

[DRAFT: WORK IN PROGRESS]

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## ■ Project Horizon: Instrument worked examples

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# 1. Project Horizon: Instrument worked examples

## 1.1 Coupon Payment analysis

Assumptions	
Current share price (DKK)	10
Fixed coupon (p.a. as a % of Issue Price)	8%
Divided linked coupon multiplier	125%
Issuer Price	Per security (DKK)
No. of securities	12.50
Conversion ratio (No. of shares underlying each security)	1
Fixed coupon (nominal p.a.)	1
	1.00

Note 1 Dividend Linked Coupon = ordinary dividend declared per share for financial year x Conversion Ratio x Dividend linked coupon multiplier

Illustrative payment scenarios				
Dividend per share (DKK)	Fixed Coupon (DKK)	Dividend Linked Coupon (DKK)	Actual Coupon Payment (DKK)	Actual Coupon Payment (DKK)
0.30	1.00	0.38	1.00	1.00
0.40	1.00	0.50	1.00	1.00
0.50	1.00	0.63	1.00	1.00
0.60	1.00	0.75	1.00	1.00
0.70	1.00	0.88	1.00	1.00
0.80	1.00	1.00	1.00	1.00
0.90	1.00	1.13	1.25	1.13
1.00	1.00	1.25	1.38	1.25
1.10	1.00	1.38	1.50	1.38
1.20	1.00	1.50	1.63	1.50
1.30	1.00	1.63		1.63

- The above table provides a simple theoretical worked example of how the Government's income payment is calculated:
- If the issue price of 1 security is 12.5 DKK, the annual income (Actual Coupon Payment) will be the higher of:
  - i. a fixed nominal coupon of DKK 1 p.a. (i.e. 8% of the issue price); and
  - ii. 125% of the nominal ordinary dividend paid per share for the relevant financial year
- The table highlights that if the ordinary dividend per share is greater than DKK 0.8 then the Actual Coupon Payment received by the Government per security will be higher than the Fixed Coupon (i.e. DKK 0.8 x 125% = DKK1)
- Finally, the table also highlights that the income received by the Government is linked only to the nominal dividend paid by the issuer and is not linked to the share price at the time (i.e. the prevailing dividend yield)

**Nominal dividend paid per share and not the dividend yield drives actual income received**

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## 1.2 Coupon payment analysis – coupon paid in scrip ordinary shares

Initial assumptions (at issue)	
Current share price (DKK)	10
Fixed coupon (p.a. as a % of Issue Price)	8%
Divided linked coupon multiplier	125%
Per security (DKK)	
Issue price	12.50
No. of securities	1
Conversion ratio (No. of share underlying each security)	1
Fixed coupon (nominal p.a.)	1.00

Level of share issuance to meet coupon payments	
Issue size (DKK m)	1,000
Total securities / shares underlying (m)	80
Fixed coupon (p.a. as a % of Issue Price)	8%
Total coupon payment p.a. (DKK m)	80
Illustrative share issuance	
Assumed VWAP (DKK)	5.0 6.0 7.0 8.0 9.0 10.0
No. of shares issued (m)	16.0 13.3 11.4 10.0 8.9 8.0

- The coupon is assumed to be paid annually for the purposes of this illustration only. We assume that a fixed coupon of 8% is paid for the duration of the instrument's life
- In this case we assume that cash payment is not available for regulatory solvency reasons, but sufficient distributable reserves are available such that the coupon is payable in shares
- The value of 1 share is the average of the daily Volume Weighted Average Share Prices ("VWAP") for the [14] days prior to the Coupon Date
- If we assume the value per share is calculated using DKK 7.00, the Issuer will have to issue 11.4m new shares to meet the total Coupon Payment of DKK 80m

**[14] day VWAP prior to coupon date will determine the no. of shares required**

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## 1.3 Call price calculation at 3 years + 1 month after issue for [8]% return p.a.

Initial assumptions (at issue)	
Current share price (DKK)	10
Fixed coupon (p.a. as a % of Issue Price)	8%
Divided linked coupon multiplier	125%
Issue Price (DKK)	12.50
No. of securities	1
Conversion ratio (No. of shares underlying each security)	1
Fixed coupon (nominal p.a.) (DKK)	1.00
Required return assuming call between 3-5 years	
Issue Price (% par)	100%
First call date: 3 yrs + 1mth (in yrs)	3.08
Return p.a. required	8%

Required call price as % Issue price at 3 yrs + 1mth	Coupon payment schedule			Required call price as % Issue price (at 3 yr + 1mth)
	Year 1	Year 2	Year 3	
Scenario 1	8%	8%	8%	100.62%
Scenario 2	0%	8%	8%	110.01%
Scenario 3	-	-	-	126.75%

Note 1 Required call price includes accrued coupon for additional month after due date of coupon payment in year 3 and reflects a calculation to generate a [8]% Internal Rate of Return to call date

- The instrument is non-callable until 3 years and 1 month post issue. Thereafter the instrument is callable until the 5<sup>th</sup> year post issue under the following conditions:
  - Callable for cash at a price that ensures an internal rate of return ("IRR") of [8] p.a.
  - Subject to consent of FSA and replacement using junior capital
- After the 5<sup>th</sup> year post issue the instrument is callable for cash at 100% of face value regardless of whether or not the coupons have been paid in the preceding years
- If we look at Scenario 2, where the issuer is unable to pay the coupon in Year 1, but resumes payment in Years 2 & 3, the required call price will be c. 110% of par. This is based on the following conditions:
  - Pricing at c. 110% ensures the Government receives an IRR of 8%

**The required call price, if called before year 5, ensures that the Government receives a minimum IRR of [8] % on the investment**

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## 1.4 Net Share Settlement in the event of conversion following an issuer call

- After 3 years and 1 month, the issuer calls the security (assuming Scenario 2 on page 3) at a price of c.110%
- The Government now has 2 options:
  - (i) redeem and accept the call price in cash; or
  - (ii) convert and receive the Conversion Value (in a mixture of cash and shares)
- The tables to the right highlight at different share prices what options are available to the Government and the consideration received
- If we take the scenario where the share price prior to conversion is DKK 15, the Government has the option to choose between option A - Call Value consideration of DKK 1,101m or B - the Conversion Value consideration of DKK 1,200m
  - The Government chooses to convert and receive the Conversion Value of DKK1,200m of which DKK 1,101m will be in paid cash and DKK 99m in shares
  - Assuming a 30 day VWAP of DKK15 post conversion 6.6m shares will have to be issued to create DKK 99m of value
- There is an additional level of detail that protects the Government from a fall in the share price between the beginning and the end of the 30 day period following conversion (See Sections 1.10 and 1.11)

**Call Price and Conversion Value comparisons**

Option A - Call Value		Option B - Conversion Value	
No. of securities issued (m)	80	No. of securities issued (m)	80
Issue Price (DKK)	12.5	Conversion Value (DKK m)	1,200
Issue size (DKK m)	1,000	Consideration received:	
Call price per security (as a % of par)	110.10%	A - Call Value (DKK m)	1,101
Call Value (DKK m)	1,101	B - Conversion Value (DKK m)	1,200
<b>Government decision</b>			
Share price pre-conversion (DKK) <sup>1</sup>	5	ReDEM	ReDEM
No. of securities issued (m)	80	ReDEM	ReDEM
Conversion Value (DKK m)	400	ReDEM	ReDEM
<b>Total rec'd (Higher of A and B)</b>			
A - Call Value (DKK m)	1,101	ReDEM	ReDEM
B - Conversion Value (DKK m)	400	ReDEM	ReDEM
Government decision	1,101	ReDEM	ReDEM
Total rec'd (Higher of A and B)	1,101	ReDEM	ReDEM
Cash received (DKK m)	1,101	ReDEM	ReDEM
Share top-up value (DKK m)	n/a	ReDEM	ReDEM
No. of shares required	n/a	ReDEM	ReDEM
<b>30 day VWAP post conversion (DKK)<sup>2</sup></b>			
Share top-up value (DKK m)	n/a	ReDEM	ReDEM
No. of shares required (m)	n/a	ReDEM	ReDEM

Note 1 14 day VWAP share price minus a 10% discount to make sale process easier  
 Note 2 Based on the 30 day VWAP post conversion which can only be calculated 30 days after the conversion date. As a result of this there will be a delay before the shares can be paid by the issuer and the number of shares to be received will be unknown

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## 1.5 Mandatory stock settlement upon Emergency Regulatory Event ("ERE")

Initial assumptions (at issue)	
Current share price (DKK)	10
Fixed coupon (p.a. as a % of Issue Price)	8%
Divided linked coupon multiplier	125%
Issue Price (DKK)	12.50
Nb. of securities	1
Conversion ratio (No. of shares underlying each security)	1
Fixed coupon (nominal p.a.)	1.00

Illustrative conversion ratios in the case of an ERE			
Mandatory stock settlement upon Emergency Regulatory Event			
A. Issue Price	12.50	12.50	12.50
B. 30 day VWAP post announcement of ERE (DKK)	8.0	6.0	3.0
C. Shares received per security (A/B) <sup>1</sup>	1.56	2.08	4.00*

Notes 1 The conversion ratio based on 30 day VWAP post announcement of ERE must be no less than the current conversion ratio i.e. no less than 1:1 and no more than 4 times the prevailing conversion ratio i.e. no more than 4:1 \* Conversion ratio capped at 4:1

