Hybrid Issue Skirts Taxes, Federal Law

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HEARD ON THE STREET

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Wall Street is marketing a hot new way for companies to skirt federal tax and securities laws.

Investment banks insist that the mechanism—a hybrid security that allows holders of blocks of stock to get the benefits of a sale without actually selling — has been specially designed to survive even the tax changes proposed last week in the new Clinton budget.

The new hybrids — known as DECS, PEPS, Prides or other acronyms — are becoming popular. But they could raise a red flag for investors. In the highest-profile case to date, **Times Mirror** used a PEPS this month to dump its exposure to **Netscape Communications**, the onetime Internet darling whose stock was sinking. Since Times Mirror's move, Netscape's stock price has fallen more than 21%.

Here's what happened: Times Mirror acquired a 2.3% Netscape stake in a private placement less than a year ago. Because it got favorable terms on stock that wasn't yet available for public sale, securities law required it to hold the stock for two years.

To sidestep that rule, Times Mirror simply hired Morgan Stanley to issue a hybrid five-year bond with repayment pegged to Netscape's stock price. Like magic, Times Mirror got its profit up front, from the bond's proceeds. It passed most of its Netscape risk to the investors who bought the bond.

Even more miraculous, its tax advisers believe that it can put off a capital-gains tax until it actually sells the underlying Netscape stock, probably in five years. Meanwhile, it can deduct interest it pays on the bond from its current taxes.

Morgan Stanley spent some time briefing the Securities and Exchange Commission and the Internal Revenue Service and getting opinions from law firms that the system slips neatly inside existing regulations, according to investment bankers at other firms. The SEC and Treasury Department declined to comment.

Thomas Unterman, chief financial officer of Times Mirror, says that this is an innovative transaction but that it isn't

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More Firms Maneuver to Cash in Their Bets On Blocks of Stock Without Actually Selling

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designed to violate either the letter or the spirit of the law. "If there had been any thought of getting around regulations, we wouldn't have done this," he adds.

Although there have already been about a dozen deals like the Times Mirror offering, the publicity this one has generated seems likely to spawn more.

"I think the Times Mirror deal has sort of put this into the mainstream of strategies," says Robert Willens, a tax and accounting analyst at Lehman Brothers. "It raised the consciousness level of corporations sitting on appreciated securities. They will be more amenable to this strategy."

On balance, it's hard to draw any clear investment signals from these securities. In 13 cases to date, five of the underlying stocks substantially lagged behind Standard & Poor's 500-index after plans for the hybrid security were announced. Three of the stocks roughly matched the S&P 500, and five soared.

Until the Netscape issue, all the big laggards were grouped among those issued before May 1995. The biggest decliner has been **Nextel Communications**, a wireless-telecommunications company that lagged 89 percentage points behind the S&P index. The biggest gainer has been **First Data**, a credit-card processor whose stock was the basis for one of the earliest hybrids.

The idea of issuing these hybrid bonds dates at least from 1993, when Salomon Brothers put together the First Data issue to help **American Express** reduce its exposure to the card processor. Salomon Brothers calls them DECS (dividend enhanced convertible securities), Morgan Stanley calls them PEPS (premium equity participating securities) and others call them ACES, MEDS, Marcs or Prides. More than $3.5 billion have been issued, but they didn't really take off until late last year; four came out in December alone.

William Benedetto, of New York investment bank Benedetto, Gartland & Greene, says one way to guess how the stock is likely to perform is to try to figure out the investor's motivation for issuing the security. "It isn't necessarily a value judgement on the underlying stock," he says.

Up to now, most of the hybrids have been used as a way of avoiding capital-gains taxes on stock sales. The Times Mirror issue appears to be the first time anyone has used one to get around securities regulations.

But Anand Iyer, who heads Salomon Brothers research in the area, notes that they aren't always aimed just at dumping a stock without running afoul of capital-gains taxes or SEC regulations. They sometimes are intended to widen the pool of possible investors for the company's stock. If that's the goal, the new securities may put less pressure on the stock because they uncover new investors.

Hybrids can widen the investment pool because, to escape the capital-gains tax, the hybrid PEPS or DECS can't be too similar to the underlying stock. The most common way of making them different is to boost the interest on the hybrid well above the dividend paid by the stock.

Hybrids Blossom

More and more big investors are hedging their positions by issuing bonds with repayment pegged to the stock's price.

STOCK	DATE HYBRID ANNOUNCED	STOCK PERFORMANCE VS. S&P 500*
Telecom Argentina	3/96	+ 2%
Netscape	3/96	−17%
Wyman-Gordon	12/95	+21%
Enron Oil & Gas	12/95	+ 7%
Enhance Fin. Services	12/95	+ 2%
NationsBank	12/95	− 2%
U.S. Filter	11/95	+22%
Inso	7/95	+15%
PMI Group	4/95	−17%
SNET	3/95	− 8%
Lyondell Petrochemical	8/94	−18%
Nextel	2/94	−89%
First Data	10/93	+44%

*As of March 22, 1996

Sources: Salomon Brothers, Baseline

Netscape common shares, for example don't pay any dividend. But the PEPS issued by Times Mirror pay 4.25%. Times Mirror may recoup the extra interest cost when the PEPS mature: If Netscape's share price gains, Times Mirror keeps 15% of the gain, up to a certain limit, and investors get the balance.

The higher yield means that the hybrids appeal to investors who want dividends, who wouldn't buy ordinary Netscape stock. That means the PEPS sale may put less pressure on the Netscape common than a straight stock sale would.

Some tax experts think the recent Clinton administration budget proposals could stimulate more hybrids. That's because the proposals crack down on another hedging mechanism — called "short-selling against the box" — but apparently don't deal with DECS, PEPS and the like.

A lot of companies and individuals have used short-selling to take profits on restricted stock they can't sell. An investor simply borrows stock equivalent to the amount already owned and then sells it. The investor takes any profit, cuts off exposure to the stock's ups and downs but doesn't pay capital-gains tax until the underlying stock is disposed of.

Now, the administration wants to charge capital-gains tax on any such arrangement immediately if it "substantially eliminates risk of loss and opportunity for gain."

Lawyers insist the hybrids can get around that proposal by leaving a little room for profit. Times Mirror's PEPS issue largely eliminates the risk of loss but leaves in a possible 15% gain.

And Wall Street has yet other methods of skirting taxes and SEC regulations. For example, another investor in the Netscape private placement, **Knight-Ridder**, recently bailed out by using a so-called collar. Knight-Ridder arranged put and call options permitting it to sell most of its Netscape shares after the two-year holding requirement expires in a price range near the recent price.

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