

The Exchange Offer

Student brief

Kitengela Ridge Developments Ltd builds mid-market apartments on the southern edge of Nairobi. Four years ago it borrowed **KSh 2 billion** from the bond market: an unsecured seven-year bond paying a **15 percent** annual coupon. Four years of the bond's life remain.

Sales slowed, two blocks stand unfinished, and last month the company told bondholders it could not pay the coupon due in thirty days. On Monday it made them an offer, open until Friday. Every holder may choose one of three things.

- **Exchange.** Swap each 100 of the old bond for 100 of a new **seven-year bond paying 10 percent**, secured on the company's completed apartments.
- **Cash.** Sell each 100 of the old bond back to the company for **KSh 62 in cash**, paid from a new bank facility.
- **Neither.** Keep the old bond.

The offer goes ahead only if holders of at least **75 percent** of the issue accept one of the first two. If it fails, the company has said it will seek administration.

You advise the investment committee of a Nairobi unit trust. The fund holds **KSh 300 million face value** of the old bond — 15 percent of the issue. Its investors can redeem their units on any business day. The registrar reports that holders of **68 percent** of the issue have accepted so far.

The committee meets on Thursday.

Exhibit 1 • What the market says

YIELDS, BEFORE AND AFTER THE ANNOUNCEMENT

INSTRUMENT	YIELD
Kenyan government bonds, four to seven years	14%
Kitengela old bond, last trade three weeks ago at 70.87	28%
Secured bonds of Kenyan issuers that have completed a restructuring	19% to 21%

The last range is an illustrative set of comparable issues, 500 to 700 basis points over government paper. No trade in the old bond has been reported since the missed coupon was announced.

Exhibit 2 · What each choice is worth, per 100 of face

TWO OUTCOMES · PER 100 OF THE OLD BOND

YOUR CHOICE	IF THE OFFER SUCCEEDS	IF THE OFFER FAILS
Exchange	your Question 1 answer	24.31
Cash	62.00	24.31
Neither	82.54	24.31

If the offer fails, the administrators' advisers estimate holders recover 35 per 100 after about two years; at 20 percent that is worth 24.31 today. If it succeeds, any old bonds not tendered stay outstanding, unsecured, and rank behind the new secured bond. If the company then pays them in full, a four-year 15 percent bond priced at 22 percent is worth 82.54.

Question 1 · 15 minutes

Price the new exchange bond per 100 of face value in Excel. Lay out its cash flows year by year, from the first coupon to the coupon and principal at the end of Year 7. Discount each year's cash flow first at the **14 percent** government yield and then at **20 percent**, and add them up. The case workbook sets out the cash flows for you; the discounting is yours.

Check each price another way: value the coupons with the annuity formula, add the present value of the principal, and confirm you get the same figure.

For each rate, state what the fund's KSh 300 million would be worth if it exchanged, against what it would receive in cash. Then find the rate at which the exchange and the cash are worth the same. Getting within half a percent is fine.

Question 2 · 13 minutes

The committee chair has seen your 14 percent figure and says the cash offer is an insult. The fund's analyst has seen your 20 percent figure and says the two choices are the same deal.

Which rate prices the new bond, and why? Then choose between the exchange and the cash, and say what about this particular fund pushes you one way.

Question 3 · 9 minutes

Read Exhibit 2 as any single bondholder would.

What does it tell each holder to do? What happens if every holder does it?

Now look at the registrar's figure. **What should this fund do?**