Chapter 16

Convertible Issues and Warrants

How do Convertible Issues and Warrants rank as investment opportunities and risks?

Convertible bonds, preferred stocks and stock-option warrants have been taking on a predominant importance in recent years in the field of senior financing.

TABLE 16-1 Price Record of New Preferred-Stock Issues Offered in 1946

Price Change from Issue Price to Low up to July 1947	"Straight" Issues (number of issues)	Convertible and Participating Issues (number of issues)
No decline	7	0
Declined 0–10%	16	2
10–20%	11	6
20–40%	3	22
40% or more	0	12
	37	42
Average decline	About 9%	About 30%

It is easy to demonstrate that the average price decline of convertible preferred stocks from December 1967 to December 1970 was greater than that for common stocks as a whole (which lost only 5%).

How do Convertible Issues and Warrants rank as investment opportunities and risks? – cont.

It is noteworthy that in our 20-stock sample of convertible preferreds only one showed an advance and 14 suffered bad declines.

TABLE 16-2 Price Record of Preferred Stocks, Common Stocks, and Warrants, December 1970 versus December 1968

(Based on Random Samples of 20 Issues Each)

	Straight Preferred Stocks Rated A or Better	*Straight Preferred Stocks* Rated Below A	Convertible Preferred Stocks	Listed Common Stocks	Listed Warrants
Advances	2	0	1	2	1
Declines:					
0–10%	3	3	3	4	0
10–20%	14	10	2	1	0
20–40%	1	5	5	6	1
40% or more	0	0	9	7	18
Average declines	10%	17%	29%	33%	65%

(Standard & Poor's composite index of 500 common stocks declined 11.3%.)

Conclusion from data in Tables

- The conclusion to be drawn from these figures is not that convertible issues are in themselves less desirable than nonconvertible or “straight” securities. Other things being equal, the opposite is true.

- It is true, of course, that a convertible preferred is safer than the common stock of the same company—that is to say, it carries smaller risk of eventual loss of principal. Consequently those who buy new convertibles instead of the corresponding common stock are logical to that extent. But in most cases the common would not have been an intelligent purchase to begin with, at the ruling price, and the substitution of the convertible preferred did not improve the picture sufficiently.

General Attitude toward Convertible Issues and Warrants

• Our general attitude toward new convertible issues is thus a mistrustful one. We mean here, as in other similar observations, that the investor should look more than twice before he buys them.

•After such hostile scrutiny he may find some exceptional offerings that are too good to refuse. The ideal combination, of course, is a strongly secured convertible, exchangeable for a common stock which itself is attractive, and at a price only slightly higher than the current market. Every now and then a new offering appears that meets these requirements. By the nature of the securities markets, however, you are more likely to find such an opportunity in some older issue which has developed into a favorable position rather than in a new flotation.

• The fine balance between what is given and what is withheld in a standard-type convertible issue is well illustrated by the extensive use of this type of security in the financing of American Telephone & Telegraph Company.

Effect of Convertible Issues on the Status of the Common Stock

- In a large number of cases convertibles have been issued in connection with mergers or new acquisitions.
- Typically the transaction results in a pro forma increase in the reported earnings per share of common stock; the shares advance in response to their larger earnings, so-called, but also because the management has given evidence of its energy, enterprise, and ability to make more money for the shareholders.
- But there are two offsetting factors, one of which is practically ignored and the other entirely so in optimistic markets. The first is the actual dilution of the current and future earnings on the common stock that flows arithmetically from the new conversion rights. And there is danger that they will grow at an uncomfortable rate.

Indicated Switches from Common into Preferred Stocks

- For decades before, say, 1956, common stocks yielded more than the preferred stocks of the same companies; this was particularly true if the preferred stock had a conversion privilege close to the market. The reverse is generally true at present. As a result there are a considerable number of convertible preferred stocks which are clearly more attractive than the related common shares. Owners of the common have nothing to lose and important advantages to gain by switching from their junior shares into the senior issue.
- Preferred stocks have higher dividend, and most important, of course, would be the senior position that the common shareholder would gain from the switch. Its conversion privilege guarantees that it could never sell lower than the common package.

Stock-Option Warrants

The recent development of stock-option warrants as a near fraud, an existing menace, and a potential disaster. Footnote from Jason Zweig: As of year-end 2002, there were only seven remaining warrant issues on the New York Stock Exchange—only the ghostly vestige of a market.

TABLE 16-4 Calculation of "True Market Price" and Adjusted Price/Earnings Ratio of a Common Stock with Large Amounts of Warrants Outstanding

(Example: National General Corp. in June 1971)

1. Calculation of "True Market Price."

Market value of 3 issues of warrants, June 30, 1971	$94,000,000
Value of warrants per share of common stock	$18.80
Price of common stock alone	24.50
Corrected price of common, adjusted for warrants	43.30

2. Calculation of P/E Ratio to Allow for Warrant Dilution

	Before	*After Warrant Dilution*	
(1970 earnings)	*Warrant*	Company's	Our
A. Before Special Items.	*Dilution*	Calculation	Calculation
Earned per share	$ 2.33	$ 1.60	$ 2.33
Price of common	24.50	24.50	43.30 (adj.)
P/E ratio	10.5×	15.3×	18.5×
B. After Special Items.			
Earned per share	$ .90	$ 1.33	$ .90
Price of common	24.50	24.50	43.30 (adj.)
P/E ratio	27.2×	18.4×	48.1×

Practical Postscript

We might say that warrants tend to sell relatively higher than the corresponding market components related to the conversion privilege of bonds or preferred stocks. To that extent there is a valid argument for selling bonds with warrants attached rather than creating an equivalent dilution factor by a convertible issue. If the warrant total is relatively small there is no point in taking its theoretical aspect too seriously; if the warrant issue is large relative to the outstanding stock, that would probably indicate that the company has a top-heavy senior capitalization. It should be selling additional common stock instead. The main objective of our attack on warrants as a financial mechanism is not to condemn their use in connection with moderate-size bond issues, but to argue against the wanton creation of huge “paper-money” monstrosities of this genre.