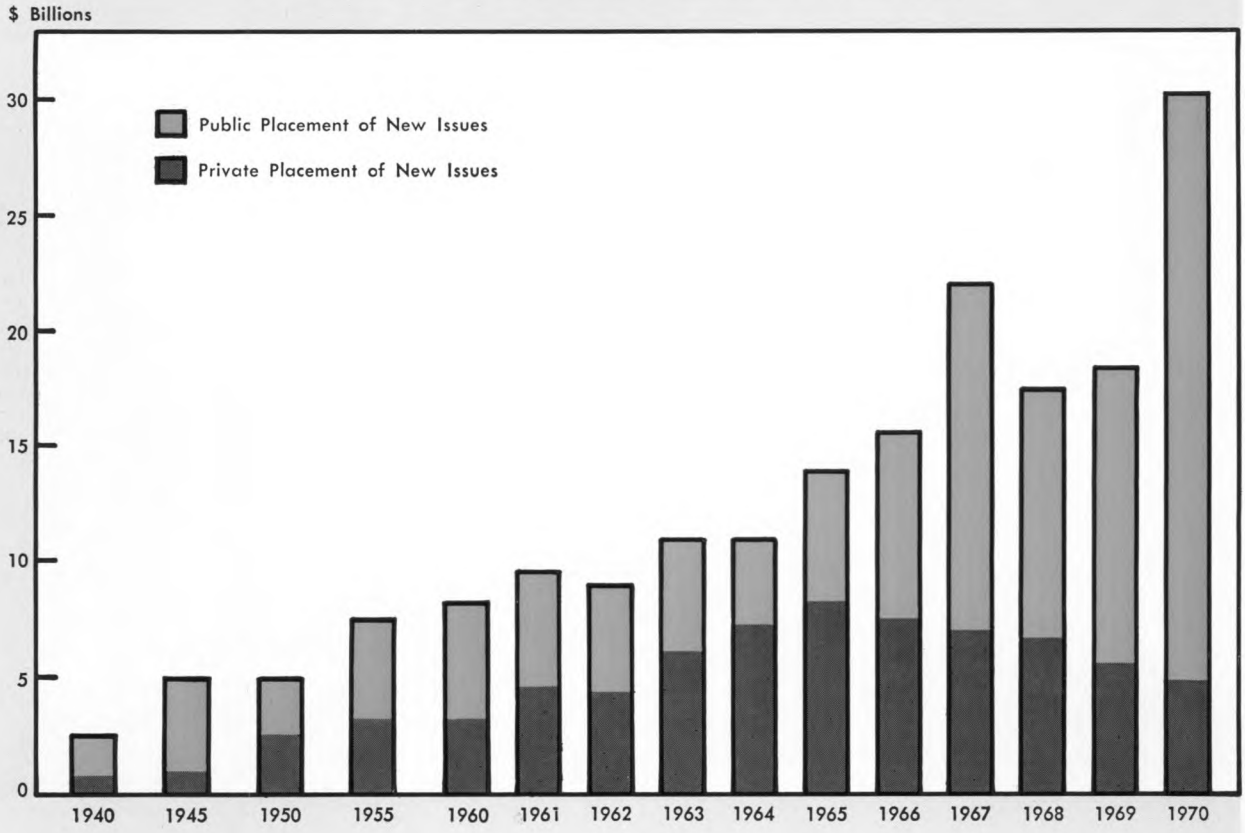
Chart 2

PRIVATE AND PUBLIC PLACEMENT OF CORPORATE BONDS



Source: Federal Reserve Bulletin.