COMMERZBANK

Product Group

Convertible Bonds / Warrant Bonds

In this information sheet, Commerzbank provides information on the underlying characteristics as well as the opportunities and risks of the convertible bonds / warrant bonds product group.

General characteristics and investment opportunities

This type of bonds is part of the category of interest-bearing securities, which are often also referred to as fixed income securities, bonds, debt obligations or debentures. The investor lends a certain amount of money to the issuer, e.g. a non-financial or a financial company, and in return receives a bond denominated in euro or a foreign currency. Bonds represent a claim to capital repayment and, typically, to fixed or variable interest payments as compensation for the provision of capital. Their yield is determined by the nominal interest rate, the issue or purchase price, the redemption price and the term of the security. The individual characteristics, such as the interest rate, maturity or ranking in the event of insolvency or liquidation of the issuer and conversion or option rights are specified in the terms and conditions of the bond issue.

As investors have a right of conversion of these bonds into company shares in line with terms set at the time of issuance, they may benefit from rising share prices which would affect the bond price as well. If the price of the underlying shares falls, this will not have any negative repercussions at maturity in the case of traditional convertible bonds and warrant bonds, as repayment to the investor is made at full nominal value. This is also referred to as an asymmetric risk/reward profile.

Typical product characteristics

Convertible bonds are a special form of corporate bonds issued by publicly listed companies. They securitise the right to interest for investors, as well as the right or obligation to exchange the bond for shares in the company or in another company (exchangeable bond) at a predetermined conversion ratio during a conversion period. In most cases, investors have the choice whether to convert or to hold the convertible bond until maturity for redemption. The bond terms and conditions may define a lock-up period for investors during which it is not possible to exchange the bond for shares. When investors exercise their conversion right or a mandatory conversion takes place, their status changes from creditor to shareholder of the company. They are then subject to the usual risks of an equity investment, such as price risk. In return, however, investors are entitled to the associated shareholder rights, such as a dividend payment (see also product group “Equities, Equity Funds, Equity ETFs”).

Convertible bonds usually pay a lower interest rate than non-convertible bonds.

Price volatility of convertible bonds is generally higher than for bonds without conversion rights because of their link to a specific equity, but at the same time lower than for a direct investment in the relevant equity. If the convertible bond carries a fixed interest rate and is redeemable at par, the price downside during its term is limited. This is different for mandatory convertible bonds. Here, the share price is the main driver for the convertible bond price, resulting in a considerably larger price risk. As the conversion ratio is fixed, investors might record conversion gains at the time of conversion. However, investors are also exposed to the risk of suffering conversion losses if the share price is below the fixed conversion ratio.

Warrant bonds work similarly to convertible bonds. They also include a right, usually to receive shares, yet not in a conversion but in addition to the bond. Warrant bonds securitise the right of investors to acquire shares or other tradable assets through a warrant that can be separated from the bond. The warrant can be traded separately. Investors are entitled to receive the shares of the warrant bond against the exercise of the warrant at predetermined conditions; instead of receiving shares, the investor might be entitled to a payment. The warrant bond itself is not exchanged but remains outstanding until it is redeemed. A warrant may be quoted on the securities exchange at up to three different prices: one price for the bond with or “cum” warrant, one price for the bond without or “ex” warrant, and one price for the warrant itself.

Due to the option right, warrant bonds usually pay a lower interest rate than bonds without option rights.

The price of the bond with warrant is based on the price of the underlying (e.g. the share), as is the price of the warrant itself. However, the latter is also driven by other factors such as the term of the securitised option, as well as the level of price volatility of the underlying (see also product group “Warrants, Factor Warrants / Leveraged ETPs, Knock-Out Products”). The price of the warrant bond without warrant moves like a conventional bond and is driven by underlying interest rate trends and the credit quality of the issuer, among other factors.

Material risks of the product group
By investing in these securities, investors benefit from return opportunities, but are also exposed to additional material risks. These include the following:
Issuer risk - also referred to as default risk - when the issuer fails to meet its obligations or can only meet them in part, for example because of insolvency. Bonds issued by banks are subject to special regulations. If the issuing bank runs into financial difficulties, a regulatory intervention may result in a bailout of the bank, partial or total loss of the investment, or a compulsory conversion into equity, such as shares. As a general rule: The worse the credit rating of an issuer, the higher the default risk, but also the risk premium and the resulting yield. Bonds are generally not covered by deposit insurance. Sustainability-related decisions relating to the environment, social aspects and corporate governance also impact on the issuer.
Interest rate and price risk - when interest rates rise, bond prices generally fall. A downgrade in the issuer's credit rating reduces the value of a bond during its term.
Risk of loss - investors may receive a lower sales price due to a fall in the price of the underlying or other parameters that have a negative impact on the bond price. This can lead to a total loss, especially for mandatory convertible or exchangeable bonds, if the underlying becomes worthless.
Liquidity risk - during the term, investors may not be able to sell the security or may only be able to sell it at a possibly much lower price.
Foreign currency risk - Investors are exposed to currency risk when investing in a foreign currency denominated security as performance could be adversely affected by exchange rate movements.
Early redemption and reinvestment risk - investors are exposed to the risk that the issuer may exercise an ordinary or extraordinary option to call the fixed income security at a time or in a financial market environment that is unfavourable for the investor, as the investor can reinvest the redemption amount only on less favourable terms.

In addition, investors need to consider the material risks for equities and warrants (see product groups “Equities, Equity Funds, Equity ETFs” and “Warrants, Factor Warrants / Leveraged ETPs, Knock-Out Products”).

Some bonds of foreign issuers have features not typically applied in Germany, which are specified in the terms and conditions of the bonds. This may result in additional risks.

Further information and costs
For further details on these aspects and the product, please refer to the relevant sales prospectus or a basic information sheet, if available. In principle, inflation trends impact your investment performance. A resulting loss of purchasing power affects both the income generated and your capital invested. When acquiring, holding and eventually selling securities and derivatives, costs will impact returns. For further details, please refer to the respective cost information before entering into a securities transaction.

For further details on the characteristics and risks of the products, please refer to the brochure “Basic Information on Securities and Other Investments”.