NATIXIS

EQUITY DERIVATIVES RESEARCH
Convertible bonds

16 April 2010

PART I
Protection for Convertible Bonds

Nearly all convertible bonds are protected by a change-of-control clause. However, there are many types of convertible bonds and the protection they carry can vary significantly from one convertible to the next.

Change-of-control clauses
1. Calendar clauses
2. Continuous premium amortisation
3. Unusual clauses: Clauses specific to UK, Make whole parity value, compensation premium.

What about exchangeable bonds?
Holders of exchangeable bonds do not own the underlying share and are therefore bound by the decisions of the issuer.

Poison puts or protection for convertibles that are well out of the money

Do unprotected or poorly-protected convertibles exist?

Classification of convertibles based on the most attractive ratchet clauses

PART II
M&A: recovery in 2010?

2009: historically-weak activity
- Volumes plunged 40% in 2009, emerging countries stood out.
- Financial sector accounts for close to 50% of transactions.

2010: a recovery?
- Most companies consider the current climate to be favourable.
- Valuations are still reasonable.
- Widespread easing of spreads, record generation of fresh capital.

Financing: more shares, less cash?

Sectors most in focus:
- Luxury Goods, Cosmetics, Consumer Goods
- Pharmaceuticals & Biotechnology
- Technology, Equipment
- Tourism, Leisure

CB selection for M&A

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PART I

Protection for Convertible Bonds

INTRODUCTION

After much lobbying from convertible bondholders, since 2004-2005 practically every convertible bond issue now carries a clause to protect the bearer in the event of a change of control of the company.

This is a legally binding clause that is designed to compensate the bearer for a loss in the value of the option they hold on the convertible bond through a compensating payment or the allocation of an additional share amount. In order to be eligible for this compensation, the bearer must have exercised their conversion right during a predefined period.

The bearers of exchangeable bonds are not protected by this clause as they do not hold the status of owner of the underlying shares. When a change of control does occur, it is up to the issuer whether or not such securities should be tendered. Nevertheless, in many cases, exchangeable bondholders can receive a compensation premium (but this clause must be provided for in the indenture). We will take a more detailed look at exchangeable bonds later on in this document.

The bearers of convertible bonds on which the price of the underlying share after the offer is below the conversion price at the time of issue are now also protected by a clause that entitles them to redemption at par value or accreted value.

We will now take a look at the various clauses that exist in order to pinpoint which ones provide investors with the best protection.

■ CHANGE OF CONTROL CLAUSES

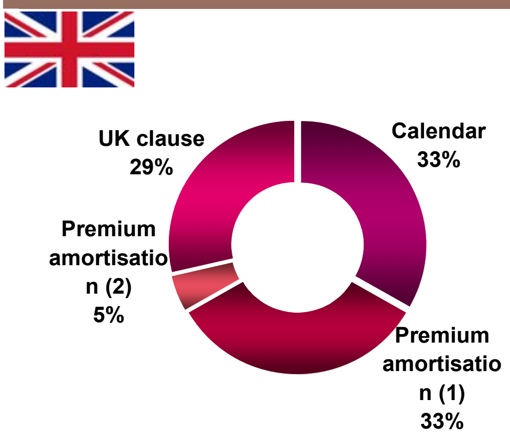
Three main clauses

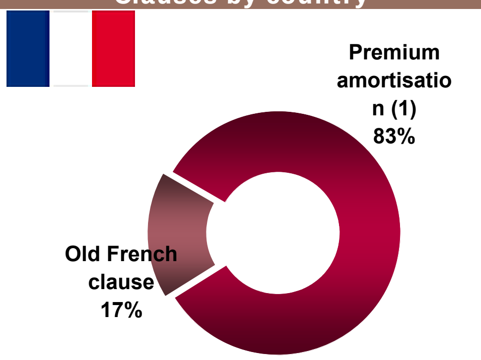
Weight of the different clauses observed in 139 convertible bonds

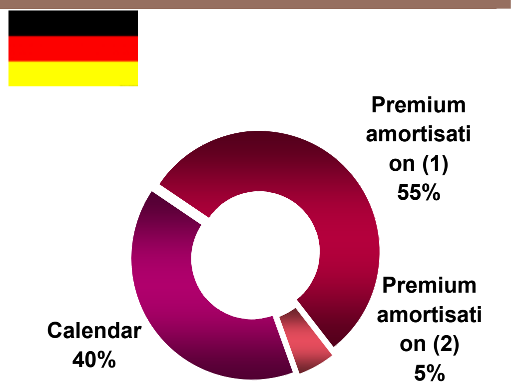
- “Conventional” form of premium amortisation (1), 54%
- Swiss or Norwegian forms of premium amortisation (2), 14%
- Calendar clause, 18%
- Other clauses (14%): old French, UK, Make Whole Amount, compensation premium.

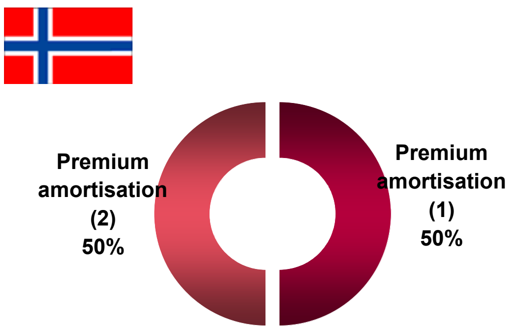
A breakdown of the clauses based on issuer country of origin suggests a certain “regional behaviour”.

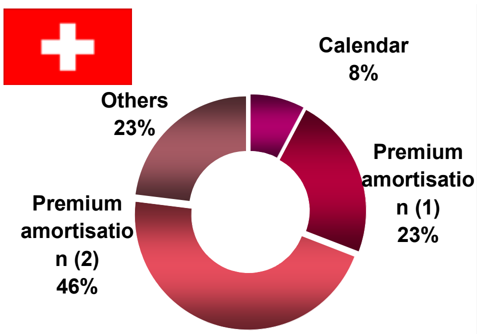
Clauses by country











► Issuers in Germany and the UK indiscriminately apply calendar or premium amortisation clauses. The “UK clause” is specific to that region.
► French and Norwegian issuers do not seem keen on calendar clauses.
► Swiss issuers have their own preference (see chart) but do not exclusively opt for any one clause.

1. Calendar clause

Principle

This protection clause increases the share allocation ratio via a downward adjustment to the conversion price, over a limited period that is laid out in the contract, and based on a specific schedule (generally in one-year blocks).

The conversion price is adjusted over time and moves closer to the initial conversion price, sometimes even slightly lower (which is the case in the example below).

If we present this in table form (e.g. example below concerning a British Airways convertible bond issue), this implicitly involves calculating at the time of issue the loss of value to be carried forward.

Example: British Airways 5.8% 2014

The offering circular states that, in the event of a change of control, the bearers will have 60 days to convert their CBs and benefit from a lower conversion price.

Conversion Date	***Conversion Price GBp***
On or before 13 August 2010	*GBp 137.3396*
Thereafter, but on or before 13 August 2011	*GBp 147.6717*
Thereafter, but on or before 13 August 2012	*GBp 158.0038*
Thereafter, but on or before 13 August 2013	*GBp 168.3358*
Thereafter and until the final maturity date	*GBp 178.6679*

The initial conversion price is GBp189 for nominal amount of GBP1,000.

