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Understanding Structured Debt and Private Convertibles

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Types of Convertibles We Will Cover Today

Convertibles can be issued by different types of companies using different marketing strategies and can be structured in a number of ways – today, we will focus on private convertibles issued by both private and public companies

Marketing Strategy	Company Type	Conversion Method	Underlying Security
Public	Post-IPO (Public)	Regular / Optional	Debt
Private	Pre-IPO (Private)	Mandatory / Auto	Preferred

A Quick Recap on the Basics of a Convertible Bond

While technically a convertible is a "discounted bond" plus "equity options," a better way to understand convertibles is to look at the various cash and share flows at various stages of the security

- **Initial Assumptions**
  - Company wants to raise $100
  - Convertible terms are "1% up 25%"
    - Coupon (Interest Rate) = 1%
    - Conversion Premium = 25%
  - Current Stock Price = $8.00
  - Conversion Price = $8.00 x (1 + 25%) = $10.00
  - # of Conversion Shares = Amount Raised / Conversion Price = $100 / $10 = 10 shares
  - Therefore, the convertible bond entitles the investor to receive (i) 10 shares or (ii) $100 back at maturity
- **At Inception**
  - Issuer: Receives $100 from the investor and delivers a convertible bond
  - Investor: Receives a convertible bond and delivers $100
- **Interim Period**
  - Issuer: Pays annual interest in two semi-annual payments (1% x $100 = $1.00 annually; $0.50 semi-annually)
  - Investor: Receives the semi-annual interest payments
    - Even if stock performs well, investors are unlikely to convert their securities early as they can retain the option value and continue to receive coupons

A Quick Recap on the Basics of a Convertible Bond (Cont'd)

- **At Maturity**
  - Depending on the stock price, the investor chooses to receive $100 back ("Redemption") or ask for 10 shares ("Conversion")
  - While the choice of "redemption" vs. "conversion" resides with the investor, the issuer can settle the conversion in cash, shares, or combination at its option as long as it delivers an equal amount of value to the investor [(1)]

Stock at Maturity	Conversion Value	Redemption Value	Investor Chooses to	Value to be Received by Investor	Issuer Chooses to Deliver Cash / Share / Combination [(1)]
$9.99	$99.90	$100.00	Receive $100 in cash ("Redemption")	$100.00	Can deliver $100 only in cash
$15.00	$150.00	$100.00	Receive 10 shares ("Conversion")	$150.00	Can deliver $150 / 10 shares / any combination of cash and shares
$30.00	$300.00	$100.00	Receive 10 shares ("Conversion")	$300.00	Can deliver $300 / 10 shares / any combination of cash and shares

1. *Assumes a convertible with flexible settlement. For a net share settled convertible, the issuer will always deliver the principal amount back in cash and only the in-the-money amount can be settled in cash, shares, or a combination at the issuer's option.*

Why Consider a Convertible Bond

Convertible securities can offer a number of unique benefits and negatives vs. other financing alternatives

Benefits and Negatives for Issuers

Compared to Equity

- ✓ Does not have to issue in a registered deal
- ✓ Sell stock at a premium to today's stock price
- ✓ Reduce dilution further by settling principal amount in cash at maturity and by executing a call spread
- × Leverage and need for repayment

Compared to Debt

- ✓ No restrictive covenants and no need for ratings
- ✓ Materially lower interest expense
- ✓ Quicker process
- ✓ Underwriters can pick up coverage
- × Equity dilution
- × Potential stock price impact on the day of the deal

Benefits and Negatives for Investors

- ✓ Higher risk-adjusted returns given downside protection and upside participation
- ✓ Ability to employ volatility monetization trading strategy
- ✓ Capture a modest yield vs. equity
- × Potentially lower absolute returns when equity markets outperform
- × Less liquidity vs. the equity markets

Public vs. Private Convertible Offering

	Public Convertible	Private Convertible
Description	• Publicly marketed 144A or registered transaction to a large group of investors	• Confidential marketing to a small group of investors
Marketing	• 2-3 week process • 1 day of public marketing; can optionally include 2-3 days of private marketing under a wall cross agreement	• 6-8+ week process • 2-4+ weeks of marketing and negotiation under an NDA

Structuring	• Some flexibility as to the terms, but options are more standardized
	  – Example: 5-7 yr senior unsecured bond, cash coupon, provisional call with a make-whole after 3-4 years, change of control make-whole
		• Greater flexibility, depending on negotiating leverage
		  – Example: Cash vs. PIK, early redemption
		• However, some investors are also likely to ask for incremental protection or value
		  – Example: Secured vs. unsecured, warrants, conversion price reset, incurrence covenants, OID, etc.

