



SECTION - 4

HYBRID FINANCING / INSTRUMENTS

This Section includes

- **Introduction**
- **Convertible Bonds and Warrants**
- **The origin of venture capital**
- **How VCs differ from banks**
- **Types of VCs**

4.1. INTRODUCTION

- 4.1.1 The term **hybrid instrument** is not precisely defined. Generally, it is used to refer to financial instruments that blend characteristics of both debt and equity markets. Convertible bonds are an example. They are debt instruments that have an imbedded option allowing the holder to exchange them for shares of the issuing company's stock at the end of the given period. For this reason, their market prices tend to be influenced by both interest rates as well as the convertible price and proportion. Another example would be a structured note linked to some equity index. These take many forms. Typical would be a five year note. It is a debt instrument issued by a corporation or sovereign, but instead of paying interest, it returns the greater of principal plus the price appreciation on the S&P 500 index over the life of the instrument, or principal.
- 4.1.2 Other examples of hybrids are preferred stock, Trust Preferred Securities (TruPS) or Equity Default Swaps (EDS).
- 4.1.3 Some people extend the definition of hybrid instrument to encompass instruments that straddle other market sectors. According to this definition, a quanto option or a volatility future would be considered a hybrid.
- 4.1.4 The terms "hybrid securities," "hybrid products" or simply "hybrids" are all synonyms for "hybrid instruments".

4.2. CONVERTIBLE BONDS AND WARRANTS

- 4.2.1 A convertible security or convertible is a hybrid security with a provision for the convertible to be exchanged for some other security. Usually, conversion is at the security holder's option, but a mandatory convertible security requires conversion, usually according to pre-determined and mutually agreed terms and time schedule.

- 4.2.2 Most convertibles are either convertible preferred stock or convertible bonds issued by a company and convertible to that company's common stock any time after lapse of a prescribed time, at the security holder's option.
- 4.2.3 A warrant is a long-term call option. A convertible bond consists of a fixed rate bond plus a call option.
- 4.2.4 Convertible securities have a par value, and their yield is quoted as a percentage of par. Each security may be converted into a fixed number of common shares. That number is the security's conversion ratio. For example, if a convertible bond's conversion ratio is 12.5, and the bond has a par value of USD 1,000, then each USD 80 of par value can be converted into a single share. This number is called the conversion price:

$$\text{conversion price} = \frac{\text{par value}}{\text{conversion ratio}} \quad [1]$$

- 4.2.5 Convertibles routinely have an anti-dilution provision, which adjusts the conversion ratio as appropriate in the event of a stock split or stock dividend. Some convertibles have a conversion ratio that changes according to a fixed schedule. For example, a convertible bond's conversion ratio might be 12.5 for the bond's first five years and then drop to 11 after that.
- 4.2.6 As is typical of hybrid securities, convertibles can be difficult to value. Also, convertibles may have additional embedded options or features. Many are callable after a few years of call protection. When called, holders are forced to either surrender the security for the call price or convert them. If they convert, the transaction is called a forced conversion. Some convertibles have a put feature, allowing holders to return the security to the issuer at a pre-determined price on certain dates.
- 4.2.7 A convertible's investment value is what the market value of the convertible would be if it were stripped of its conversion feature. This reflects the security's future cash flows, current interest rates, the issuer's credit quality and any other features such as put or call provisions other than the conversion option. Investment value isn't generally observable in the marketplace, but it is a useful notion that can be ascribed a value using standard bond pricing or financial engineering methodologies.
- 4.2.8 A convertible's conversion value (or parity value) is the value that could be realized by immediately converting the convertible to common stock. It is easily calculated as:
- $$\text{conversion value} = (\text{conversion ratio}) \text{ current stock price} \quad [2]$$
- 4.2.9 These notions viz. investment value and conversion value—are important because a convertible's market price should always exceed both quantities. Otherwise, arbitrageurs will step in and start accumulating the convertible, thereby driving up its market price. The two quantities are often quoted as premiums: