eFinanse
financial internet quarterly

THE USE OF EXCHANGEABLE BONDS DURING THE PRIVATIZATION PROCESS

Damian Kaźmierczak*, Jakub Marszałek**

Abstract In our article we present the use of hybrid securities in the privatization process. We show that exchangeable bonds may be successfully applied during privatization of state companies throughout the world. It may be profitable for many reasons. Firstly, the exchangeables offer a much lower coupon in comparison with the ordinary government bonds which may be crucial for highly indebted countries. Secondly, throughout the entire maturity period the state remains the owner of the privatized firm which means that the government can be a beneficiary of high dividends paid by the public enterprises and can actively manage them. Thirdly, in the case of unfavorable market conditions the authorities get an opportunity to wait for the end of economic turmoil in order to avoid selling the equity participations under their true value. Finally, the issue of certain types of exchangeables (e.g. callable exchangeables or mandatory exchangeables) and adding several provisions (e.g. greenshoe option or clean-up call) makes the instrument more flexible for the issuer. We also present a few examples of the privatization processes by means of exchangeable bonds i.a. in Germany and in Austria. Most of such operations, e.g. German Deutsche Post, Austrian Telekom Austria or Portuguese Galp Energia SGPS S.A. were completed with success.

JEL Classification: G32, L33, G34
Keywords: exchangeable bond, privatization, financing

Received: 25.02.2013 Accepted: 05.03.2014

Introduction

Over several decades the effective use of state owned assets has been considered both in practical and theoretical analysis. The important dilemma seems to be the ownership problem. Many experts claim that only a privately owned company can be run efficiently because of proper risk-profit relation. In many countries state-owned firms are managed by the politicians who are often not capable of making proper operational decisions. They are usually not involved in the ownership structure of the company, so they do not risk more than losing an attractive job, or sometimes reputation. Even if the company is managed well, it still remains at the mercy of the state's social and financial expectations.

The former is usually related to the specific sector in which the company operates, very commonly as a part of e.g. an industrial or telecommunication infrastructure and which

are more or less monopolized. Such enterprises play a crucial role in society, so it is sometimes not surprising that they are under state control. Because quite often they do not have any comparable competitors they simply do not go public. The latter is associated with the company's financial dependence as a result of the state budget needs. A non-tax income by virtue of a state ownership may sometimes determine the fiscal policy of the country. If the firm is a monopolist in an important economic sector it gains a permanent profit which may pose a significant state income as a dividend paid to the central budget. This is why the governments may be reluctant to relinquish such privileges and hinder commercialization. On the other hand, the authorities may obtain certain benefits from sending state-owned companies public,

* MSc. Damian Kaźmierczak, University of Lodz, Faculty of Management, Department of Business Management, 22/25 Matejki St., 90 - 237 Lodz, Poland, damian.kazmierczak@op.pl.
** Ph.D., Jakub Marszałek, University of Lodz, Faculty of Management, Department of Business Management, 22/25 Matejki St., 90 - 237 Lodz, Poland, jakmarszalek@gmail.com.

since the potential revenues may be used to finance public expenses. If the state eventually decides to sell a part of their equity participation in a state owned company, it has to tackle the problem of receiving as high an income from the initial public offering as possible. But it cannot be forgotten that it is strongly associated with the market conditions which tend to be very volatile. What if the IPO date falls within the middle of the market turmoil? For that reason, such a financial hazard seems to be one of the biggest key barriers for the commercialization process of the state companies. In such cases, several other solutions may be more appropriate. One of them is the use of hybrid securities like convertible bonds.

This paper focuses on the use of a particular type of the convertible bonds during the privatization process, namely the exchangeable bonds. The issues of such instruments are dominated mainly by the companies from the private sector. So far, none of the articles have concentrated on the use of the exchangeable bonds by state-owned companies. The aim of this paper is to present a unique application of hybrid securities, usually issued by private companies, in a quite unusual situation. We would like to demonstrate the broad model of capital privatization by means of the exchangeable bond financing. It is supported by the examples from business practice regarding the privatization of the state companies in several countries e.g. in Germany and in Austria.

The paper is structured as follows. Section I concerns the theoretical aspects of the privatization. Section II describes the premises of the exchangeable bonds issues. Section III provides examples of the use of exchangeables during the privatization process. Section IV summarizes and concludes the article.

The issue of privatization

Privatization has been a world-wide phenomenon for the past thirty years. We can define this policy as the process of transferring ownership and control of state-owned enterprises or assets to the private sector. This transfer takes the form of issuing, selling or distribution of the shares to the general public. In OECD glossary, broadly used the term of privatization *"includes other policies such as contracting out that is, the process by which activities, while publicly organized and financed, are carried out by private sector companies, e.g., street cleaning, garbage collection, housing, education"* (Khemani & Shapiro, 1993). Privatization is being considered and carried out in both industrial countries, transition economies and emerging countries across the world[1].

Governments have launched ambitious programs in order to improve the state enterprises' efficiency and mobilize capital for expansion and modernization. It is worth stressing that the objectives for privatization often include some fiscal components, such as the desire to diminish public debt[2]. Privatization encompasses many forms, from the wide-ranging voucher privatization in the former Soviet Union and other East European countries, to granting of concessions to operate water supply and sewerage treatment services in India[3]. Its popularity partly stems from privatization's capability of generating a great deal of revenue for the governments without the need to raise taxes or cut spending programs.

The main possible determinants of privatization are usually classified into four groups: (1) political preferences, (2) hard budget constraints, (3) legal origin and (4) stock market liquidity. Government can privatize companies through (1) share issue privatization, (2) asset sale privatization or (3) voucher privatization (Prokopenko, 1995). The choice of each method depends on the size of the company which is privatized, the market conditions and the main goals of the privatization program.

A share issue privatization is the most popular type of privatization. It may be beneficial for various reasons. Share issues can broaden and deepen the domestic capital market, improve liquidity ratio and in the long term economic growth. However, if the capital market is poorly developed, several problems with attracting potential buyers could occur which may increase the transaction costs. The choice between the share issue privatization and the trade sale usually depends on the size of a company. Smaller firms are sold to a single buyer via private markets because it helps to separate the ownership and the control in the countries with poor corporate governance. As for the large companies, it is more difficult to sell them as a

1 This process began in the late 1970s., with the Thatcher government in Great Britain, and spread across countries and continents. In the 1980s. governments implemented privatizations programs in Western European countries (eg. France, Italy, Germany, Sweden, Spain), Latin America, South and East Asia, the Middle East and Africa. In the early 1990s. the privatization process began in Central and Eastern European countries, and India, Pakistan, Turkey, Brazil, Mexico, Taiwan, among others.

2 See: Privatization in the 21st Century: Recent Experiences of OECD Countries. Report on Good Practices (2009).

3 See: Implementing privatization. The UK experience (2013).

whole and therefore they are usually privatized via public capital markets (Guriev & Megginson, 2013). An asset sale privatization is the sale of an entire enterprise to a strategic investor, a private firm or to a small group of investors, usually by auction. Voucher privatization involves mass public participation. Citizens are allowed to by cheap vouchers (often at zero price) which can be then exchanged for the state-owned company shares of future issue.

There are many articles that delve into the theory of privatization and review the literature (Netter & Megginson, 2001). A lot of them show distinct weaknesses of a state ownership. According to Sheifer (1998): "... *a good government that wants to further 'social goals, would rarely own producers to meet its objectives.*". Many arguments in favor of privatization are based on the premise that it can eliminate the harmful effects of state intervention in an economy. In Shleifer and Vishny's (1998) work we find some evidence that the long-run impact of each privatization method depends on the evolution of the firms' ownership structure and the governance structures. Galal *et al.* (1994) identify gains and losses of privatization programs and find out that, in most cases, the net effects were positive both for the enterprises and the national economy.

Exchangeable bond characteristics

Exchangeable bonds are a particular type of convertible bond and are securities which in a pre-determined time in the future give the bondholders the possibility to convert them into common stock of another company. A key feature that distinguishes exchangeables from convertibles is the entity, whose shares are taken up as a result of conversion *(underlying shares)*. Such an entity is called an *underlying company*. In the case of convertible bonds, the underlying firm is simply the issuer of convertibles. And as far as the exchangeables are concerned, they entitle the bondholders to convert debt into common stock but of a different enterprise. In other words, an issuer accepts all liabilities which arise from the bond and at the same time it sells an American call option on shares of the firm, in which he has an equity participation.

Similar to a convertible bond, an exchangeable has a predetermined maturity and fixed terms of conversion, i.e. *conversion price* (the price per share at which an exchangeable bond can be exchanged for a common stock), *conversion ratio* (a number of common stock that at maturity can be exchanged for a bond) and *conversion period* (the time during which an exchangeable security can be converted into the common stock). Depending on the *conversion parity* (a value of the shares that can be converted as a result of exercising a call option on the underlying stock), at maturity investors make a decision on whether to convert exchangeable bonds into underlying shares or if it would be more profitable for them to resign it and to have their bonds redeemed (par value plus interests).

Despite the fact that exchangeable bonds have been known in the financial markets for more than 50 years, they are not commonly used. The theoretical premises of the exchangeables issues have been an object of researchers' interests since the 1990s. The researches encompass the analysis carried out especially in the U.S. market, but also in Germany, Switzerland and in the CEE. The literature review helps to understand why firms make a decision to raise capital through the exchangeable bond[4].