- In the case of an Emergency Regulatory Event ("ERE") the conversion ratio (i.e. the number of shares received per security) may be adjusted upwards to reduce the amount of loss suffered by the Government depending on the share price at the time
- The new adjusted conversion ratio is calculated by dividing the issue price of 1 security (in the current example DKK 12.50) by the 30 day VWAP post the announcement of the ERE
- If we assume the 30 day VWAP post announcement is DKK6 we see the new ratio rises to 2.08:1 from the current conversion ratio of 1:1 to compensate the Government for the subsequent fall in the share price
  - It should be noted that the new adjusted conversion ratio must be no less than the current conversion ratio i.e. no less than 1:1 and no more than 4 times the prevailing conversion ratio i.e. no more than 4:1 to prevent the Government from taking full ownership of all shares
- The clause is structured to take into account a likely fall in the share price post announcement of an ERE

**The Government's value will be protected for a share price fall up to 75% below the Issue Price**

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## 1.6 Listed but Illiquid Banks: Using an Equity Linked element

- The Government could consider the following illustration as a mechanism to restrict the use of an equity linked upside option by illiquid Banks to either a maximum relative size or even altogether
- Restriction**
- All capital injections (excluding Banks where the holding company resides in a foreign jurisdiction) will include an Equity Link in the form of a conversion option embedded in the tier one capital instrument; unless the number of shares required to underlie the total size of the capital injection required exceeds the lower of:
    - (a) The average number of shares traded on a daily basis over the previous year multiplied by 260 (days)<sup>1</sup>; or
    - (b) 50% of the enlarged share capital, post conversion
  - In the event that the total injection required breaches the lower of the above threshold's the Government could reserve the right to either:
    - (i) Permit a two tranche issue where convertible hybrids are issued up to the threshold amount provided above (i.e. the lower of (a) and (b) and the remaining capital injection is issued in the form of straight hybrid only with no Equity Link; or
    - (ii) Offer the Bank in question a straight non-convertible hybrid investment only, where coupon = required return
  - Please see practical worked illustrations that follow in Sections 1.8 and 1.9

<sup>1</sup>Note 1 Number of trading days in a calendar year

***A mechanism is available to restrict the Equity Link to more liquid stocks only...***

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## 1.7 *Practical considerations for the Government when considering the impact of receiving illiquid shares*

- From a theoretical, equity capital markets perspective, the rational buyer would prefer the equity linked element to be restrained under the liquidity criteria outlined in 1.6 to protect his ability to exit through a sale of any shares received upon conversion
- However, from the Government's perspective, holding a conversion option into a large amount of underlying equity in an illiquid investment may actually result in the following benefits:
  - Could be a useful "stick" to ensure management develop the business in a manner expected by the Government, otherwise conversion will occur in order to control the votes
  - Sources of capital, in order to be able to call a large straight tier one hybrid instrument for redemption, are likely to be limited for illiquid issuers (i.e. ability to raise equity constrained). This reduces the probability of an exit even without an Equity Linked element
  - Conversion into shares will increase the Government's influence and therefore ability to force a merger or sale of the business to provide an exit
  - The shares are likely to be easier to sell to a strategic investor for example (although pricing discount will be very large) compared to an unlisted tier one hybrid instrument
  - Such influence will allow the Government to force / encourage consolidation within the sector should this be a priority or a potential objective going forward

***A mechanism as outlined in 1.6 provides a way to ensure the Government avoids conversion into illiquid shares it will not be able to sell, but there may be specific benefits to the Government of receiving large shareholdings in illiquid companies which are not applicable for a private investor***

***...but there may be Government specific benefits from an Equity Link to be considered***



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## 1.8 Basic illustrations of calculations in 1.6

- Issued Share Capital: 100m shares
- Current Share Price: DKK 10
- Market Capitalisation: DKK 1,000m
  
- Assumptions for convertible instrument:
  - Conversion Premium (required pricing if a convertible permitted): 25%
  - Issue Price per security: DKK 12.5 (=10 x (1+25%))
  - Average number of shares traded on a daily basis over the previous year: 50,000 shares
  - Required total return: 10%
  - Coupon: 8%
  - Total capital injection required: DKK 600m
  
- Permitted issue size is the lower of:
  - (a) 50% of enlarged share capital = 100m shares x DKK 12.5 (Issue Price) = DKK 1,250m permitted issue size
  - (b) 50,000 shares x 260<sup>1</sup> days = 13m shares x DKK 12.5 (Issue Price) = DKK 162.5m permitted issue size
  
- The permitted Equity linked tranche would therefore be: DKK 162.5m paying an 8% coupon convertible into 13m shares
  