Implicitly, this involves defining the lost value of the option for each period, i.e. making a strong assumption of the volatility in one year's time, two year's time, etc. until maturity.
➔ Any increase of volatility will be lost by the bondholder.

The reduced conversion price entitles the bearer to additional shares in order to compensate for the loss of value.

Conversion Date	***Conversion Price***	**Estimated loss of option value (GBp) …**	**…compensated via additional shares**
On or before 13 August 2010	*GBp 137.3396*	51.7	199
Thereafter, but on or before 13 August 2011	*GBp 147.6717*	41.3	148
Thereafter, but on or before 13 August 2012	*GBp 158.0038*	31.0	104
Thereafter, but on or before 13 August 2013	*GBp 168.3358*	20.7	65
Thereafter and until the final maturity date	*GBp 178.6679*	10.3	31

► **All other things being equal, the maximum gain for the bearer will come in the year following the issue.**

2. Continuous amortisation of premiums

Principle

As with the calendar clause, this protective clause increases the share allocation ratio via a downward adjustment of the conversion price over the entire maturity of the convertible bond, starting from the day after issue.

► **All other things being equal, this clause does not protect the bearer as well as the previous clause** (see below for an illustration and example).

Formula

The new conversion price depends on the conversion price in effect before the change-of-control offer, multiplied by a factor that depends on the issue premium and the date on which the change of control is to take effect.

This clause is the most common clause (see charts p.2). However, it can be formulated in three ways.

a. Most common formulation

In this formulation, the purpose is to either calculate the share allocation ratio or the conversion price.

New share allocation ratio = ratio before the offer x [1 + (issue premium x $\frac{J}{JT}$)], or

New conversion price = $\frac{\text{conversion price before offer}}{1 + (\text{issue premium x J/JT})}$

J = the number of days between the change-of-control date and the maturity date for the convertible bond.
JT = the maturity of the CB, expressed in days.

b. Swiss and Norwegian formulations

Although the Swiss and the Norwegians use different formulation approaches, when we develop their respective formulations, we can see that they are strictly identical.

"Swiss" formulation:

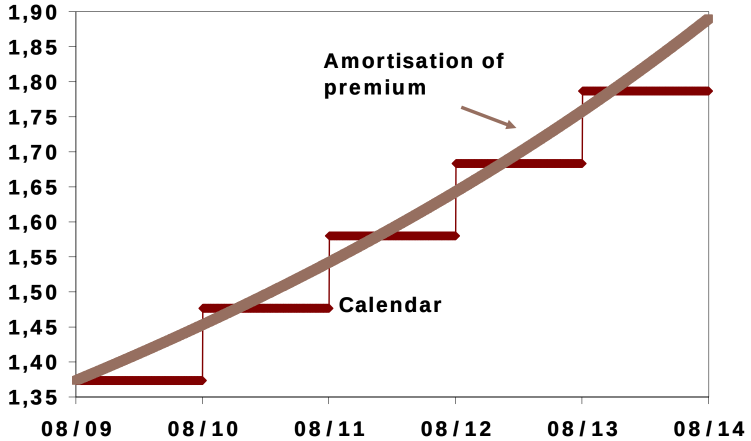
New conversion price = $\frac{\text{conversion price before offer}}{1 + \text{issue premium}} \text{ x } \left[1 + \text{issue premium x } (1 - \frac{J}{JT})\right]$

"Norwegian" formulation:

New conversion price = $\frac{(\text{[Reference Price x (N - n)]} + \text{[conversion price before offer x n]})}{N}$, with

Reference Price = the reference price for the underlying share at the time the definitive terms of the issue were set.
N=JT
n = number of days between the settlement date and the change-of-control date (vs. COC date and maturity in the most common formulations and in the "Swiss" formulation).

*Changement/comparison of **new conversion price** according to calendar clauses and continuous amortisation of premium in the case of British Airways 5.8% 2014*



Comparison of these clauses with the calendar clause: reformulation of the protection for British Airways 5.8% 2014

Simulation (1): takeover offer within the 250 day period following issue, at a premium of 20% to the share price.

The market characteristics of the CB are the same as at the time of the issue:

- CB price 100%
- underlying share price 137.34p
- delta 50%
- premium 37.6%

Clause	Conversion ratio before offer	Conversion price before offer	New CP	New share ratio	CB after offer	Loss of Δ/CB (curncy)	Pos. gain long CB (curncy)	Total arbitrage gain	Directional profit
Calendar	529	1.89	1.373	728	120.01	72.7	200.1	12.7%	20.0%
Common (1)	529	1.89	1.427	701	115.51	72.7	155.1	8.2%	15.5%
Swiss or Norwegian (2)	529	1.89	1.444	692	114.13	72.7	141.3	6.8%	14.1%

► The calendar clause provides the best protection.

► At any time, clause (1) will generate a gain > clause (2) insofar as: conversion price (1) will always be lower than conversion price (2).

Simulation (2): what would happen today?

Takeover offer on 05/09/2010, premium of 20%

- CB price 141.93% i.e. 142.78% with accrued interest
- underlying share price 237.40p
- delta 78%
- prime 13%

Clause	Conversion ratio before offer	Conversion price before offer	New CP	New share ratio	CB after offer	Loss of Δ/CB (curncy)	Pos. gain long CB (curncy)	Total arbitrage gain	Directional profit
Calendar	529	1.89	1.477	677	192.9	196.9	501.3	21.3%	35.9%
Common (1)	529	1.89	1.458	686	195.4	196.9	525.8	23%	37.7%
Swiss of Norwegian (2)	529	1.89	1.483	674	192.1	196.9	492.8	20.7%	35.3%

► Outperformance of CB vs. share.

► Simul. gain (2) > simul. gain (1). The CB has recovered strong sensitivity since the issue (delta of 78% vs. 50%) and the premium reduced.

Conditions to maximise gains:

- strong issue premium (ensures a lower conversion price under the premium amortisation clauses)
- change of control close to the issue date
- the CB regains sensitivity, the premium contracts
- in the event of a strong conviction that a COC will occur within the year of issue, we would advise pushing for a calendar clause.

Illustration: comparison of two convertibles covered by the same clause (conventional premium amortisation) with similar characteristics at the time of issue

• Characteristics of the issue

Maurel & Prom 7.125% 2014	**Soitec 6.25% 2014**
- nominal: EUR15.60	- nominal: EUR8.55
- conversion price: EUR15.60	- conversion price: EUR8.55
- conversion ratio: 1/1	- conversion ratio: 1/1
- premium: 30%	- premium: 32.5%
- maturity: 1,850 days	- maturity: 1,826 days
• Valuation of the CBs today	
CB price: EUR18.7	CB price: EUR12.9
Premium: 53%	Premium: 12%
Delta: 47%	Delta: 78%
• Impact of a takeover offer within 60 days at a 20% premium	
Directional loss: 2.3%	Directional profit: 37.3%

► Soitec 6.25% 2014 presents maximum gain conditions. The same cannot be said of Maurel & Prom 7.125% 2014.