First of all, they can be applied as an useful divestition instrument. The term *divestition* can be defined as a diminishing the scope of the company's economic activity. The use of exchangeables in such cases regards only a separated part of a company which mainly operates as a holding. Distinct legal personality enables each separated subject to pursue its own financial policy and manage capital independently. Under these circumstances a divestition by means of exchangeable bonds has some features of bridge financing. It may be very profitable for the company. Firstly, the issuer raises capital through the exchangeables issue which can be devoted to current operations. Secondly, we should highlight the bondholders' right to convert the bonds into the underlying shares which decreases the exchangeables coupon in comparison to the ordinary corporate bond. Thirdly, if the company issues zero-coupon exchangeable securities, it is not burdened with any interest payments until debt maturity.

Moreover, thanks to a fixed conversion ratio and conversion price, the issuer may gain a higher share price in comparison to current share value at the moment of issue. The company gains a so-called *initial premium*. It may be particularly important

4 See i.a.: Ghosh, Varma, Woolridge (1990, 1996); Barber (1993); Gentry, Schizer (2002); Ammann, Fehr, Seiz (2004); Kleidt (2006); Danielova, Smart, Boquist (2010, 2012).

in the case of negative market reaction to a rush divestition of holdings' assets. Such a hasty sell off may be interpreted as a deterioration of the firm's financial performance which quickly tries to raise cash at all costs. If the company carries out an equity issue, it may result in undervaluation of the newly-issued shares. Thus, combining a call option on underlying shares with an ordinary bond may be very beneficial for the issuer.

Another motive for exchangeable bond issuers is their willingness to remain the beneficiary of dividends paid by the underlying companies. Although the issuer decided to get rid of equity participation in certain entities, thanks to the exchangeables it does not lose its dividend payments out of hand, because he is still a shareholder until debt maturity. It also applies to the ability of the parent company to run and administrate the underlying company which does not end until the moment of a conversion (Barber, 1993).

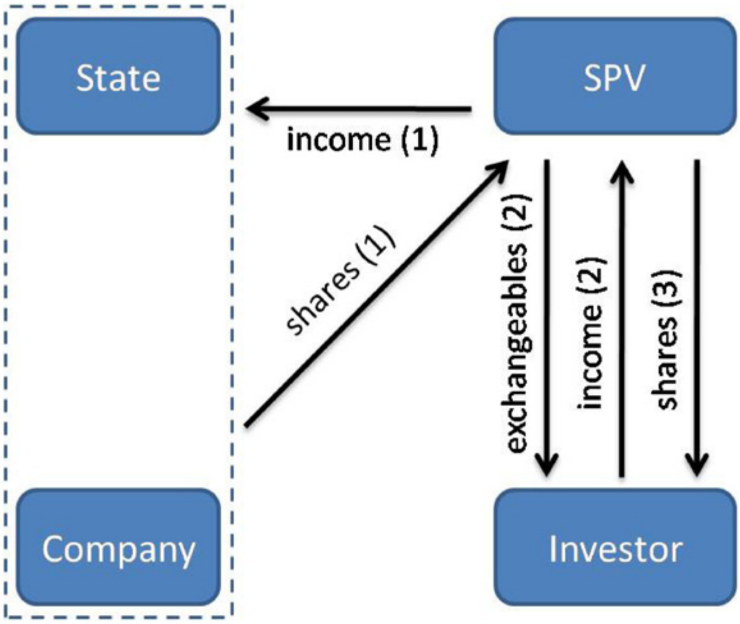
Many researchers put forward an argument that the exchangeable debt issue may be a method of defending against a hostile takeover. Issuing exchangeables contributes to stockholders' dispersion in the future which makes a takeover much more difficult to carry out. It is more difficult to persuade dispersed shareholders to sell their equity participation than to convince one big block shareholder (Ghosh, Varma, Woolridge, 1990).

As for the investors' perspective, it is worth noting that a call option on the underlying shares is not mandatory and the right to exercise it falls only to the bondholders. Considering the market conditions at maturity and the issuer's financial prospects, they can decide either to make the conversion or to have the bonds redeemed by the company at par. Therefore, the creditors are not exposed to the risk of underlying stock volatility. It may have a positive impact on potential market demand for exchangeable bonds. Furthermore, conversion price is always fixed above current share price at the issue (so-called *conversion premium*). The favorable market conditions and a decision about exchanging debt for the underlying shares may allow the bondholders to gain high profits which compensate them for a lower coupon offered by the exchangeable bonds.