Sizing and Deal Terms	• Size and terms are based on stock technicals, particularly "stock borrow" availability • Generally low single digit coupon, 20-40% conversion premium • High degree of certainty around execution and terms	• Size may not be limited by stock technicals – more dependent on issuer need and investor check size • Mid-single digit coupon or higher, ~20-25% conversion premium • Variability around execution and terms
Stock Impact	• Stock is often down 5-15%+ during the day of marketing (often 1 day of market exposure)	• Convertible is generally priced off of "unaffected" stock price • Stock price performance upon announcement can vary – an attractive deal may result in a positive stock impact

Public vs. Private Convertible Offering (Cont'd)

	Public Convertible	Private Convertible
Typical Investors	• Long-only convertible funds, hedge funds, equity income funds	• Strategic investors, sovereign wealth funds, private equity investors, equity and credit investors, hedge funds, and other special situations investors
Bank Syndicate	• While the lead left bank and the advisor complete most of the work, issuers can select a large group of banks, and banks can pick up coverage	• 1-2 banks; banks often do not pick up coverage • In certain reverse inquiry situations, issuers may hire only an advisor
Call Spread	• Common practice to raise conversion premium by purchasing a hedge from banks	• Uncommon
Governance	• None	• Potentially board seats, particularly for large checks
Others	• Includes standard anti-dilution protection and change of control make-whole	• May include transfer and hedging restrictions, minority investor protections, registration rights, and standstill agreement

Key Private Convertible Structuring Terms

Consideration	Alternatives	Comments
Security Type	Bond; Preferred	• The convertible security can have either a bond or preferred stock as the base instrument – Depends on the issuer's covenants and need for rating agency equity and investor's particular desire to invest in preferred format vs. bond protection
Maturity	Redeemable; Perpetual	• Bonds always have a dated maturity while preferreds can be perpetual or can have a shorter redemption date – Longer dated preferred securities have higher equity credit but terms tend to be worse
Issuer Call Right	Yes; No	• An early call allows the issuer to pay down the security early • Since an early call also reduces option value, investors prefer to not have early calls
Issuer Provisional Call / Forced Conversion Right	Yes; No	• In a provisional call / forced conversion right, an issuer can call the securities and force conversion if after a pre-set non-call period, stock price > 130-200% of the conversion price for 20 trading days in a 30-consecutive day period
Investor Put Right	No; Par; Premium	• Some securities may have an early investor put right which creates a shorter effective maturity – Redemption amount can be par or can be a premium to par which allows investors to target a minimum IRR
Coupon	Cash; PIK; Cash or PIK	• Private convertibles often allow issuers to pay coupon in cash or in PIK, although there may be limitations on how much of the coupon / how long the coupon can be paid in PIK – PIK rate is generally higher than cash coupon

Key Private Convertible Structuring Terms (Cont'd)

Consideration	Alternatives	Comments
Conversion Premium Method	Avg of VWAP / Last Trade	• While the conversion price can be set off of the last trade or an average of the VWAP for disclosure purposes, the conversion price / premium is mostly driven by the investor's stock price views
Conversion Price Reset	Yes / No	• Some transactions include a downward reset (subject to a floor) in the conversion price either for a period of time after announcement or based on an observation period in the future – Downward resets are not common and are often seen in pre-deSPAC convertibles
Equity Upside	Incremental Warrants / No Warrants	• Incremental warrants can increase equity return for the investors but make the security more dilutive • Generally added as a sweetener
Anti-Dilution Adjustments	Public-Style / Incremental	• Convertibles include customary protections for stock splits, stock dividends, rights distribution, asset or other distribution • Some investors may demand adjustments for dilutive capital raises either through a full rachet or a partial rachet through a formula
Voting Rights	As-Converted / None	• Most private convertible preferreds include the right to vote on an as-converted basis
Board Representation	Board Seat / Board Observer / None	• Most sizable investments, particularly by PE firms, include board seats • Board seats are typically a function of investment size / equity stake

Key Private Convertible Structuring Terms (Cont'd)

