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## Convertible Bonds of Countrywide Financial Corporation

Late in the afternoon on Friday, October 22, 2004, the trading floor at First Convergence Inc. was relatively quiet, as most traders had left for the weekend. However, Mary Lucas, a junior trader, was still sitting in front of her Bloomberg terminal, browsing through the recent trading activities of a few convertible bonds the firm held.

First Convergence Inc. was a hedge fund specializing in convertible arbitrage that had been founded by three Wall Street traders in 2002. Lucas had joined the firm only recently after getting her MBA. Prior to starting at the firm, she had known little about convertible bonds. Now she stayed late almost every day in order to learn as much about the business as possible.

Suddenly, she noticed something unusual about the trading of a convertible bond issued by Countrywide Financial Corporation (NYSE:CFC). Although the average daily trading volume on this bond had been only three thousand during the previous month, it had shot up to fifty thousand in the last three days.

Lucas remembered this particular bond. In fact, First Convergence was actually holding a slightly different convertible bond (known as the liquid yield option note or LYON) issued by the same company. On August 20, Countrywide had offered to exchange the new convertible bond for the original LYON. First Convergence had accepted the exchange offer, thus ending up with the new convertible bond. At that time, Lucas was asked to help evaluate the offer, so she was familiar with the features of both bonds.

“What’s happening?” she asked herself. She quickly checked the recent price movement on Countrywide’s stock. The stock had plunged 11.5 percent on Wednesday, October 20, after the company announced an earning below analysts’ expectations. On the same day, trading on the convertible shot up (see **Exhibit 1**). These two events must be related. But how?

### Countrywide Financial Corporation

Founded in 1969, Countrywide Financial Corporation was a member of the S&P 500, Forbes 2000, and Fortune 500. Through its family of companies, Countrywide provided mortgage banking and diversified financial services. During 2004, the growth of the company had been phenomenal. The shares of Countrywide rose 48 percent, outperforming the 1 percent drop in the S&P 500 index. On September 6, *Fortune* magazine ranked Countrywide Number 7 in its annual

list of “America’s Fastest Growing Companies.” However, home lending slowed shortly thereafter amid increasing interest rates. On October 20, the company announced an earning per share (EPS) of 94 cents for the third quarter, which fell short of the analyst consensus estimate of \$1.01 (see **Exhibit 2**). Analysts now worried whether recent growth had come at the expense of some profitability.

## The Exchange Offer

On August 20, Countrywide had announced an offer of up to \$675 million aggregate principal amount at maturity of its convertible securities due in 2031 (the “new securities”) in exchange for an equal amount of its LYONs (the “old securities”). Specifically, for each \$1,000 of principal amount at maturity of the old securities, Countrywide was offering to exchange \$1,000 of principal at maturity of the new securities and a cash payment of \$2.50.<sup>1</sup> The exchange offer expired at midnight on September 17.

The new securities differed from the old securities in only a few respects (see **Exhibit 3**). The most notable difference pertained to the terms of settlement on conversion. The new securities could be converted into a mixture of cash and Countrywide stock (newly issued upon conversion), while the old securities could be converted solely into Countrywide stock (newly issued upon conversion). Like the old securities, the new securities were both callable and puttable (see **Exhibit 4**). The closing price of the stock during the exchange offer period is provided in **Exhibit 5**.

As of the expiration date, \$637,177,000 (principal amount at maturity) of the old securities, representing 94.7 percent of the outstanding issue, had been tendered for the exchange.<sup>2</sup>

## Trading of the New Convertible Securities

The stock of Countrywide traded at an average price of \$37 in the previous month. At a conversion ratio of 46.2820, the average conversion value of the new convertible security ( $\$1,712.4 = 37 \times 46.282$ ) was much higher than its face value (\$1,000). Therefore, the conversion option embedded in the new security was deep in the money. For this reason, Mary Lucas conjectured that the new security should trade very much like the stock. To test her conjecture, she quickly pulled out the recent transaction prices on the new convertible security during the previous month. For each convertible security transaction, Lucas then found Countrywide’s corresponding stock transaction price occurring roughly at the same time.<sup>3</sup> Next, she plotted the two transaction price series (see **Exhibit 6**). Confirming her conjecture, the transaction prices of the stock and the convertible securities moved very closely.

Lucas also tabulated the daily closing prices of the convertible securities and the stock (see **Exhibit 7**) during the previous month. She then multiplied the stock prices by the conversion ratio (46.2820) to get the conversion values. On all dates, the convertible security prices were a

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<sup>1</sup> Countrywide Financial Corp., press release, August 20, 2004.

<sup>2</sup> Countrywide Financial Corp., press release, September 20, 2004.

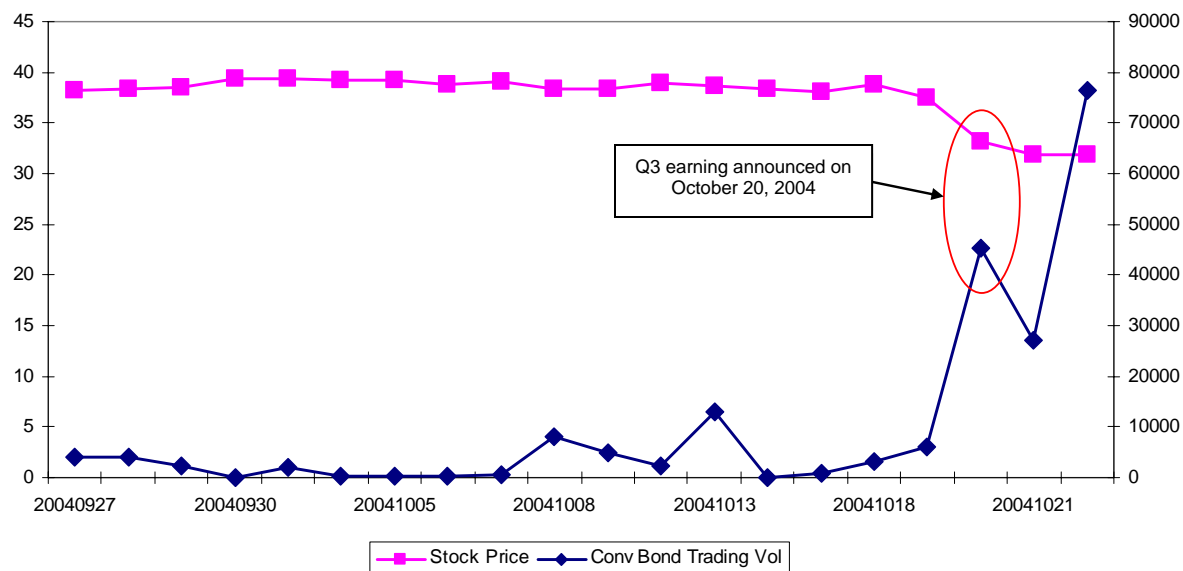
<sup>3</sup> The time difference between the convertible security transaction and stock transaction was less than ten seconds.

bit higher than the conversion values, reflecting the small but consistently positive value of the conversion option.

Based on the quick calculations she had made so far, Lucas could not identify any obvious reasons that would explain the sudden surge on the trading of the convertible bonds. She told herself to think harder as she really wished to figure out the situation before talking to her boss the next Monday.



**Exhibit 1:** Countrywide Financial Corporation Daily Stock Price and Convertible Bond Trading Volume since September 20, 2004



Sources: CRSP and TRACE

**Exhibit 2A:** Countrywide Financial Corporation Income Statement Highlights, September 30, 2004

	2004	2003
Revenue	\$2,245,607,000	\$2,923,370,000
Net income	582,241,000	1,100,067,000
Average shares (diluted)	620,844,000	571,152,000
Share earnings		
<i>Net income per share</i>	0.94	1.93
Nine months:		
Revenue	\$6,785,206,000	\$5,994,706,000
Net income	1,972,836,000	1,809,219,000
Average shares (diluted)	618,519,000	554,364,000
Share earnings		
<i>Net income per share</i>	3.19	3.26

Source: Countrywide Financial Corp., press release, October 20, 2004.