Exchangeable bonds in the privatization process

Exchangeable bonds can be successfully applied during the privatization processes of state companies. The theoretical motives of using exchangeables mentioned above. becomes meaningful for the governments which want to dispose of equity participation in certain enterprises. In general, the privatization process organized by the state is conducted indirectly through another state company, which is responsible for settling a privatization effectively. We can treat such an enterprise as a kind of special purpose vehicle (SPV). The first step is a sale of shares possessed by the government which are then taken up by the SPV. Secondly, on its own behalf the SPV issues exchangeable bonds which at their maturity can by converted into the underlying company's stocks. If at debt maturity the conversion is not fulfilled, the issuer redeems bonds, either by itself or with the state's help. The privatization process by means of the exchangeable bonds is depicted in Figure 1.

Figure 1: The outline of a state company privatization Process by means of exchangeables bonds



Source: Own Elaboration

The use of exchangeable bonds are particular profitable in such cases for two reasons. Firstly, exchangeables offer a much lower coupon than the ordinary treasury bonds, which is very important for highly indebted countries. Secondly, a possible share disposal does not occur until the debt maturity. It means that throughout the entire maturity period the government can actively manage the firm as well as be a beneficiary of high dividends paid by state companies which the subsidize national budget. Thirdly, in the case of unfavorable market conditions the authorities get an opportunity to wait for the end of economic turmoil. The exchangeables may then prevent the state from disposing of certain equity stakes too rashly, very often under their real value. For that reason, such bonds may be perceived as a kind of a safety buffer for governments. Finally, it cannot be forgotten that uncertainty is an inevitable element of any hybrid financing. The issue of the exchangeable bonds does not mean that at maturity all underlying shares will be sold for sure. The bondholders may simply decide not to make the conversion. However, adding certain provisions may solve this inconvenience. The call option may help to force conversion by the issuer when he regards it as reasonable (so-called callable exchangeable). In case of mandatory exchangeables at maturity the investors are obliged to convert them into the privatized company's stocks regardless of the market conditions. In the next Section we present an exact examples of the privatization process using exchangeable bonds in several countries in order to bring this mechanism closer to the understanding of the readers.

The privatization of *Deutsche Post*

At the end of the 1990s, German politicians understood that a giant state company – "The German Federal Post Office" *(Deutsche Bundespost – DBP)* required profound transformations in order to adjust it to the Single European Market background. Besides, the government wanted to break up the monopoly of this institution in the German market and help the DBP to achieve competitiveness with other entities across the world. The conviction of the government concerning the necessary changes resulted in three large post office and telecommunications market reforms *(Postreformen)*. Following the second reform in 1994 *(Postreform II)* the *DBP* was restructured into three different joint-stock companies: functioning in the post office sector – *Deutsche Post AG* (hereafter: *DPAG*), the telecommunication sector – *Deutsche Telekom AG*, and the banking sector – *Deutsche Postbank AG*.

The federal government decided to privatize these entities gradually and potential revenues derived from this process would be transferred to the national budget. Such an operation seemed to be very complex, hence a sale of the equity stakes was staggered in order to avoid needless haste and to wait for more favorable market conditions. The role of the SPV company was played by "The Reconstruction Credit Institute" (*Kreditanstalt für Wiederaufbau – KfW*)[5]

Between 1999 and 2003 the German government sold about 80% of the *DPAG* shares to the *KfW*. The *KfW* was then obliged to make a choice for their further disposal, mainly into the hands of both retail and institutional investors. In November 2000, 29% of *DPAG* shares went public, which brought in revenue €6,6bn. Three years later, in December 2003, the *KfW* sold another 5,7% the *DPAG* shares to institutional investors and at the same time it decided to issue the exchangeable bonds on the *DPAG* securities[6]. The total value of 5-year exchangeables amounted to €1,15bn, conversion price was fixed at €20,54. The federal budget expected an extra revenue which would be a difference between the *DPAG* shares price which was initially paid by the *KfW* between 1999 and 2003, and a conversion price (€20,54) potentially paid by the bondholders at debt maturity. Five years later, it turned out that almost all exchangeable bonds were exchanged for the *DPAG* common stock, which diminished the state equity participation in this company up to 30,6%.

The next issue of exchangeables took place in 2005 but the entire operation was quite unconventional. The *KfW* in cooperation with international investment company *Nomura International plc* made a decision to issue the exchangeable bonds in Japan (Drücke, 2005). It was the first exchangeable bonds issue on the Japanese market. They were so-called *Uridashi bonds* which are the securities placed in the Japanese market, denominated in foreign currencies rather than Japanese Yen and destined directly for Japanese household investors. Based on the differences in interest between the foreign currency and the Yen, they offer a higher coupon in comparison to the Japanese government bonds. Their maturity period was arranged at 5 years and at maturity investors had a right to exchange them for the *DPAG* shares at €19,38 with a conversion premium amounted at 12%. Their coupon was relatively low (0,5%), which is typical for exchangeables and the issue value came out €1,1bn.

