Debt to Equity Swaps
Overview

Kevin O'Brien

- ► Investment Schematics
- ► Transactional Elements
- ► Procedural Templates

The implementation of a debt to equity conversion program is an effective government incentive for stimulating private capital investment within a host nation. A debt conversion program also functions to reduce the external debt burden on the host country and enables the government to apply national resources to nation building as opposed to debt service.

Essentially, a debt conversion program affords foreign investors with a governmental subsidy in the form of discounted debt capitalization to offset the cost of direct investment transactions. If the nation in which the investment project (e.g., manufacturing plant) is to be sited has any outstanding external sovereign debt (i.e., national debt owed to foreign creditor nations or foreign creditor banks) which is in arrears or in default, it may be possible for the foreign investor to purchase a participation interest in such debt in an amount equivalent to the cost of the planned investment project, at a substantial discount to par value, and subsequently redeem the participation interest at or near full par value denominated in the host nation's currency. The conversion proceeds would then be committed to funding the capital costs (or in some cases, the operating costs as well) associated with the investment project. The purchase and redemption discount constitutes the economic value of the subsidy provided with respect to the investment.

Such transactions are generally approved by the host nation government subject to a comprehensive evaluation of the economic impact of the proposed investment project (i.e., provided that the proposed project conveys a significant economic development benefit to the host nation). Accordingly, the criteria for evaluating debt conversion application memorandums should include a requirement for a comprehensive fiscal and economic impact analysis of the proposed project which is required to specify in detail the benefits to the local area(s), adjacent region(s), and the national economy.

In the event that a secondary market develops for the distressed sovereign debt of the subject nation, the integration of original issue discount U.S. Treasury obligations with discounted debt participation interests may be utilized as a credit enhancement to institutions which express an interest in obtaining investment positions (for subsequent sale as conversion interests) or in refinancing such debt (in conjunction with the extension of new monies). Such an enhancement mechanism provides assurance to such parties regarding the safety of investment principal.