Consideration	Alternatives		Comments
Transfer & Hedging Restrictions	Yes	No	• Investors are generally precluded from transferring and hedging the securities for a period of time – the exact time period is a negotiation item • Investors may ask for a carve out to transfer to a margin loan provider
Change of Control	Public-Style	Bespoke	• Public-style change of control treatment includes two protections: investors can either (1) receive par in cash or (2) convert the securities and receive incremental make-whole shares • Some private deals have different change of control mechanisms (e.g. premium redemption that guarantees a minimum IRR, etc.)
Minority Investor Protections	Yes	No	• Can include limitations on additional preferred stock issuance, investor consent for certain asset sales or corporate transactions, and limitations on amendments that adversely affect the investor without its consent
Registration Rights	Demand Rights	Piggyback Rights	• Investor can require the Company to register its securities in a public offering initiated by the investor ("demand rights") or by the Company / another investor ("piggyback rights") • It is customary to include both rights for the investor
Standstill	Yes	No	• Often included but exact terms are negotiated

Convertible Sizing and Pricing Calculations

For a public convertible offering, there are three primary technical considerations that need to be satisfied in order to launch an offering with a high likelihood of success and optimal pricing; Private deal sizing is primarily based on an investor's willingness to deploy capital and an issuer's need for capital and willingness to incur dilution

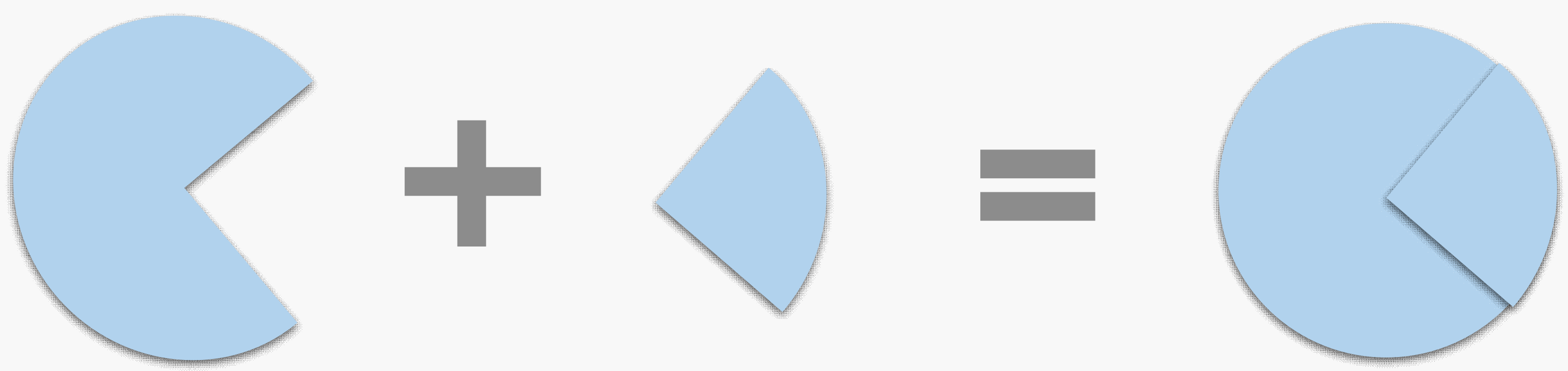
- **Below we show (1) the sizing parameters with respect to stock technicals for public convertibles and (2) also actual calculations for a recent private deal we worked on**

Deal Metrics	Rule of Thumb	Recent Private Deal
% of Market Capitalization	**Up to ~20%**	**~40%**
Multiple of Stock Trading Liquidity	**Up to ~20x**	**~70x**
Multiple of "Stock Borrow"	**Up to 2x**	**~90x**

Convertible Sizing and Pricing Calculations (Cont'd)

Theoretically valuing a convertible security requires ascertaining (1) the company's credit spread to value the bond / preferred component and (2) the company's volatility to value the option component

Theoretical Value of a Convertible Bond = Value of the Bond Component + Value of the Option Component



- **Value the bond component using the company's debt rate / credit spread**
- **Value the option component by using the company's expected volatility**
- **In a public convertible, total package is worth ~100-104%**

Convertible Sizing and Pricing Calculations (Cont'd)

However, investors in a private convertible may use other methodologies, such as equity valuation and expected IRR / MOIC, precedent deals, etc. to value a security in addition to looking at the theoretical valuation