The next exchangeables issue (worth €750m) occurred in July 2009 and posed a signal toward the market suggesting that the state still wanted to continue the privatization process of the *DPAG*. The issue was designated exclusively for European investors (40% from Great Britain; 32% from France and 10% from Switzerland). The securities could be exchanged for the *DPAG* shares throughout the entire maturity period, starting from the first interest payment date (the end of July 2010). In June 2012 the conversion price was revaluated and adjusted for dividend payment (€0,70 per share). The conversion price declined from €13,86 to €13,76 (KfW, 2009).

The privatization of *Deutsche Telekom*

A similar privatization mechanism was applied in the case of the *Deutsche Telekom* (hereafter: *DT*) – the largest telecommunication company in Germany. The privatization was initiated in 1996 through three issues of common stock, but the low share price of the *DT* (so-called *T-Aktien*) in 2004 made the fourth issue impossible. In February 2003 the *KfW* announced the exchangeable debt issue on the telecommunication giant's shares and it was carried out in July 2003. At that time, it was the biggest undertaking of this kind in the world and newly-issued securities amounted to €4,5bn, although the demand for them was almost twice as high as supply[7].

The exchangeables issue seemed to be reasonable, regarding the market conditions at that time. At the end of September 2002 the *DT* shares price started to rise (from €9,45 per share) and the stocks remained in an upward trend over the year. The conversion price was fixed at €17,53 with the conversion premium and amounted to almost 40%. The conversion price could not be too low since the possible revenues from the issue would not meet either the government or the *KfW* expectations. The *KfW* decided to issue the *callable exchangeables* which enabled the issuer to force conversion at any time within the next three years, if a current *DT* share price exceeded the conversion price by 20%.

5 The KfW was formed in 1948, as an institution connected with the Marshall Plan. Nowadays KfW is responsible for taking care of development of the country through supporting German enterprises and financing infrastructure and social projects. Its shareholders are the German Federal Government (80%) and particular federal states (20%).

6 The government's political opponents suggested that the revenues from the restructuring would be designed for financing a large tax reform total cost of which was estimated at €15bn; see: 2004 fehlen Eichel 15 Milliarden Euro (2003).

7 See: *KfW überrascht Kapitalmarkt mit weltgrößter Wandelanleihe* (2003).

The issue of the exchangeables undoubtedly allowed the government to achieve several goals. Firstly, a possible exchange for the *DT* common stock would increase its *free float* value. Secondly, the national budget would catch potential revenues from the issue (estimated at €500m). Thirdly, the *KfW* could issue debt with a much lower coupon (worth only 0,75%) compared to the ordinary treasury bonds. The difference between the market interest rate and the interests offered by newly-issued exchangeables would subsidize the federal budget and had to be covered directly by the *KfW*. The same applies to the difference between a purchase price of the *DT* shares acquired by the *KfW* from the government (estimated at about €15) and a conversion price (€17,53). So the total revenue for the national budget was estimated at about €630m[8].

Unfortunately, the government's plans to privatize the *DT* did not end with success. The *DT* share price at debt maturity was too low (less than €11 in July 2008), so most investors did not decide to exchange the bonds for the *DT* stakes. The *KfW* even considered imposing the exchange of unconverted bonds into equity but, firstly, it was not compatible with the law and secondly it would be difficult for the *KfW* to pay the difference between conversion price (€17,53) and share price at maturity (less than €11). Hence, this plan was soon abandoned (Cünnen, 2008).

The privatization of Österreichische *Industrieholding AG's* companies

The privatization process by means of exchangeable bonds also took place in Austria. Its mechanism was very similar to the German model. In 1967, as a result of the economic reforms, all large Austrian state companies created one big conglomerate – *Österreichischen Industrieverwaltungs GmbH (ÖIG)*, which in 1970 was transformed into a joint-stock company – *Österreichische Industrieholding AG (ÖIAG)*. Unfortunately, most of the enterprises were showing losses, although between 1980 and 1992 the Austrian government supported the industry with a sum corresponding to about €4,4bn. That is why it was decided to start the privatization. In 1993 *ÖIAG* became a government agency whose main aim was to carry out the entire process and to sell off unprofitable entities. In its portfolio, *ÖIAG* had equity participations i.a. in the Austrian post office, *Telekom Austria*, the Vienna airport, petroleum giant *ÖMV* as well as in companies operating in heavy industry. The cases of privatization concerning the *Telekom Austria* and the large metallurgical company *voestalpine AG* are particularly interesting.