► This example shows that a COC clause does not systematically guarantee a gain.

3. Unusual clauses

Clause specific to UK companies

Principle

This clause has nothing to do with premiums, volatility or calendar aspects.
Protection simply depends on the price of the convertible and of the underlying share, irrespective of the COC date.

This protection concerns seven convertibles in our universe: Inmarsat'17, IPR'13, IPR'23, Anglo American '14, Sainsbury'14 ITV'16 and Xstrata '17.

Formula

The new conversion price is equal to the price before the offer and depends on the average price of the convertible and of the underlying share during a set period prior to the offer. This period is specified in the indenture.

New conversion price = $\frac{\text{conversion price before offer}}{[A \times C \div B]}$, with

A = arithmetical average of the convertible price calculated over a predefined period (15 days in the case of CBs issued since 2007, 12 months for older CBs)
B = arithmetical average of the underlying share price for the same period
C = conversion price before the offer

► For the purposes of simplification, new conversion price for mono-currency CBs = $\frac{\text{underlying share price}}{\text{CB price}}$

► All other things being equal, this clause provides better protection than the calendar clause and the continuous premium amortisation clause. <u>At any time</u>, the gain generated by the bearer of the convertible is equal to that of a bearer of shares in the company.

Example: reformulation of the clause for British Airways 5.8% 2014

Characteristics of the issue:

- nominal: GBP1,000 (100%)
- conversion price: GBP1.89
- conversion ratio: 529.1 shares
- share reference price: GBp137.34

New CB price with a takeover offer at a 20% premium

Share bef. offer	**CB price before offer**		
	80	100	150
1.00	96	120	180
1.373	96	120	180
2.00	96	120	180

➔ Outright profit of 20%.

➔ With a constant delta of 0.5, the arbitrage gain would range between 9% and 13% for a share trading at between GBp137.34 and GBp200 before the offer. The higher the delta, the weaker the gain.

Compensation premium

This provides minimal protection and is offered for just three convertibles: GBL ’12 and Pargesa 2013 & 2014 (i.e. two holding companies with concentrated shareholder structures).

In these cases, the compensation premium = the value of each convertible (determined by an independent financial institution) – Max [nominal + accrued interest; countervalue of the CB].

Make whole parity value

Under this clause, the bearer receives an additional payment calculated on the basis of a price-date matrix defined at the time of issue. This matrix determines the “lost” value of the option component depending on the CB’s exchange value and the change-of-control date. Holders are not well protected by this clause.

It concerns: Nobel Biocare ’11 and AngloGold ’14.

WHAT ABOUT EXCHANGEABLE BONDS?

In the event of a takeover offer on the underlying share, the issuer is entitled to accept or reject the tender of exchangeable bonds. Various clauses exist to provide for compensation for the bearers of such bonds (on loss of the value of the options that they have purchased).

In rare cases, the issuer may be the subject of a takeover offer independent of the underlying share. Should this happen, the bearers of exchangeable bonds are entitled to redeem the bonds at par.

1. Standard K-squared compensation

Principe

This protection bears "slight" similarities to the protection provided by continuous premium amortisation, which entitles the bearer to additional shares. However, with standard K-squared compensation, the issuer is not allowed to deliver more shares than it holds.

In the event of a cash offer, once the bearer exercises his/her conversion right, they will receive the countervalue of the convertible (exchange parity x cash paid for one share) along with a compensation premium, which will depend on the issue premium and the date on which the offer was made. All other things being equal, the sum of this payment decreases over time.

Of the exchangeables in our universe, this clause concerns: Parpublica/EDP '14, BES/Bradesco '11 & '13, Artemis/Vinci '15 and Eurazeo/Danone '14.

Formula

$$PC = K^2 \times (\text{Issue Premium - PI}) \times \frac{T}{C} \times \frac{CB}{CB + CS}$$, with

K = PI/EV if EV>PI
K = EV/PI if EV<PI
PI = share reference price on the issue date
CB = cash sum offered
CS = value of securities offered (CS=0 in the case of an offer exclusively in cash)
EV = exchange value of the convertible
C = maturity of the convertible, expressed in days
T = time, expressed in days, between the offer closing date and the maturity date.

Example: Artemis/Vinci 4.25% 2015, simulation of a cash offer at the time of issue (premium: 20%).

Reminder of initial terms:

- C = 1,891 days
- PI = EUR39.3238
- Issue price = EUR51.12 (i.e. an issue premium of 30%)
- Conversion ratio: 1/1

Hypotheses:

- T = 1,891 days (best case scenario)
- Share price after offer: EUR47.19
- CS = 0 (100% cash offer)

⇨ EV = 47.19
⇨ K = PI/EV = 39.3238 / 47.19
⇨ CP = EUR8.19 / exchangeable bond

⇨ **Gain for the bearer of 8.3%**. With a delta of 0.50, the arbitrage gain would have been 0.6%.

The compensation premium decreases rapidly over time. It would only represent EUR5.77 for an offer that would be made on 28/04/2010, i.e. six months after issue with current CB valuation.

2. Replacement shares

This clause concerns very few exchangeable bonds: Rallye/Casino ’13, BCP/PorTel ’15.

Principle

Any cash amount received by the issuer as part of an offer has to be reinvested in securities (in equivalent listed securities, securities in the buyer, securities defined in the indenture or securities replicating an index as stipulated in the offering circular).

► **Conclusion: avoid using exchangeable bonds to play takeover offers!**

POISON PUTS OR PROTECTION FOR CONVERTIBLES THAT ARE WELL OUT OF THE MONEY

89% of the convertibles in our panel provide this additional protection.

Principle

In the event of a change of control, the bearer can request early redemption of the convertible bond at par (or at its accreted value) plus accrued interest but with no additional premium. In this case, the option component of the convertible bond becomes null.

► Among "recent" issues, Steria and REC are the only companies not to have included this clause in their offering circular.

► Three issuers have included additional clauses restricting the use of poison puts (e.g. ratings downgrade): FCC, Unibail and Banca Carige.

► Additional protection introduced last year as part of the Infineon '14 issue:

Bearers will receive, in addition to the par value and accrued interest, an added payment that will depend on the nominal amount, the issue premium and the date on which the change of control takes effect.

$$\text{Change of Control Put Price} = \text{Nominal x } \left(1 + \text{Initial Premium x } \frac{J}{JT}\right) + \text{accrued}$$

➔ This could be an initiative that is worth encouraging…

DO UNPROTECTED OR POORLY-PROTECTED CONVERTIBLES EXIST?

The answer is yes. However, there are very few and it is important to make a distinction between those that:

1. have never been covered by any protection clause;
2. are no longer protected;
3. are going to lose their protection.

1. The first category mainly concerns convertibles issued in 2000-2003 and nearing maturity.

We include "old" French CBs in this category, insofar as the indentures for these bonds do not provide for cash offers, nor do they envisage the possibility for bearers to request redemption of the CBs at par.

