WHAT ARE CONVERTIBLE BONDS?

Just like classic bonds, convertible bonds pay a fixed coupon and have a fixed term. The difference is that holders of these bonds have the right (but not the obligation) to convert their bonds into shares or new shares of the issuer or, as an exception, of another company during one or more periods and under conditions specified in advance.

The **conversion period** is the period during which the exchange (or conversion) can take place.

The **conversion price** is determined by the issuer when the convertible bonds are issued. It is the price to be paid in convertible bonds (at their par value), at which the issuing company will sell shares during the conversion period.

The **conversion ratio** is established as follows: this is the number of shares received from a bond conversion (based on the par value).

Features

A convertible bond has the same basic features as an ordinary bond.

- The **issuer** is the entity issuing the bond. This entity borrows money from investors and will pay interest (**coupon**) to those investors in return. Interest is usually paid annually.
- Convertible bonds can also be **rated**. This rating gives an indication of the creditworthiness of the issuer when it is awarded. It is awarded by specialised, independent firms (mainly Moody's and Standard & Poor's).
- Most convertible bonds also have a fixed **term**. Once the term has expired (at maturity), the issuer repays the borrowed capital.

A convertible bond differs from an ordinary bond in the following ways:

- Bondholders have the right (not the obligation) to **convert their bonds into shares** or new shares of the issuer (or, as an exception, of another company) during one or more periods and under conditions specified in advance. Just like ordinary bonds, you will recoup your invested capital at maturity if you don't exercise this right.
- As bondholders enjoy an additional right, convertible bonds usually pay **less interest** than classic bonds.

Risks

Currency risk: if you invest in convertible bonds in foreign currency, there is a currency risk against the euro. The amount in euro that you receive in the event of sale or on maturity can be more or less than the amount that you originally invested owing to the exchange rate.

Liquidity risk: this risk may be considerable, because the secondary market is generally limited.

Market risk: the value (price) of a convertible bond is determined by the evolution of the market interest rate, but above all by the evolution of the underlying share price. The market risk inherent in a convertible bond is therefore greater than for a classic bond; the price can rise and fall sharply during the term.

Credit risk: convertible bonds are usually issued by companies in a growth phase that want to finance themselves at an attractive price. These companies are therefore often slightly less creditworthy than larger companies. This is why you should be extra cautious and definitely consult these bonds' **rating**, which is often lower than for classic bonds.

Costs and taxes

When you buy bonds, it is in your best interest to take the costs and taxes that you will have to pay into account. This is because they will affect the return on your bonds.

COSTS

Brokerage: banks charge fees to execute your orders on the secondary market.

Custody fee: most banks charge fees for keeping your bonds in a custody account.

Sale and placing commission: when buying bonds on the primary market, you pay placing commission. Together with the par value, this forms the issue price.

TAXES

Stamp tax on share deals: if you buy or sell existing bonds on the secondary market, you have to pay stock exchange tax. If you buy new bonds on the primary market, you don't have to pay this tax.

Withholding tax on interest: you have to pay withholding tax on the interest earned on Belgian corporate and government bonds. The interest earned on non-Belgian corporate and government bonds is taxed first in the country of origin and then it is subject to withholding tax in Belgium.

Capital gains tax : if you sell bonds before maturity for more than the price you paid at the time of purchase, you make a capital gain. You don't have to pay any tax on this capital gain.

Note: you do have to pay withholding tax on the difference between the purchase price and redemption price of a zero-coupon bond.

Do you want to find out more about convertible bonds?

Read our *Financial instruments information sheet* on our website at www.bnpparibasfortis.be.

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