- **Private Convertibles are Valued Differently by Different Investors**
  - Purely financial investors are likely to ask for a 110-120% theoretical valuation for a security
  - However, other investors will look at the current equity valuation and run IRR / MOIC models based on future equity valuations
- **Practical Implications for Issuers**
  1. As a starting point, incremental cheapness vs. a public deal translates into 1-3%+ higher coupon
  2. However, terms differ significantly depending on type of investor and interest in the company
     a. *If equity is undervalued and a blue chip investor wants to invest in the company, private convertible terms may be similar to or even slightly better than public convertible terms*
     b. *On the other hand, if public markets are weak / stock technicals are challenged, a deal sold to purely financial investors will have materially worse terms vs. a normal convertible*
  3. Also, there may be massive variability between what an issuer sees from a bank in terms of "indicative" terms and actual terms
  4. Deal is set off of the "unaffected" stock price, so while headline terms might be worse, all-in terms may still be more attractive

A Private Convertible is Priced off of the "Unaffected" Stock Price

Hedge funds in a public convertible "delta hedge" the security by shorting a portion of the underlying shares on the day of marketing

1		*Deal Size (Including Overallotment Option)*	• Assume a $100mm deal
2	x	*Hedge Fund Allocation*	• Assume a 50% hedge fund / 50% long-only allocation for our deal
3	x	*Delta %*	• Amount of shares shorted for every $100 bond ("Bond Delta") tends to be in the 50 – 55% area • Assume 50% delta for our calculations
	=	*Total $ Amount Hedge Funds Need to Short*	• Total Hedge Fund Shorting = $100mm x 50% hedge fund allocation x 50% delta = $25mm
4	less	*Any Share Purchase by Company*	• Share repurchase can be executed either as a (1) "delta" share repurchase by the issuer or (2) share purchase by banks in connection with a call spread
5		*or by Capped Call Banks*	
	=	*Net Shares Shorted in the Market*	• Absent any share buyback, net short to the market would be ~$25mm shares per $100mm offering in our example

A Private Convertible is Priced off of the "Unaffected" Stock Price (Cont'd)

Stock price typically declines on the day of public convertible marketing; Since private deals are marketed privately and are generally priced off of the "unaffected" stock price, the effective conversion premium is likely to be higher as illustrated by the following calculations

	Private Deal	Comparable Public Deal
Pre-Launch Stock Price	$100.00	$100.00
Coupon	5.00%	3.00%
Conversion Premium	30.0%	30.0%
Illustrative Stock Price Impact	-	(15%)
Stock Price @ Pricing	$100.00	$85.00
Conversion Price	$130.00	$110.50
Conversion Premium vs. Unaffected Stock Price	30.0%	10.5%

200bps higher coupon in a private deal

We have assumed stock price declines by 15% on the day of the deal

However, effective conversion premium is ~20% higher

Depending on the attractiveness of the deal and the quality of the private investor, the "halo effect" may help stock price upon the announcement of a private deal; On the other hand, if the transaction is perceived negatively or if investors short shares after the deal, stock price may decline after the deal

A Private Convertible Process is Significantly Longer and Certainty of Execution is Lower vs. a Public Deal

Public Convertible Execution Timeline: 2-3 Weeks

~2 weeks
- Conduct Due Diligence, Prepare Transaction Documents, and Marketing Materials

~1 day
- Launch and Market Transaction
- Price Transaction

~2 days
- Finalize Closing Documents and Close/Fund

1-2 weeks
- Complete Post-Closing Items

Private Convertible Execution Timeline: 6-8+ Weeks [1]

~2 weeks
- Preparation of Marketing Materials, Data Room, and Investor Targeting

~2-4 weeks
- Marketing / Diligence
  - Initial Investor Outreach
  - Meetings & Investor Diligence
  - Receive & Analyze Term Sheets

~2-4 weeks
- Execution
  - Finalize Investors
  - Negotiate & Finalize Terms
  - Finalize Documents & Announce

1-2 weeks to 1-2 months
- Complete Post-Closing Items

1. *Timing could be shortened to 4-6 weeks if there is a reverse inquiry.*

Private Convertible Investors

Strategic Investors

- Often a larger company that is interested in building a new business relationship or enhancing an existing partnership
- Business terms may be more important than financial terms
- Requires long-term relationship building by the issuer

Sovereign Wealth Funds & PE Firms

- Blue chip real money investors, such as sovereign wealth funds, private equity firms, and family offices
- Equity story is critical – equity valuation is more important than financial terms
- A deal is often easier if the fund is an existing equity investor

