May 13, 2020

Creating Liquidity during the COVID-19 Pandemic: Convertible Bonds

In the face of unprecedented shocks to their businesses and uncertain future cash flows, companies have, for the past two months, taken aggressive steps to stockpile liquidity: first by drawing existing lines of credit and then by exploring more creative options. Among the most popular approaches over the past month has been the issuance of convertible bonds: the number and volume of these offerings in April represented a massive jump in this activity by a variety of historical metrics.

These instruments can be an elegant solution for many companies in need of financing in the current environment: they typically bear interest at lower rates than regular-way debt (which is particularly attractive when businesses are looking to build and preserve as much cash as possible), contain few restrictions on the operations of the company, as a result are relatively quick to negotiate and execute, and generally set the conversion price at a substantial premium to current market price so that the dilution to stockholders is less than the result of a straight equity offering. The market has also developed complex derivative products (including call-spread transactions and capped calls) to help companies hedge this risk of dilution.

From the investor's perspective, in the face of uncertain equity markets and relatively low equity values, the debt portion of these instruments provides a hedge on equity downside, and the conversion feature provides an opportunity to capitalize on an economic recovery.

But these instruments, like any other financial products, are not without their tradeoffs. Listed below are some considerations for companies considering issuing convertible debt:

- **Examine Existing Debt:** A company's existing debt documents may treat convertible notes (and any related derivative transactions) in unexpected ways, including by prohibiting them altogether, restricting the company's ability to make required payments on such instruments or treating certain events under the convertible notes or derivatives as defaults under the existing debt. Before embarking on a convertible offering, an issuer should scour its existing debt documents and create a plan to obtain any required consents from existing creditors.

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- **Scrutinize the Hedge:** While on their face, hedging products offer promising solutions to the equity dilution that convertible notes can create, companies should focus on the hedge-specific risks before entering into this portion of a convert transaction. First, their upfront cash costs can be substantial. Second, their terms are somewhat opaque and complex, and at their core give the counterparties broad discretion over many aspects of the transaction, including calculating the costs of unwind and, under certain circumstances, adjusting the economics of the deal. This is particularly true if the company undertakes a significant corporate transaction during the life of the bonds, such as a spin-off or business combination. While in some instances it is possible to negotiate bespoke adjustments up front, such transactions can trigger substantial cash costs under the convertible notes and (oftentimes in unexpected and unpredictable ways) under any related derivative instrument. When considering these instruments, issuers should take into account any short- or long-term plans they may have to engage in such transactions.

- **Analyze the Model:** Issuers should work with their financial advisors to model various scenarios (including the impacts of payment of cash dividends and of potential fundamental corporate transactions) and the associated costs (including any resulting adjustments to the conversion rate and their impact on expected dilution), so that they have a full picture of the potential costs of these instruments. Issuers should also anticipate a short-term impact on their stock price, which can be negative (as a result of potential dilution and hedging activity by purchasers of notes), consider their tolerance for such an impact, and evaluate whether a contemporaneous derivative transaction by the issuer may mitigate some of these effects.

- **Focus on Tax and Accounting:** These products raise complex and important questions with respect to tax and accounting treatment. Issuers should involve their tax and accounting advisors early in the process, especially in transactions involving hedges, so that they can fully understand the options and tradeoffs and craft the instruments in ways that will suit their particular needs.

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