The privatization process of the *voestalpine AG* began in 1995, when the IPO of its shares took place. In September 2003 the second step of privatization occurred and it consisted of two elements: the second public offering of the *voestalpine* shares and the issue of 3-year exchangeables worth €240m. They were exchangeables with the *call* provision which significantly improved the flexibility of this instruments, even if they offered a higher coupon in comparison to the ordinary exchangeable bonds[9]. Furthermore a *clean-up call* was used to make sure that the entire privatization process would end with selling all shares outstanding[10].

It was also important for the state to preserve a certain shareholder structure. Privatization is very often associated with anxiety about possible ownership changes in the future as a result of going public. It concerns especially companies with a strategic importance for the country. For that reason, according to the government's plan, the shareholder structure of the *voestalpine AG* should have consisted mainly of Austrian institutional and retail investors as well as the current employees[11]. In order to accomplish that goal, a *pre-emption* clause was added in which only certain entities were entitled to pre-empt the *voestalpine* shares. That is why a large part of its equity stakes became an ownership of the Austrian regional banks and the state of Upper Austria, where *voestalpine AG* has its headquarters[12]. The entire privatization process was finished successfully by the end of September 2006.

Nearly at the same time, the privatization of *Telekom Austria* (hereafter: *TA*) took place. In July 2003 ÖIAG made a debt issue exchanged for the *TA* stakes with a maturity period of 3 years and accounted for €300m[13]. Together with the greenshoe clause it constituted 5% of the *TA* shares[14]. The privatization of *TA* ended with

8 *Ibidem*

9 See: *Privatisierung der voestalpine geht ins Finale* (2005).

10 The clean-up call the option which falls to the issuer and it entitles him either to force an early bond redemption or its conversion into equity when the principal outstanding is less than 10% of the original debt issued.

11 1st of April 2012 54% of voestalpine shares were in Austrian institutional and retail investors' hands; 13% belonged to employees; see: Voestalpine AG (2012).

12 The state of Upper Austria kept pre-emption right to buy 16% of shares; see: *Privatisierungs-Poker: voest-Aktie kostet 32,50 Euro!* (2003).

13 See: *ÖIAG begibt Österreichs erste Umtauschanleihe* (2003).

14 The *greenshoe option* (or the over-allotment option) is the clause which enables the issue agents to buy more shares at issue

success and in summer 2006 almost all of the bonds were converted into *TA* equity.

The privatization process in other countries

Several countries within the Euro Zone, which are still contending with a debt crisis, put forward privatization plans concerning some state companies in order to improve their public finances. The Portuguese authorities can provide a good example. In mid-2010 they decided to sell a parcel of shares of two large, strategically important companies: a refinery *Galp Energia SGPS S.A.* and *EDP Energia* which operates in the electricity and the gas sector.
As for *Galp Energia*, it was the second issue of exchangeable bonds and it constituted the next stage of privatization which began at the end of 2005[15]. As far as *EDP Energia* is concerned, the issue of exchangeables was carried out by the state company *Parapública*, which plays the same role as the *KfW* in Germany or the *ÖIAG* in Austria. Nominal interest rate of the issued exchangeables was relatively higher in comparison to other exchangeable bonds discussed before which results from the country credit rating (5,25% in the case of Galp and 3,25% of *EDP*). However, when we compare these coupons with the interests of 10-year Portuguese government bonds it is clear that the issue of these exchangeables were profitable from the government's point of view [16].
In Central East Europe exchangeable instruments are used very rarely, let alone their use in the privatization process. The only well-known example is the government of Hungary, which disposed of the state shares in a company by means of exchangeable debt. These securities gave the investors the right to exchange them for 25% of the shares of pharmaceutical conglomerate *Gedeon Richter Ltd.* The issue took place at the end of 2004 and at maturity all the exchangeables were converted into *Gedeon*'s stocks. The government representatives admitted that the revenue from the *Gedeon*'s privatization would help to diminish public debt. The second issue of exchangeables amounted to about €800m and with maturity in 2014 took place in 2009 [17].
Privatization mechanisms using exchangeables were also successfully carried out by the governments of the Philippines, Morocco and Papua New Guinea. Also the Russian authorities do not exclude the use of hybrid securities in the privatization process, but each time, since 2002, it has ended up in the planning stage only. In 2003 the Kremlin wanted to issue exchangeables converted into the *VTB* bank shares but in the end the equity stakes were disposed of through an ordinary share sale. In 2011 President D. Medvedev, and then V. Putin, did not rule out the use of exchangeables converted into several Russian companies' shares, probably the monopolist in the diamond industry *Alrosa* or the *Sberbank* bank (Pronina, 2011).