Of the convertibles that have been issued since 2006, the only ones that do not provide any protection are:

- Nexans 1.5% 2013
- Gedeon Richter (MNV) 4.4% 2014
- Swiss Re 3.25% 2021 (no ratchet feature, only a put)

2. In the second category, the put is still valid but there are no longer any ratchet features:

- Infineon 5% 2010
- Skyepharma 6% 2024

3. <u>In the third category, there is a date limit on the ratchet clause in the event of conversion</u>:

Adecco 0% 2013 - put August 2010	26/08/2010 (call date)
SGL Carbon 0.75% 2013	16/05/2011
Subsea (Siem Industries) 0% 2017 - put July 2010	26/07/2012 (call date)
Subsea 0% 2017 - put June 2010	13/07/2012 (call date)
Groupe Steria 5.7% Perp.	31/12/2012

CLASSIFICATION OF CONVERTIBLES BASED ON THE MOST ATTRACTIVE RATCHET CLAUSES

Hypotheses: takeover within 60 days at a premium of 20%.

Table 1: outperformance of CB vs. share

13/04/2010

Sector	Name	Share price		CB price + cc	Δ	Arbitrage gain	Outright gain
Tourism, Leisure	BRITISH AIRWAYS 5.8% 2014	239,50	GBp	144,2	79%	31%	46%
Technology, Equipment	Nexans 4% 2016-put Jan. 2015	64,46	EUR	71,0	59%	26%	38%
Basic Products and Chemicals	Clariant 3% 2014	14,69	CHF	185,4	87%	22%	38%
Basic Products and Chemicals	Vedanta 5.5% 2016-put Jul. 2014	2.849,00	GBp	137,3	74%	24%	37%
Oil	Subsea 3.5% 2014	123,50	NOK	135,2	77%	22%	37%
Media, Advertising	Publicis 3.125% 2014	31,21	EUR	35,5	63%	25%	37%
Basic Products and Chemicals	ArcelorMittal 7.25% 2014	33,70	EUR	37,1	83%	20%	37%
Basic Products and Chemicals	Arcelor $ 5% 2014	45,60	USD	166,2	81%	22%	37%
Software & Services	Temenos 1.5% 2013	32,25	CHF	179,1	100%	15%	35%
Oil	Evraz 7.25% 2014	41,05	USD	215,3	90%	17%	34%
Technology, Equipment	Soitec 6.25% 2014	11,01	EUR	12,6	76%	20%	34%
Luxury, Cosmetics & Consumer Goods	Bulgari 5.375% 2014	6,34	EUR	146,1	78%	19%	33%
Technology, Equipment	ASM Intl 6.5% 2014	20,02	EUR	136,7	73%	20%	33%
Oil	Seadrill 4.875% 2014	147,80	NOK	123,5	77%	18%	32%
Media, Advertising	WPP 5.75% 2014	691,00	GBp	137,9	65%	19%	30%
Oil	Euronav 6.5% 2015	18,05	EUR	122,4	78%	16%	30%
Pharmaceuticals & Biotechnology	Qiagen 1.5% 2024-put Aug. 2011	23,52	USD	188,5	93%	11%	29%
Technology, Equipment	Infineon 7.5% 2014	5,09	EUR	241,7	86%	13%	29%
Oil	TMK 5.25% 2015-put Feb. 2013	22,63	USD	117,3	70%	17%	28%
Basic Products and Chemicals	NYRSTAR 7% 2014	11,45	EUR	172,4	82%	14%	27%
Basic Products and Chemicals	Kloeckner 6% 2014	22,03	EUR	145,2	76%	14%	27%
Software & Services	Capgemini 3.5% 2014	36,73	EUR	43,9	61%	17%	27%
Oil	Alliance Oil 7,25% 2014	120,50	SEK	130,6	73%	12%	26%
Utilities	International Power 3.25% 2013	335,01	GBp	108,9	36%	20%	25%
Technology, Equipment	Autonomy 3.25% 2015	1.819,00	GBp	113,8	67%	13%	24%
Holding	INDUSTRIVARDEN 2.5% 2015	96,25	SEK	112,9	46%	18%	24%
Tourism, Leisure	Xstrata 4% 2017	1.261,00	GBp	136,0	90%	6%	24%
Property	Swiss Prime 1.875% 2015	65,50	CHF	106,1	60%	14%	24%
Basic Products and Chemicals	Anglo American 4% 2014	2.943,00	GBp	176,9	84%	8%	24%
Property	Unibail 3.5% 2015	150,95	EUR	185,0	65%	13%	23%
Tourism, Leisure	Air France 4,97% 2015	12,40	EUR	15,6	70%	12%	23%
Luxury, Cosmetics & Consumer Goods	Swatch 2.625% 2010	62,30	CHF	127,7	95%	3%	22%
Utilities	Abengoa 6.875% 2014	21,69	EUR	124,9	69%	11%	22%
Property	Gecina 2.125% 2016	83,33	EUR	111,3	28%	16%	20%
Pharmaceuticals & Biotechnology	Celesio 3.75% 2014	23,84	EUR	129,8	66%	9%	20%
Software & Services	Altran 6.72% 2015	4,00	EUR	5,1	66%	10%	20%
Distribution	Sainsbury 4.25% 2014	349,01	GBp	117,6	27%	16%	20%
Media, Advertising	ITV 4% 2016	63,44	GBp	123,7	65%	10%	20%