**Exhibit 2B: Countrywide Financial Corporation Balance Sheet, September 30, 2004 (\$ in thousands, except share data)**

	Sept. 30, 2004 (unaudited)	Dec. 31, 2003 (audited)	% Change
<b>ASSETS</b>			
Cash	\$595,261	\$633,467	(6%)
Mortgage loans and mortgage-backed securities held for sale	20,787,735	24,103,625	(14%)
Trading securities owned, at market value	9,390,977	6,996,699	34%
Trading securities pledged as collateral, at market value	2,828,990	4,118,012	(31%)
Securities purchased under agreements to resell	11,453,350	10,348,102	11%
Loans held for investment, net	34,928,215	26,368,055	32%
Investments in other financial instruments	8,480,827	12,761,764	(34%)
Mortgage servicing rights, net	8,153,203	6,863,625	19%
Premises and equipment, net	917,180	755,276	21%
Other assets	6,852,714	5,029,048	36%
<i>Total assets</i>	<i>\$104,388,452</i>	<i>\$97,977,673</i>	<i>7%</i>
<b>LIABILITIES</b>			
Notes payable	\$43,155,390	\$39,948,461	8%
Securities sold under agreements to repurchase	21,124,329	32,013,412	(34%)
Deposit liabilities	18,732,698	9,327,671	101%
Accounts payable and accrued liabilities	8,476,662	6,248,624	36%
Income taxes payable	2,877,510	2,354,789	22%
<i>Total liabilities</i>	<i>\$94,366,589</i>	<i>\$89,892,957</i>	<i>5%</i>
Commitments and contingencies	—	—	—
<b>SHAREHOLDERS' EQUITY</b>			
Preferred stock—authorized, 1,500,000 shares of \$0.05 par value; none issued and outstanding	—	—	—
Common stock—authorized, 1,000,000,000 shares of \$0.05 par value; issued, 565,269,737 and 553,471,780 shares at September 30, 2004, and December 31, 2003, respectively; outstanding, 565,236,558 and 553,449,278 shares at September 30, 2004, and December 31, 2003, respectively	28,263	27,674	2%
Additional paid-in capital	2,495,841	2,289,082	9%
Accumulated other comprehensive income	61,179	164,526	(63%)
Retained earnings	7,436,580	5,603,434	33%
<i>Total shareholders' equity</i>	<i>\$10,021,863</i>	<i>\$8,084,716</i>	<i>24%</i>
<i>Total liabilities and shareholders' equity</i>	<i>\$104,388,452</i>	<i>\$97,977,673</i>	<i>7%</i>

**Exhibit 3: Material Differences Between the Old Securities and New Securities**

	Old Securities	New Securities
Notes offered	<p>\$675,000,000 aggregate principal amount at maturity of old securities.</p> <p>On February 8, 2001, each old security was issued at a price of \$741.37 per old security and a principal amount at maturity of \$1,000.</p>	<p>Up to \$675,000,000 aggregate principal amount at maturity of new securities.</p> <p>The initial accreted principal amount per new security will be deemed to equal the accreted principal amount per old security on the date the new securities are issued (the "exchange date").</p>
Settlement upon conversion	<p>Upon conversion of old securities, we will deliver shares of our common stock.</p>	<p>Upon conversion of new securities, we will deliver, for each \$1,000 principal amount at maturity of new securities:</p> <ul style="list-style-type: none"> <li>▪ Cash (the "cash amount") in an amount equal to the lesser of (a) the accreted principal amount of the new securities<sup>a</sup> and (b) the product of the conversion rate (46.2820 after giving effect to our August 30, 2004, stock dividend, but subject to adjustment) multiplied by the average of the closing price of our common stock (on the New York Stock Exchange or such other national or regional securities exchange or market as described herein) for each day of the twenty-day cash settlement averaging period (the "stock price"); and</li> <li>▪ A number of shares of our common stock equal to (a)(i) the conversion rate multiplied by the stock price, minus (ii) the cash amount, all divided by (b) the stock price.</li> </ul>
Conversion rate adjustments for cash dividends	<p>None, except for extraordinary cash dividends.</p>	<p>The conversion rate will be adjusted, subject to certain limitations, for cash distributions to all holders of shares of our common stock, excluding (a) any dividend or distribution in connection with our liquidation, dissolution, or winding up, or (b) any quarterly cash dividend on our common stock to the extent that such quarterly cash dividend does not exceed the dividend threshold amount; the "dividend threshold amount" means \$0.10 per share and is subject to adjustment on the same basis as the conversion rate, provided that no adjustment will be made to the dividend threshold amount for any adjustment made to the conversion rate pursuant to this provision; in the event of a dividend or distribution to which this provision applies, the conversion rate will be adjusted by multiplying the conversion rate in effect immediately prior to such adjustment by a fraction:</p>

. . . . .