Conclusions

Privatization by means of exchangeable bonds can be an attractive alternative to public offerings of state company shares. It is initiated by creating the state-owned SPV company which then buys the shares of the privatized enterprises from the state. After that, on its own behalf, the SPV issues the exchangeables which at maturity can be converted into the initially acquired stocks. Such a mechanism has numerous advantages and can be very profitable for the state. First of all, the government can benefit from a low coupon offered by the exchangeables. Although it strongly depends on the state credit rating, it is much lower than the interests of the ordinary government bonds. This may be particularly important for the countries fighting against indebtedness. Secondly, the state retains the ownership of the underlying companies until debt maturity so by that time it can still administrate and control them as well as it can be a beneficiary of the dividends which subsidize the central budget. Moreover, in the case of unfavorable market conditions and the undervaluation of the privatized companies, exchangeables enables the state to postpone the final sale of their shares below their true value. Furthermore, issuing *callable exchangeables* or *mandatory exchangeables* increases the flexibility

price from the issuer, and which was fixed in the underwriting agreement. The stocks are then disposed to investors in order to meet demand if higher than expected. In the case of exchangeables it means the greater amount of bonds that can be exchanged for underlying stocks. The parties precisely specify an option expiration (in general 30 days) as well as the additional number of securities which can be taken up (no more than 15% of original shares issue). A use of *the greenshoe* option in EU member states are enclosed in Comission Regulation no 2273/2003 from 22nd December 2003 executing directive 2003/6/EC of the European Parliament and of the Council.

15 The first issue was not successful and not all shares were converted.

16 Those days the coupon of the Portuguese treasury bonds were estimated at 5,7% and about 18% at the end of January 2012.

17 See: *MNV prices its offering of €833.3 million Bonds due 2014 exchangeable into Gedeon Richter shares* (2009).

eFinanse
financial internet quarterly

of hybrid debt and assures the government that the entire privatization process will end successfully and the state will dispose of all equity participation in unwanted firms. It can also be achieved by adding several clauses to the ordinary exchangeable bonds.
If the government eventually wants to finish the privatization process and notices that only a small part of exchangeables were not converted into equity, it can exercise a *clean-up option* and thereby force conversion of remaining bonds, regardless of the fact of whether investors would voluntarily decide to do it or not. The government can also meet high demand for newly issued bonds which significantly exceeds their supply by attaching the *greenshoe option*. It enables the issuer to issue an additional amount of bonds if necessary.
The issuer can also widen the circle of customers by issuing the exchangeables not only in the homeland but also abroad. The public issue in a foreign market seems to promote the privatization to a greater extent than the ordinary shares offering. The investors simply do not perceive foreign shares as safe and thus may be reluctant to acquire them. In the case of exchangeables, the foreign purchasers are guaranteed to obtain the face value of the bonds at maturity and have an additional right to convert the bonds into the underlying shares.

References

2004 fehlen Eichel 15 Milliarden Euro. (2003). *Frankfurter Allgemeine Zeitung (121)*. Retrieved from: http://www.faz.net/aktuell/wirtschaft/finanzpolitik-2004-fehlen-eichel-15-milliarden-euro-1102734.html.

Ammann, M., Fehr, M., Seiz, R. (2004). New Evidence on the Announcement Effect of Convertible and Exchangeable bonds. *Journal of Multinational Financial Management,* 16(1), 2006, 43-63.

Barber, B. (1993). Exchangeable Debt. *Financial Management,* 22(2), 48-60.

Bartolotti B., Fantini M., Siniscalco D. (2003). Privatisation Around the World: Evidence from panel data, *Journal of Public Economies,* 88(2), 307.

Batchelor, C. (2005). Japanese Get Fresh Bite at Deutsche Post. *Financial Times.* Retrieved from: http://www.ft.com/intl/cms/s/0/cead7106-64d6-11d9-9f8b-00000e2511c8.html#axzz2KixG7VVy

Cünnen, A. (2008). Kein Futter für die Sparschweine. Handelsblatt. Retrieved from: http://www.handelsblatt.com/finanzen/boerse-maerkte/boerse-inside/umtauschanleihe-kein-futter-fuer-die-sparschweine/2952166.html.

Danielova, A., Smart, S., Boquist, J. (2010). What Motivates Exchangeable Debt Offerings? *Journal of Corporate Finance,* 16(2), 159–169.

Danielova, A., Smart, S., Boquist, J. (2012). Stock Price Effects of Mandatory Exchangeable Debt. *International Advances in Economic Research,* 18(1), 2012, 40-52.