■ **CLASSIFICATION OF CONVERTIBLES BASED ON THE MOST ATTRACTIVE RATCHET CLAUSES (CONT.)**

<u>Table 2</u>: underperformance of CB vs. share

13/04/2010

Sector	Name	Share price		CB price + cc	Δ	Arbitrage gain	Outright gain
Technology, Equipment	Inmarsat 1,75% 2017 - put Nov. 2012	753,64	GBp	118,7	49%	12%	19%
Tourism, Leisure	Tui Travel 6% 2014	302,40	GBp	112,2	48%	11%	19%
Utilities	International Power 3.75% 2023 - put 2010	335,01	GBp	210,4	100%	-2%	18%
Property	CA Immo 4.125% 2014	9,49	EUR	104,0	62%	8%	18%
Property	Conwert Immo 5.25% 2016	9,45	EUR	104,3	68%	7%	18%
Oil	Salamander 5% 2015	264,00	GBp	101,4	60%	9%	17%
Property	Wereldhave 4.375% 2014	72,10	EUR	115,5	54%	7%	17%
Food, Beverages	Marine Harvest 4.5% 2015	5,47	NOK	108,0	64%	7%	17%
Pharmaceuticals & Biotechnology	Qiagen 3.25% 2026 - put May 2013	23,52	USD	135,6	75%	4%	16%
Utilities	Pennon 4.625% 2014	536,50	GBp	115,3	39%	10%	16%
Basic Products and Chemicals	Suedzucker 2.5% 2016-put June 2014	16,52	EUR	116,7	58%	7%	15%
Oil	Dana Petroleum 2,9% 2014 - put July 2012	1.286,00	GBp	109,4	61%	6%	15%
Tourism, Leisure	Sol Melia 5% 2014	6,62	EUR	110,6	60%	6%	14%
Bank	Banca Carige 4.75% 2015	2,00	EUR	109,6	4%	13%	14%
Food, Beverages	Pescanova 6.75% 2015	22,45	EUR	104,9	67%	3%	14%
Software & Services	Atos 2.5% 2016	37,77	EUR	53,6	63%	5%	14%
Telecoms	Iliad 2.20% 2012	80,21	EUR	93,3	46%	6%	14%
Oil	Petroplus 4% 2015	21,54	CHF	98,0	65%	2%	13%
Bank	Baloise 1.5% 2016	95,15	CHF	110,5	31%	8%	13%
Automobile	Faurecia 4.5% 2015	16,15	EUR	21,5	55%	4%	12%
Pharmaceuticals & Biotechnology	UCB 4.5% 2015	32,50	EUR	118,4	38%	6%	12%
Oil	Acergy 2.25% 2013	112,00	NOK	108,5	47%	4%	12%
Financial services	Aberdeen AM 3.5% 2014	135,60	GBp	100,9	30%	6%	12%
Automobile	Peugeot 4.45% 2016	22,45	EUR	30,9	58%	3%	11%
Utilities	Abengoa 4.5% 2017-put Feb. 2015	21,69	EUR	101,2	54%	3%	11%
Basic Products and Chemicals	Salzgitter 1.125% 2016-put Oct. 2014	68,43	EUR	109,1	55%	2%	11%
Pharmaceuticals & Biotechnology	Actelion 0% 2011	48,58	CHF	105,6	46%	2%	10%
Oil	Seadrill 3,625% 2012	147,80	NOK	105,6	49%	1%	9%
Software & Services	Cap Gemini 1% 2012 (OCEANE)	36,73	EUR	44,0	34%	4%	9%
Technology, Equipment	Alcatel 5% 2015	2,40	EUR	3,4	57%	1%	9%
Basic Products and Chemicals	SGL 3.5% 2016-put June 2014	24,22	EUR	119,8	65%	-3%	6%
Services Aux Entreprises	Neopost 3.75% 2015	61,12	EUR	87,5	51%	-1%	6%
Oil	Premier Oil 2,875% 2014	1.294,00	GBp	107,2	54%	-3%	5%
Basic Products and Chemicals	Anglogold 3.5% 2014	39,60	USD	116,6	58%	-5%	4%
Property	Aldar 5.767% 2011	4,58	AED	102,9	-	-	2%
Investissement Industriel	MTU 2,75% 2012	43,78	EUR	108,5	38%	-3%	2%
Telecoms	Portugal Telecom 4,125% 2014	8,40	EUR	106,0	14%	0%	1%

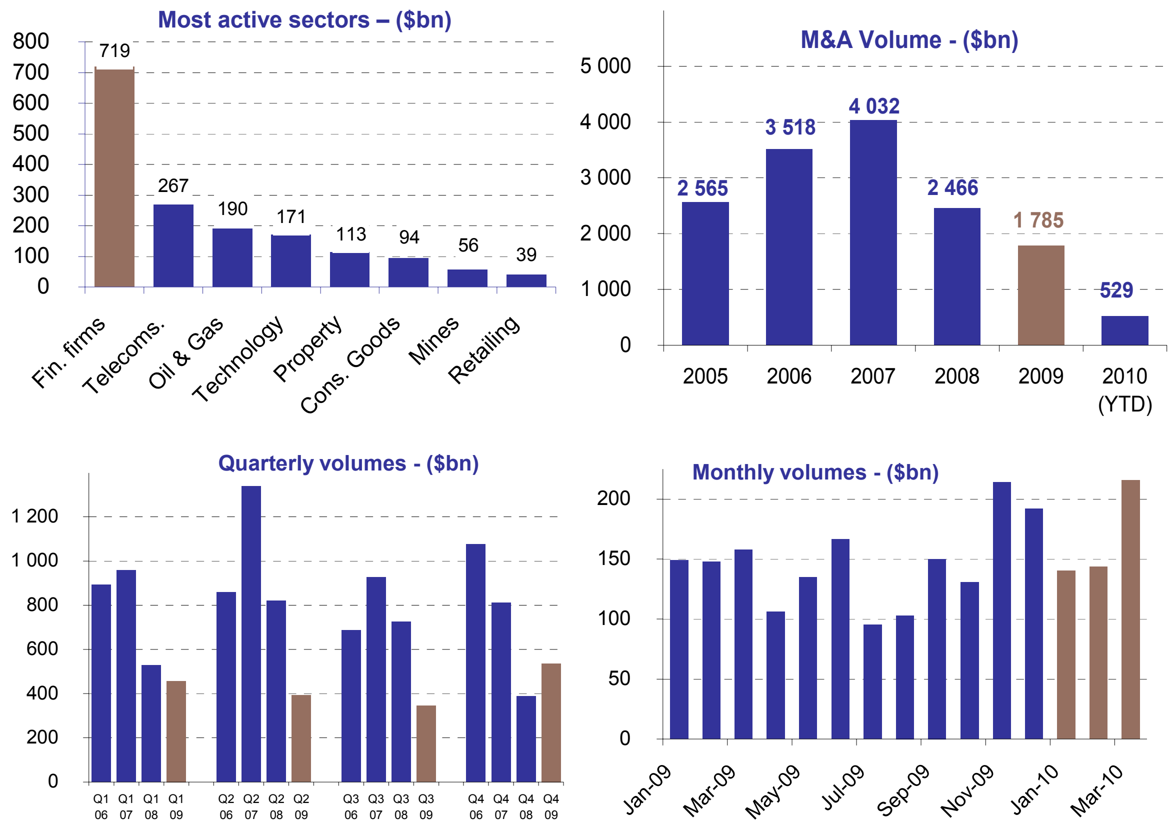
PART II

M&A: recovery in 2010?

2009: HISTORICALLY-WEAK ACTIVITY

The M&A market plunged by 40% in 2009 (of which -65% concerning hostile bids alone). However, the fall could have been even steeper had the statistics not been “blown up” by banks and other financial institutions (e.g. part or full nationalisation of RBS or Hypo Real Estate). Government backed M&A account for 15% of total volume in 2009.
This financial sector, in the broad sense of the term, accounted for close to 40% of M&A transactions.
The US held onto its position in the rankings (40% of volumes vs. 30% for Europe), but emerging market continued to make headway: 24% of the market (vs. 20% in 2007 and 10% and 2000), of which a quarter in China. In a sign of the times, there was a shift in the flow of transactions between emerging economies and developed economies in favour of the emerging countries.