Equity Investors

- Existing equity investors that have the mandate to invest in convertible securities and are interested in increasing equity ownership
- Equity story is critical – equity valuation is more important than financial terms

Credit Investors

- Credit-focused funds that want to invest in a security with downside protection
- Requires a minimum fixed income IRR – incremental return comes from the option
- Often have strict guidelines around type of company to invest in

Convertible & Other Investors

- Traditional convertible funds, multi-strategy hedge funds, special situations investors, etc.
- Highly focused on terms and often require incremental structural elements to reduce downside risk / increase upsize participation

When to Consider a Private Convertible?

While private convertibles can provide benefits vs. a public convertible, the process is long and execution risk is higher; therefore, private convertibles should be a tactical tool in your toolkit used only in specific circumstances

Reverse Inquiry from a "Halo Investor"

- *A "halo investor" (i.e. a high quality strategic investor, a sovereign wealth fund, a private equity fund, or a blue chip equity investor) wants to invest in the company*
- Consider the capital need vs. check size, potential dilution, private terms vs. public terms, and value of the "halo effect"

Capital Need in a "Special Situation"

- *An M&A or a cap structure refinancing where public marketing is not possible due to the complexity and confidentiality around the transaction*
- A convertible may appeal to private investors as it provides downside protection with equity upside and allows investors to capture value from the positive news

Issuer with Limited Stock Technicals

- *Stock technicals and / or market conditions are challenging and synthetic borrow creation strategies are not available or useful*
- Can approach a handful of private convertible investors and negotiate a deal
- Terms are likely to be materially worse than what would be available in a normalized public deal

Precedent Private Convertible Securities

	Cepton	Unity	2U	ChargePoint	Rockley Photonics
Date	• October 2022	• July 2022	• January 2023	• March 2022	• June 2022
Size	• $100mm	• $1.0bn	• $147mm	• $300mm	• $81.5mm plus $81.5mm overallotment
Offering Type	• Perpetual Convertible Preferred Stock	• Senior Unsecured Convertible Notes	• Senior Unsecured Convertible Notes	• Senior Convertible Notes	• Senior Secured Convertible Notes and 1.0x Warrants
Maturity	• Perpetual	• 5 Years	• 7 Years	• 5 Years	• 4 Years
Coupon	• 3.25% Cash or 4.25% PIK	• 2.00%	• 4.50% Cash	• 3.50% Cash or 5.00% PIK	• 9.50% Cash or 5.75% Cash *plus* 6.25% PIK
Conversion Feature	• 10% premium to 20-day VWAP prior to announcement	• 23% premium to last close	• ~42% premium to last close	• 30% premium to 3-day VWAP after announcement	• 10% to last close
Stock Reaction	• (3.9%)	• (17.5%) [1]	• +14.4%	• (5.1%)	• (16.8%)
Investors	• Strategic (Koito Manufacturing)	• Private Equity and VC (Silver Lake – 94%, Sequoia – 6%)	• Equity Investors (Greenvale Capital & The Berg Family Trust)	• Credit / Special Situations Fund (Antara)	• Hedge / Special Situations Funds (ATW, Wazee, Highbridge, Whitebox)

1. Concurrently announced merger with ironSource

Source: ICR Capital, SEC filings, Bloomberg.

Pre-IPO Convertible Security

A pre-IPO convertible is a bond or a preferred security that is issued by a pre-IPO company that can be converted into equity in the future

Overview	• A bond or a preferred security that is issued by a pre-IPO company and that can be converted into equity in the future • Often issued by companies that are considering an IPO in the near-to-medium term and viewed as the last financing round before an IPO • There are generally two primary variations of pre-IPO convertible bonds: – Security that automatically converts into equity at the time of the IPO, often at a discount to the IPO price – Security that becomes a post-IPO convertible security at the time of the IPO
Benefits	• Raise capital potentially at a premium to the current equity valuation • Defer valuation discussion until time of IPO / avoid a "down round" • Diversify investor base
Negatives	• Structural complexity – some features may have higher cost / may limit flexibility in the future, particularly if the Company delays its IPO plans • Equity-like overall cost of capital (but yield and downside protection can make a deal easier to sell vs. equity raise) • Given pre-IPO convertibles are not market standard, requires investor education; many investors may still not participate in a pre-IPO convertible round
Types of Investors	• Existing investors and sector specialists • Sovereign wealth funds, pension funds, PE firms, credit funds, and cross-over investors • Multi-strategy funds / hedge funds
Precedents	• Both marquee companies as well as mid-sized private companies considering an IPO in the near-to-mid term have issued pre-IPO converts before – Select marquee issuers include Prada (2001), Glencore (2009), American Energy Partners (2014), Uber (2015), Spotify (2016), DoorDash (2020), Gopuff (2021), Telegram (2021), Robinhood (2021), Rivian (2021), Arctic Wolf (2022), Doral Renewables (2022) • While pre-IPO convertible securities are not nearly as common as post-IPO convertible securities, there has been more interest in pre-IPO convertibles in recent months