**Exhibit 3 (continued)**

	Old Securities	New Securities
Conversion rate adjustments for cash dividends (continued)		<ul style="list-style-type: none"> <li>The numerator of which will be the current market price of our common stock; and</li> <li>The denominator of which will be the current market price of our common stock minus the amount per share of such dividend or distribution (or a portion of such dividend or distribution, as determined below).</li> </ul> <p>If an adjustment is required to be made as a result of a quarterly cash dividend, the adjustment will be based upon the amount by which the distribution exceeds the dividend threshold amount. If an adjustment is required to be made under this clause as a result of a cash distribution that is not a quarterly cash dividend, the adjustment will be based upon the full amount of the distribution.</p>
Contingent interest	<p>The amount of contingent interest payable per old security in respect of any applicable six-month period will be equal to the greater of:</p> <ul style="list-style-type: none"> <li>0.125% of the average market price of an old security for the five-trading-day period ending on the second trading day immediately preceding the first day of the applicable six-month period; or</li> <li>The sum of all regular cash dividends paid by us per share on our common stock during that six-month period multiplied by the number of shares of common stock issuable upon conversion of an old security on each such payment date.</li> </ul>	<p>The amount of contingent interest payable per new security in respect of any applicable six-month period will be equal to the greater of:</p> <ul style="list-style-type: none"> <li>0.125% of the average market price of a new security for the five-trading-day period ending on the second trading day immediately preceding the first day of the applicable six-month period; or</li> <li>A fixed amount multiplied by the conversion rate in effect on the accrual date for such contingent interest payment.</li> </ul> <p>The "fixed amount" will be equal to \$0.20 and will be adjusted on the same basis as the conversion rate.</p>
Purchase of new securities by CFC at the option of the holder	<p>We have the option to satisfy all or a portion of the purchase price of old securities that the holders require us to purchase (other than purchases in connection with a change in control) with our common stock, with the number of shares to be delivered being equal to (a) the amount of cash to which the holders are otherwise entitled to receive (or, if less, the portion of such amount that we have elected to settle with common stock), divided by (b) the market price of our common stock.</p>	<p>We must satisfy all of the purchase price of new securities that holders require us to purchase in cash.</p>

<sup>a</sup> Accreted principal amount of the new securities.

Year	2004	2004	2005	2005	2005	2005	2006	2006	2006	2006	2007	2007	2007	2007
Quarter	3	4	1	2	3	4	1	2	3	4	1	2	3	4
	766.89	768.74	770.60	772.45	774.76	776.61	778.46	780.31	782.17	784.48	786.33	788.18	790.03	792.35

Source: Prospectus of Countrywide Financial Corporation's exchange offer

**Exhibit 4: Call and Put Features of the Old Securities and New Securities**

Call feature: redemption of new securities at the option of CFC We may redeem all or a portion of the new securities for cash at any time on or after February 8, 2006, at the redemption prices set forth in the following call schedule:

Feb. 8,		Feb. 8,	
2006	\$779.28	2019	\$887.18
2007	787.10	2020	896.08
2008	794.99	2021	905.06
2009	802.96	2022	914.14
2010	811.01	2023	923.30
2011	819.14	2024	932.56
2012	827.35	2025	941.90
2013	835.64	2026	951.35
2014	844.02	2027	960.88
2015	852.48	2028	970.52
2016	861.03	2029	980.25
2017	869.66	2030	990.07
2018	878.38	maturity	1,000.00

Put feature: purchase of new securities by CFC at the option of the holder Holders may require us to purchase for cash all or a portion of their new securities on February 8, 2006 for a price equal to \$779.28 per new security, on February 8, 2011 for a price equal to \$819.14 per new security, on February 8, 2016 for a price equal to \$861.03 per new security, on February 8, 2021, for a price equal to \$905.06 per new security, and on February 8, 2026 for a price equal to \$951.35 per new security.