M&A 2009 (world): sharp drop in volumes (Data: Bloomberg, Natixis)

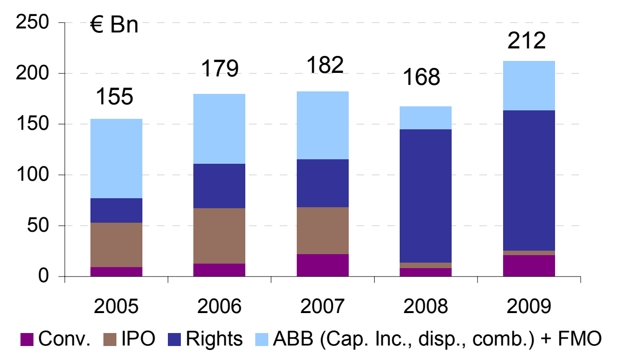


▪ CLIMATE STILL DEEMED TO BE FAVOURABLE

If we look at past economic cycles, every recovery has been preceded by a sharp increase in transactions involving listed companies: in the last crisis, the lag was eight months. In view of the timing, we could see M&A activity resume as from this year.
According to research by Ernst & Young, a majority of companies consider that the current climate lends itself well to M&As. More than 25% of the companies surveyed said that they were envisaging carrying out such a transaction over the next six months. According to UBS/BCG, 20% of companies are planning a deal worth over €500m in 2010.
The most common reason given for M&A plans is a strengthening of core businesses. The second reason given is the opportunity to make forays into new markets. Domestic markets should continue to harbour the most attractive opportunities. In Europe, the most favoured markets are the UK, Germany and France.
UBS is projecting a rebound in the market of 15% in 2010, Boston Consulting Group a 20% increase and Sanford C. Bernstein a jump of 35%!
Q1 2010 statistics do not point to any real sign of a recovery in M&A activity ($500bn).

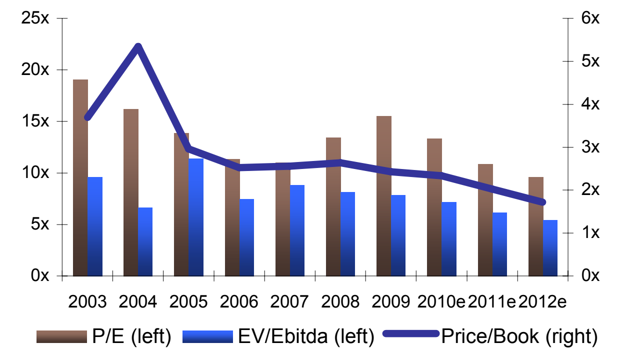
M&A in 2010: conditions for a recovery? (Data: Lazard-Natixis, Natixis, ExcelConnect)

2009 was a very good year in ECM!



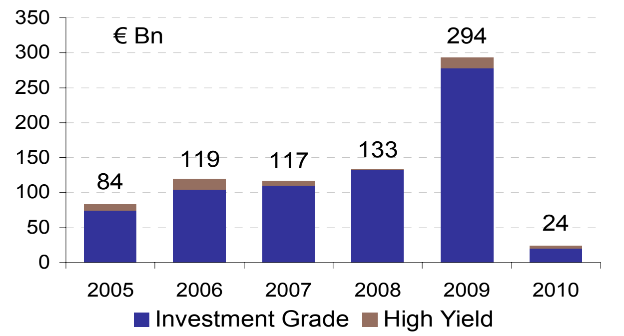
Stock markets registered record activity volumes in 2009. The most common transactions involved capital increases with rights issue.
CB issues also created high volumes.

Reasonable valuation



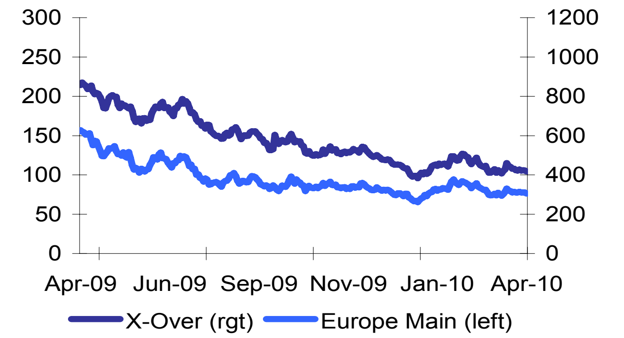
The liquidity crisis saw companies focus on generating FCF and restoring their margins.

A record year for corporate issues



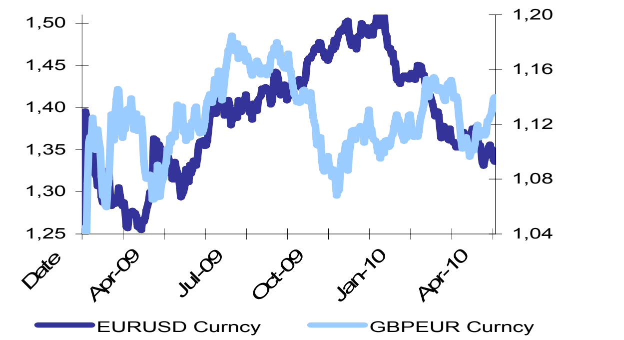
The normalisation of the interbank market opened up the bond markets again. After first being reserved for investment grade names in the defensive sector, the primary market opened up significantly more as macroeconomic conditions improved and companies delivered better than anticipated Q2 2009 earnings.

Widespread easing of credit spreads



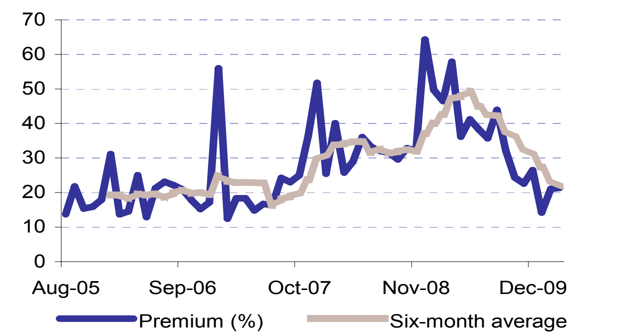
There was a sharp tightening of credit spreads after the record levels registered at the beginning of 2009.
Uncertainties tied to Greece in particular brought the X-Over spread above the 400bp.

Currencies



The recovery of the dollar against the euro since the beginning of the year means that issuers that mainly issue in dollars are not penalised as heavily as before, particularly in cash transactions (cross-border mergers: 36% of volumes in Q1 2010).
Certain European companies are likely to recover some of their appeal in the eyes of foreign predators.

Premium

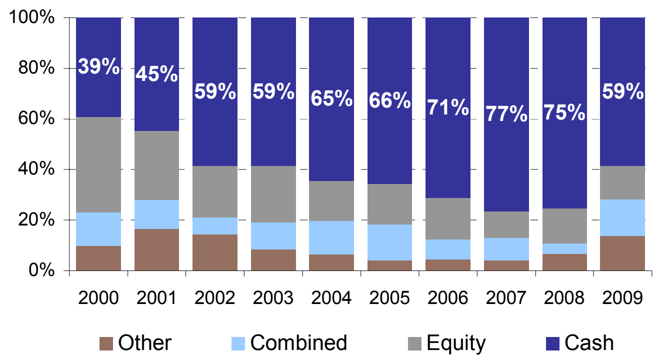


The premium is returning to average levels, after soaring at the end of 2008/beginning of 2009 amid extremely low valuations. It neared 21% in Europe and 36% in the US, i.e. between 2 and 5pts above the 10-year average.
Advantage with companies in private equity funds: synergies can be integrated within the premium offered.

FINANCING: MORE SHARES, LESS CASH?