Drücke, N. (2005). KfW Uridashi-Umtauschanleihe auf Aktien der Deutschen Post AG trifft auf außergewöhnliche Nachfrage in Japan - Anleihevolumen beträgt 1,1 Mrd. EUR. Retrieved from: http://www.presseportal.de/pm/41193/642731/kfw-uridashi-umtauschanleihe-auf-aktien-der-deutschen-post-ag-trifft-auf-aussergewoehnliche.

Galal A., Leroy J., Pankaj T., Vogelsang I. (1994). *Welfare Consequences of Selling Public Enterprises: An Empirical Analysis,* New York, Oxford University Press, 529-570.

Gentry, W., Schizer, M. D. (2002). Frictions and Tax-Motivated Hedging: An Empirical Exploration of Publicly-Traded Exchangeable Securities. *NBER Working Paper (9243),* 9-74.

Ghosh, C., Varma, R., Woolridge, J.R. (1990). An Analysis of Exchangeable Debt Offers. *Journal of Financial Economics,* 28(1–2), 251–263.

Ghosh, C., Varma, R., Woolridge, J.R. (1996). Exchangeable Debt Calls and Security Returns. *Journal of Business Finance & Accounting,* 23(1), 107-114.

Guriev S., Megginson W. (2013). *Privatization: What Have We Learned?,* http://siteresources.worldbank.org.

Implementing privatization. The UK experience (2013). WTO, Retrieved from: http://www.wto.org.

KfW. (2009). Privatisierung der Deutschen Post. Retrieved from: http://www.kfw.de/kfw/de/KfW-Konzern/Unternehmen/Auftrag/Sonderaufgaben/DeutschenP.jsp

KfW überrascht Kapitalmarkt mit weltgrößter Wandelanleihe. (2003). Handelsblatt (129). Retrieved from: http://www.handelsblatt.com/finanzen/boerse-maerkte/anleihen/telekom-begruesst-emission-kfw-ueberrascht-kapitalmarkt-mit-weltgroesster-wandelanleihe/2257368.html

Khemani R.S., Shapiro D.M. (1993). *Glossary of Industrial Organisation Economics and Competition Law,* compiled by, commissioned by the Directorate for Financial, Fiscal and Enterprise Affairs, OECD, Retrieved from: http://www.oecd.org.

Kleidt, B. (2006). The Use of Hybrid Securities; Market Timing, Investor Rationing, Signalling and Asset Restructuring, Wiesbaden: Deutscher Universitäts-Verlag, 105-148.

MNV prices its offering of €833.3 million Bonds due 2014 exchangeable into Gedeon Richter shares. (2009). Retrieved from: http://www.mnvzrt.hu/data/cms469575/Press_release___Richter_en.pdf.

Netter J. M., MegginsonW. L. (2001). From State to Market: A Survey of Empirical Studies on Privatization, *Journal of Economic Literature,* 39(2), 321-389.

ÖIAG begibt Österreichs erste Umtauschanleihe. (2003). Retrieved from: http://aktien-portal.at/shownews.html?id=5106.

Privatisation in the 21st Century: Recent Experiences of OECD Countries. Report on Good Practices. (2009). OECD, Retrieved from: http://www.oecd.org.

Privatisierung der voestalpine geht ins Finale. (2005). Retrieved from: http://www.ots.at/presseaussendung/OTS_20050720_OTS0029/privatisierung-der-voestalpine-geht-ins-finale.

Privatisierungs-Poker: voest-Aktie kostet 32,50 Euro! (2003). Retrieved from: http://www.news.at/articles/0338/30/64904/privatisierungs-poker-32-50-euro.

Prokopenko J. (1995). *Management for Privatization: Lessons from Industry and Public Service,* International Labour Org, 10-12.

Pronina, L. (2011). Russian Government May Issue Bonds Exchangeable for Shares. Retrieved from: http://www.bloomberg.com/news/2011-10-31/russian-government-may-issue-convertible-debt-to-aid-asset-sales.html.

Sheifer A. (1998). State Versus Private Ownership, *NBER Working Paper (6665),* 25-26.

Shleifer, A., Vishny, R. W. (1988). The Grabbing Hand: Government Pathologies and their Cures, Cambridge, Mass: Harvard University Press, 228-233.

State issues bonds exchangeable for Richter shares. (2004). Retrieved from: http://www.ceeretail.com/158561/State-issues-bonds-exchangeable-for-Richter-shares.shtml.

Voestalpine AG. (2012). Eigentümerstruktur. Retrieved from: http://reports.voestalpine.com/1112/gb/unternehmen/investorrelations/eigentuemerstruktur.html?cat=m.

Wandelanleihe belastet T-Aktie deutlich. (2003). *Financial Times Deutschland.* Retrieved from: http://www.ftd.de/finanzen/geldanlage/:wandelanleihe-belastet-t-aktie-deutlich/1045472708675.html.