Journal of Applied Corporate Finance / Volume 10, Issue 1 / pp. 54-63

PERCS, DECS, AND OTHER MANDATORY CONVERTIBLES

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First published: 08 April 2005
https://doi.org/10.1111/j.1745-6622.1997.tb00125.x

The author is grateful to Brooks Harris and James Ryan for their insights into the practical aspects of mandatory convertibles, and to Don Chew for his thoughtful comments and editorial assistance.

Abstract

From their beginnings in 1988, mandatory convertibles such as PERCS and DECS have grown to account for as much as 25% of a convertible market that experienced new issuance of $20 billion in 1996. Mandatory convertibles usually pay a higher dividend than the company's common stock (generally for a three-year period) and then require the holders to convert into common stock under terms that provide limited appreciation until conversion.

This article examines the rationale for mandatory convertibles from the point of view of issuers as well as investors. Like conventional convertibles securities, mandatory convertibles reduce the costs of the information asymmetry problem that confronts equity issuers. But, to a greater degree than ordinary convertibles, mandatory convertibles provide a solution to the financial restructuring problem faced by highly leveraged (and, in some cases, troubled) companies. They also enable growth companies to signal confidence about their future, particularly by including features such as guaranteed appreciation.

The last section of the article discusses the valuation of three varieties of mandatory convertibles: PERCS, DECS, and mandatory convertibles with a value guarantee. The valuation method builds on the insight that each of these securities can be decomposed into three basic components: (1) the underlying common stock; (2) the fixed-income cash flow promised investors; and (3) the option on the company's stock embedded in the security.