More than half of companies are not expecting financing conditions to return to the 2007 levels. Looking to the near term, these companies are citing inadequate financing capacities as the reason preventing them from taking advantage of opportunities.
Less than 60% of transactions in 2009 were carried out solely in cash. However, the percentage of cash transactions has remained high in Europe, at 76% (compared to 41% in the US).

Financing sources



Sources: Dealogic

The reduction in the weight of private equity funds (6% of M&A volumes versus a peak of 18%) is largely attributable for the fall in the cash component and this situation is expected to last over the near term.

Credit should continue to account for a limited proportion of financing. 2009 saw a gradual shift away from bank loans towards bond markets (41% drop in volumes on the syndicated euro loan market). Bond issues outweigh credit in the financing structures of large companies. In 2007, financing through credit was 4.5 times higher than financing through bond issues and accounted for 35% of acquisitions financing: it now barely accounts for 10%.

We would expect to see a strong recovery in acquisitions involving share exchanges, particularly in transactions that are mainly strategically-motivated.

SECTORS

The most fragmented sectors will be the most active ones in terms of M&A activity. Huge importance will be placed on relative intra-sector valuations and the need for horizontal integration.
Strategic importance and synergies are likely to be very important aspects, particularly in a climate of weak growth.

We review here the various sectors of our universe, and we allocate them a rating concerning the relevance M&A, going of 1 (strong) in 3 (weak).

Sector	Probability	Natixis / Natixis Securities comments
Food, Beverages	2	Solid balance sheets and strong cash flow generation allow for firm M&A activity. Current valuation multiples are quite attractive.
Insurance	3	A focus on M&A still seems premature. Insurance firms will first seek to improve their financial flexibility and their own leeway before turning their attention to major acquisitions. We would not expect to see any major change in sector concentration levels (although the level of concentration varies significantly depending on the segment).
Automotive	2	Currently low concentration levels, particularly among parts makers, who represent the most exposed segment. Consolidation potential is thus highest in this area, as auto parts makers seek to grow volumes and broaden their product ranges as much as possible in order to make carmakers more dependent on them and therefore oblige them to accept better pricing terms.
Banks	3	It is too early to envisage a wave of mergers in the banking sector as the effects of the economic crisis in terms of the cost of risk are not yet known. However, 2010 will probably see a large number of asset disposals.
Construction	2	Concentration in this sector is high and the companies are heavily leveraged. The priority is therefore to reduce debt loads, particularly as banks have become more restrictive in their lending policies.
Retailing	2	Relatively strong concentration in Europe. Large deals in the sector have not lived up to expectations. The retailing sector does not lend itself well to major mergers. However, some players could take advantage of still-low valuations and cleaner balance sheets to make tactical acquisitions and shore up their positions in targeted markets. In specialised retailing, the DIY segment is likely to be the most active in terms of acquisitions.
Property	3	We are inclined to believe that the sector has completed its large-scale M&A. The newly-formed entities have only just come out of their reorganisation phases. In many cases, this means that companies are still in the process of cleaning up their balance sheets. It is therefore unlikely that we will be seeing any major M&A deals this year.
Software & Services	2	Some segments are more concentrated than others. There is moderate concentration in services but strong concentration in software. Surprisingly, there appears to be little strategic motivation for M&As in the IT services segment. The situation is radically different in software publishing. The main drivers behind M&A decisions are growth in the installed base (based on the Oracle model), new end-markets, and complementarities in terms of technology. Indian IT services firms have made no secret of their M&A aspirations. They now appear to be on the look-out for small players that would act as commercial bridgeheads in Europe.
Luxury, Cosmetics, Consumer Goods	1	Luxury/Cosmetics: this is a relatively concentrated sector with some heavyweights that lead sub-segments. Consumer Goods: very little concentration. There are several small family-run businesses that may interest the larger players in the sector.

Sector	Level	Natixis / Natixis Securities comments
Media, Advertising	3	There is little concentration in this sector. External growth aspirations would make more sense for advertising agencies, but market conditions are still depressed.
Oil Services	2	Moderate concentration in construction and offshore drilling. Consolidation is more likely to concern the construction segment than the drilling segment. The crisis has had large repercussions on players in this sector and an increase in size is seen as a good way to strengthen resilience. Integrated oil companies: addition of acquisitions to existing portfolios in order to round out geo-reach or acquire a technology.
Pharmaceuticals & Biotechnology	1	Concentration in the sector is far from complete: the top 10 players only control 45% of the market. Potential for strong cost synergies representing (before taxes) 6%-7% of cumulative revenues makes consolidation a particularly attractive option.
Basic Products and Chemicals	2	In the chemicals industry, a single entity can be present in a very diverse range of activities. Only certain assets appeal to potential buyers. Basic Products: India and China still have a strong appetite for mineral resources. The number and size of transactions is expected to rise, although mega-deals will be rare. China accounted for close to 27% of M&A activity in the sector in 2009.
Enterprise Services	3	Temporary employment agencies: players are dominant only in certain geographical zones, concentration is a way to expand in new markets or businesses. Fundamental valuations are nearing their all-time highs.
Technology, Equipment	1	Concentration would make sense from a near-term perspective in view of: 1/ the increasing momentum of Chinese telecoms equipment makers (Huawei and ZTE), leading to pressure on prices; and 2/ the concentration of telecoms operators across the globe (Europe, US, Asia), enabling them to streamline investment management: only the largest players will be able to generate the economies of scale needed to continue to invest in R&D. The CEO of Cisco sees acquisition volumes speeding up in the sector. Semiconductors: concentration is weak (Intel: 15% market share) but depends on the segment. The need to grow investment in R&D and equipment makes ongoing consolidation inevitable. According to the former CEO of Infineon, there will only be four of five majors in the future.
Telecoms	2	Intra-European M&A activity would make sense (consolidation in a sector that is losing momentum). However, from a short-term perspective, the regulators, associations, trade unions and politicians are not prepared for such a scenario. On this basis, bearing in mind that transnational synergy potential is not all that obvious, we are continuing to play intra-country consolidation movements, particularly in markets where competition is intensifying.
Tourism, Leisure	1	There are two drivers behind consolidation in the leisure sector: size and optimisation. Players are seeking critical mass in an effort to absorb a high fixed-cost base. On average, fixed costs make up around 70% of the cost base.
Utilities	3	Following two periods that saw a wave of concentration in this sector (2000/03: international expansion; then in 2005/07: formation of European or national oligopolies), stabilisation has become a priority, with a desire to harmonise operating regulations across Europe. The 2012 expiry of free carbon quota allocations is another major hindrance to external growth sprees, given the repercussions that this is expected to have. In addition, for the near term, in view of the present balance sheet situations of most players, there is not much leeway for large-scale external growth.

CB SELECTION FOR M&A

Within every sector, we tried to identify securities susceptible to take advantage of a return of the M&A.
- Hedge Profit/Outright profit ► hypothesis : Takeover bid in 60 days with a premium of 20%
- Proba ► rating going of 1 (strong) in 3 (weak).