- The non-convertible hybrid tranche would therefore be: DKK 437.5m paying a 10% coupon
  
- Given the required capital injection is in excess of the Equity Linked tranche permitted under the mechanism, the Government could choose whether it purchases DKK 600m of non-convertible hybrids or the package two different instruments detailed above

Note 1 Number of trading days in a calendar year

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## 1.9 Illustration of calculations in 1.6 for [REDACTED] (using previous assumptions shown)

- Issued share capital: [REDACTED]
- Current Share Price: [REDACTED]
- Market Capitalisation: [REDACTED]
  
- Assumptions for convertible instrument
  - Conversion Premium: 25%
  - Issue Price per security: DKK [REDACTED] (1+25%)
  - Average number of shares traded on a daily basis over the previous year: 3,036,956 shares
  - Illustrative total return: 10%
  - Equity Linked Coupon: 8%
  - Total capital injection required: DKK [REDACTED] (2% of Risk Weighted Assets<sup>1</sup>)
  
- Permitted issue size is therefore the lower of:
  - (a) 50% of enlarged share capital = [REDACTED] shares x DKK [REDACTED] (Issue Price) = [REDACTED]
  - (b) [REDACTED] shares x 260 days<sup>2</sup> = [REDACTED] shares x DKK [REDACTED] (Issue Price) = [REDACTED]
  
- In this case the issue size of a convertible hybrid for the total required capital injection would be well within both limits and therefore would automatically become fully convertible

Note 1 Source Brokers' notes  
Note 2 Number of trading days in a calendar year \*

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## 1.10 Net Share Settlement – additional protection for the Government

*The Conversion Value is calculated using the 30 day post conversion share price, but subject to a floor set pre conversion*

- There are further protection mechanisms for the Government (when calculating the Conversion Value) if it chooses to convert when the instrument is called
- Following conversion by the Government (after the call date) the share price is more likely to fall than increase as the Issuer attempts to sell the Shares on behalf of the Government, therefore given part of the consideration will be in the form of shares the Government's Conversion Value would be more likely to fall in this period
- To help protect the Government, the calculation for the amount of value received is based on the higher of:
  - (i) a 10% discount to the average share price for the 2 weeks prior to the Conversion Date (so the minimum value attributable to the Government will be known); and
  - (ii) the average of the daily share prices for 30 days after conversion (so if the share price rises substantially for any reason the Government will receive the upside in the Conversion Value)
- The number of shares the Issuer needs to deliver to top-up the value of the cash call price will then be calculated based on the share price performance post conversion (and will not necessarily reflect the calculation used for the Conversion Value unless the share price has risen)
- If the share price falls following conversion their will be a floor to the Government's Conversion Value (as indicated in (i) above), but the number of shares the Issuer will need to deliver will increase as the post conversion share price falls
- Please see a worked illustration of how the number of shares received will vary depending on the share price performance during the first 30 days post conversion on the following page

***The value received upon conversion is subject to a floor (set pre-conversion)***

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## 1.11 Net Share Settlement – illustrative workings for Conversion Value calculation

If the share price post conversion falls from say DKK 13.5 (post a 10% discount) to DKK 4 after 30 days, the Government's incremental value above the cash call price will be protected through the receipt of 20m shares instead of the initial 5.9m

**Illustrative table to show effects of change in 30-day VWAP post-conversion on the number of shares issued**

Issue Price (DKK):	12.5
Issue size (DKK m):	1,000
No. of securities issued (m):	80
Conversion Ratio:	1 for 1
Total shares underlying (m)	80
Call Price (DKK):	12.5

Share Price Scenario (post conversion)	Dramatic fall	Marginal fall	Flat	Marginal Increase	Substantial increase	Extreme Increase
14 day average share price pre-conversion (DKK):	15.0	15.0	15.0	15.0	15.0	15.0
A. plus a 10% discount (DKK):	13.5	13.5	13.5	13.5	13.5	13.5
vs.						
B. 30 day VWAP (post conversion)	4.0	11.0	13.5	16.0	25.0	50.0
C. Conversion Value owed (DKK) (higher of A and B):	13.5	13.5	13.5	16.0	25.0	50.0
D. Value to be delivered in Cash (DKK)	12.5	12.5	12.5	12.5	12.5	12.5
E. Value to be delivered in Shares (DKK) (C-D)	1.0	1.0	1.0	3.5	12.5	37.5
F. No. of Shares delivered per security (E/E)	0.25	0.09	0.07	0.22	0.50	0.75
G. Total no. of Shares received (m) (F x Total shares)	20.0	7.3	5.9	17.5	40.0	60.0

**Conversion value is protected if share price falls post conversion as no. of shares increases (favourable structure for the Government)**