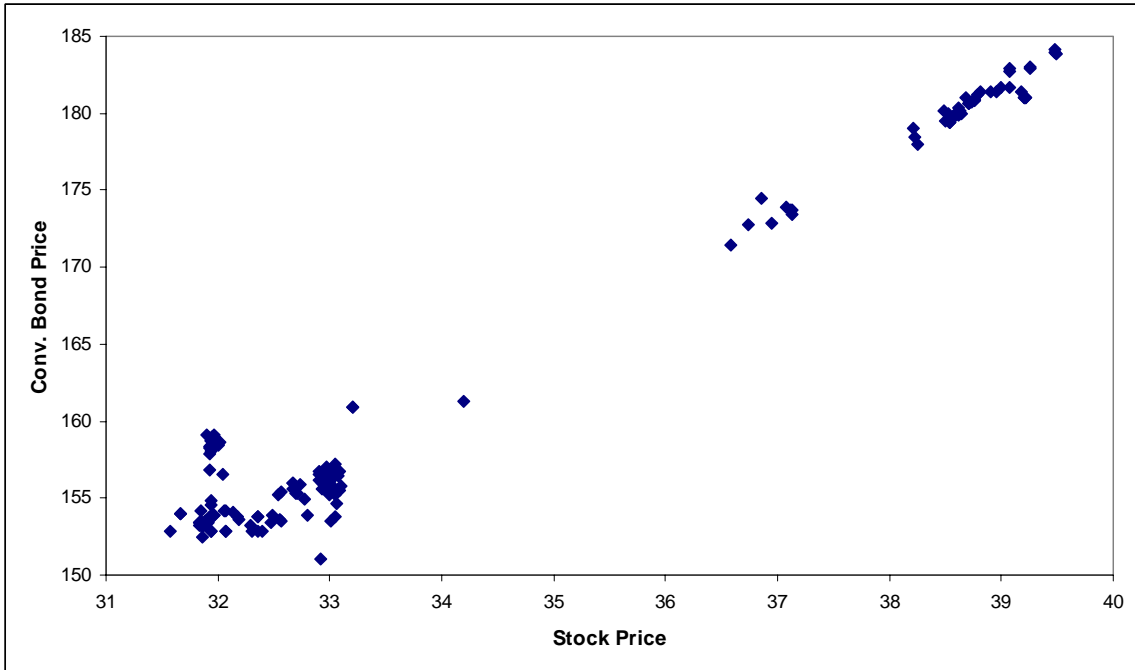
Source: Prospectus of Countrywide Financial Corporation's exchange offer

**Exhibit 5: Closing Prices of Countrywide Stock During the Period When the Exchange Offer Is Valid (August 20–September 17)**

Date	Closing Stock Price	Average Twenty-Day Closing Price	Convertible Bond Price (per \$100 par) "Old Security"
8/20/2004	34.350	34.55325	160.125
8/23/2004	34.375	34.51150	160.438
8/24/2004	34.390	34.45775	161.387
8/25/2004	34.360	34.38800	159.500
8/26/2004	34.725	34.33475	161.125
8/27/2004	34.800	34.27225	162.000
8/30/2004	34.470	34.16650	160.000
8/31/2004	35.550	34.15525	165.500
9/1/2004	35.890	34.24275	164.875
9/2/2004	36.330	34.38550	168.625
9/3/2004	36.630	34.54550	169.800
9/7/2004	37.310	34.74100	174.250
9/8/2004	37.120	34.89400	168.000
9/9/2004	36.540	35.04250	172.438
9/10/2004	36.050	35.19350	168.000
9/13/2004	36.510	35.36050	170.375
9/14/2004	36.770	35.48600	170.438
9/15/2004	37.450	35.63575	175.000
9/16/2004	37.920	35.78825	172.167
9/17/2004	37.500	35.95200	173.750

Note: Stock prices are adjusted for split as of August 20, 2004. The convertible bond (the old security) prices are obtained from TRACE. They are the last trade prices.

**Exhibit 6:** Countrywide Financial Corporation Transaction Prices of the New Convertible Securities vs. Transaction Prices of the Stock from September 23, 2004 to October 22, 2004



Source: The transaction prices of the convertible securities are obtained from TRACE with a minimum trading volume of 5. The transaction prices of the stock are obtained from NYSE TAQ.

**Exhibit 7: Countrywide Financial Corporation Daily Closing Prices of the Stock and the New Convertible Securities**

Date	Price of the New Convertible Security per \$100 par (1)	Stock Price (2)	Conversion Rate (46.282) × (2)
9/27/2004	179.125	38.20	1,767.97
9/28/2004	179.750	38.34	1,774.45
9/29/2004	180.250	38.56	1,784.63
9/30/2004	184.125	39.39	1,823.05
10/1/2004	183.875	39.34	1,820.73
10/4/2004	183.250	39.21	1,814.72
10/5/2004	183.125	39.17	1,812.87
10/6/2004	181.375	38.80	1,795.74
10/7/2004	182.750	39.10	1,809.63
10/8/2004	179.125	38.30	1,772.60
10/11/2004	179.500	38.39	1,776.77
10/12/2004	181.750	38.89	1,799.91
10/13/2004	180.875	38.68	1,790.19
10/14/2004	179.125	38.30	1,772.60
10/15/2004	178.375	38.14	1,765.20
10/18/2004	181.125	38.75	1,793.43
10/19/2004	175.375	37.50	1,735.58
10/20/2004	156.750	33.17	1,535.17
10/21/2004	152.750	31.89	1,475.93
10/22/2004	158.250	31.90	1,476.40

Source: Bloomberg