Name	Hedge profit./Outright	Proba	Comments
FOOD, BEVERAGE			
Danone (Eurazeo) 6.25% 2014	Takeover premium should be > 20%, for a winning COC.	2	There have already been rumours (Pepsi), but this is a politically-sensitive issue. Pepsico and Coca Cola may be interested in the water business; Nestlé and Unilever in the other activities. The shareholder structure is fragmented.
AUTOMOTIVE			
Peugeot 4.45% 2016	Outright profit : 11% Hedge profit: 3%	3	A number of link-up rumours (FIAT, BMW, Mitsubishi) but the family wants to hold onto control of the group.
Valéo 2.375% 2011	Negative ratchet and no put at par	2	A deal with Pardus was cited at one point, but the idea appears to have been dropped.
RETAILING			
Praktiker 2.25% 2011	Negative ratchet. Exercise the put Put profit : 4%	2	100% free float and a fragmented shareholder structure. The only headache could be a change-of-control clause in the group's syndicated loan contract. Any interested buyers would need to have an abundance of cash in order to enable the group to pursue its strategy. Repeated rumours (Home Depot/Adeo/Lowe's)
Sainsbury 4.25% 2014	Outright profit : 20% Hedge profit: 16%	2	Qatar Investment Authority holds a 25.89% stake (Give up a bid in 2007).
SOFTWARE & SERVICES			
Cap Gemini 1% 2012 (OCEANE)	Outright profit : 9% Hedge profit: 4%	2	Past talk of a takeover by an Indian player (Infosys, Wipro) does not seem very credible (the Indians are focusing more on small cap deals), but the group is still an attractive target for US heavyweights.
Capgemini 3.5% 2014	Outright profit : 27% Hedge profit: 17%		
Atos 2.5% 2016	Outright profit : 14% Hedge profit: 5%	2	Generation of shareholder value, as Atos Worldline is undervalued. Indian ESPs (Enterprise Service Providers) or PSPs (Payment Service Providers) may be interested, as may Capgemini.
LUXURY, COSMETICS & CONSUMER GOODS			
Bulgari 5.375% 2014	Outright profit : 33% Hedge profit: 19%	2	Several rumours but the family (46% interest) does not appear to be looking to sell and recently denied that it had been approached with an offer.
MEDIA, ADVERTISING			
ITV 4% 2016	Outright profit : 20% Hedge profit: 10%	2	The share has been weighed on by the saga involving BSkyB, which has been ordered to sell its interest. Will the disposal revive speculation?

Names	Hedge profit. / Outright	Proba	Comments
OIL			
Acergy 2.25% 2013	Outright profit : 12% Hedge profit: 4%	1	Subsea7/Acergy: first failed merger attempt in the summer of 2008. Consolidation seems inevitable in the sector.
Subsea (Siem) 0% 2017 - put juillet 2010 Subsea 0% 2017 - put juin 2010 Subsea 2.8% 2011	Negative Put. Takeover premium should be > 20%, for a winning COC.	1	Subsea7/Acergy: first failed merger attempt in the summer of 2008. Consolidation seems inevitable in the sector.
Subsea 3.5% 2014	Outright profit : 37% Hedge profit: 22%		
Maurel & Prom 7.125% 2014	Takeover premium should be > 20%, for a winning COC.	1	Could interest an oil major, but the group would first need to build back up a large portion of its reserves following its two latest disposals (ENI/Ecopetrol).
PHARMACEUTICALS & BIOTECHNOLOGY			
Actelion 0% 2011	Outright profit : 10% Hedge profit: 2%	2	Sanofi has already been cited as a potential buyer.
Qiagen 1.5% 2024-put aout 2011	Outright profit : 29% Hedge profit: 11%	2	Sanofi has already been cited as a potential buyer.
Qiagen 3.25% 2026 - put mai 2013	Outright profit : 16% Hedge profit: 4%	2	
Shire 2.75% 2014 - put mai 2012	Negative Ratchet. Put profit : 1%	2	Pfizer and Teva have already been cited as potential buyers.
BASIC PRODUCTS AND CHEMICALS			
Anglo American 4% 2014	Outright profit : 24% Hedge profit: 8%	2	Xstrata had proposed a merger and was anticipating $1bn in annual synergies, but never came forward with a firm offer.
Rhodia 0.5% 2014	Negative Ratchet. Put profit : 9.5%	2	Potential buyers: BASF (although it is in the process of integrating Ciba), DuPont, Dow Ch.
ENTERPRISE SERVICES			
USG People 3% 2012	Negative ratchet and put. Takeover premium should be > 20%, for a winning COC.	2	Adecco had shown an interest but ended up opting for MPS. Other groups could envisage a deal in order to grow their positions in professional temporary employment services.
TECHNOLOGY, EQUIPMENT			
Alcatel 4.75% 2011	Old french clause New ratio = ratio before the offer x parity exchange. No put at par.	2	A deal would be a way for Nokia to diversify in networks (via Alcatel's MEN division) at a time when the Finnish group has hit a plateau due to an already-high market share in handsets (38%). Cisco may also be interested. Major difference between the group's market position and its market capitalisation.
Alcatel 5% 2015	Outright profit : 9% Hedge profit: 1%		
ASM Intl 6.5% 2014	Outright profit : 33% Hedge profit: 20%	2	Already rejected an offer in 2008. Applied Materials might be interested.
Inmarsat 1,75% 2017 - put nov. 2012	Outright profit : 19% Hedge profit: 12% CB is already at its theoretical COC price.	2	Rumours have already done the rounds concerning Harbinger (28% interest).
Soitec 6.25% 2014	Outright profit : 37% Hedge profit: 26%	1	Regular rumours citing AMD, which is Soitec's largest client.

Names	Hedge profit. / Outright	Proba	Comments
TELECOMS			
C&W 5.75% 2014	Outright profit : 14%	2	According to the CEO, disposal has revived interest in the group. Allows for a clarification of scope.
Iliad 2.20% 2012	Outright profit : 14% Hedge profit: 6%	2	Founder, Xavier Niel, does not seem willing to sell his stake, particularly with the acquisition of the fourth 3G licence in France. However, Iliad still stands out as a very attractive target for any group looking to enter the French market.
TOURISM, LEISURE			
Air Berlin 1.5% 2027 - put avril 2012	Negative Ratchet. Exercise the put Put profit : 16.5%	2	Ryanair, AF-KLM, Lufthansa and Etihad have all been cited. Air Berlin is one of the smallest airlines.
Air Berlin 9% 2014- put oct.11	-		
Club Méditerranée 4.375% 2010	Old french clause New ratio = ratio before the offer x parity exchange. No put at par.	1	TUI AG could be interested: acquisition of a well-known brand (injected into TUI Travel?) and allocation of property assets to TUI AG.
UTILITIES			
International Power 3.25% 2013	Outright profit : 25% Hedge profit: 20%		
International Power 3.75% 2023 - put 2010	Outright profit : 18.5% Hedge profit: -1.5%	1	Although GDF has not submitted an offer, there is no denying that it was interested and this still appears to be the case.
International Power 4,75% 2015	CB is already at its theoretical COC price.Negative Ratchet. Flat at put.		
REC 6.5% 2014	Negative Ratchet. Put profit : 13%	2	REC could appeal to a player that wants to secure its procurement. However, the three main shareholders (industrials) control more than 50% of the share capital.

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