Variations of Pre-IPO Convertibles

There are a number of pre-IPO convertible structures, including convertible bonds that convert into equity at the time of IPO, convertible bonds that become a post-IPO convertible at IPO, convertible preferreds that have a pre-set equity valuation, debt/preferred with warrants, etc; Below we have outlined the two primary variations of pre-IPO convertible bonds

	1. Security that Automatically Converts into Equity at IPO	2. Security that Survives an IPO and Becomes a Post-IPO Convertible
Description	• A pre-IPO convertible security that converts into equity at the time of the IPO either at a pre-set discount to the IPO price or at a pre-set valuation	• A pre-IPO convertible security that does not convert into equity at IPO, rather stays on the issuer's balance sheet as debt and becomes a convertible security that may convert into equity in the future
Benefits	• More common pre-IPO convertible structure • Potentially simpler/less complex	• Potentially higher conversion price • May appeal more to credit investors
Negatives	• Equity sold at a discount to IPO • Potential impact to IPO demand, particularly if the convertible round is too large	• More complex • Hedging/shorting in the future post-IPO if transferred to convertible arbitrage investors / hedge funds • Leverage on the balance sheet post-IPO
Precedent Transactions	• Common structure – nearly all the pre-IPO convertibles use this structure	• Arctic Wolf is the first sizable deal of this variation, and more issuers are now considering this structure
Potential Investors	• Existing investors, sovereign wealth funds, pension funds, PE firms, cross over investors, and multi-strategy funds / hedge funds	• In addition to pre-IPO investors, may attract some credit funds, hedge funds, and post-IPO convertible investors • However, structural complexity may discourage some equity investors

Key Provisions in a Pre-IPO Convertible

Provisions in a pre-IPO convertibles are highly negotiated; however, we have outlined key structural items below

Interest	• Historically used to be in the low-to-mid single-digit area, but in recent deals, investors have demanded high single-digit / low double-digit coupons – Ultimately depends on an issuer's credit quality as well as equity story – In certain cases, coupon is initially lower and then steps up after ~12 months – Coupon is often structured as PIK since issuers are often high growth companies with limited free cash flow
Conversion Premium / Discount	• For an automatic conversion security, discount is generally 10-30% to IPO Price – In rare cases (example: DoorDash), the convert could be convertible at IPO price without any discount – Security may also include a "valuation cap" • For the premium conversion security, conversion price could be 10-30% premium to the IPO Price – Arctic Wolf had a "lower of" provision where conversion price was the lower of (1) a modest premium to the last round valuation and (ii) a 25% premium to the IPO price
Maturity	• Marquee issuers can generally achieve ~5-year terms, although investors prefer shorter maturities for smaller issuers – Rivian, Spotify, DoorDash had 5-year maturities – While Arctic Wolf had a 5-year final maturity, it had a 4-year effective maturity due to an early investor put right
Rachet Provisions	• Discount and / or coupon may increase if there is no IPO within a pre-set time frame • Conversion price may be lowered in the event of a pre-IPO "down round"

Source: ICR Capital, SEC filings, Bloomberg.

Key Provisions in a Pre-IPO Convertible (Cont'd)

Premium Redemption / Minimum Return	• If the securities are not converted, the redemption price the issuer pays could be substantially higher than the principal amount – Arctic Wolf had a redemption price of 145% in 4 years guaranteeing a 10% minimum IRR – A similar premium redemption feature also comes into play upon a change of control • Can choose coupon, PIK, premium redemption, or a combination to deliver a minimum IRR to investors – if the coupon / PIK is high, redemption price can be set at or near par – Example: An 8% annual PIK is similar to a premium redemption at 147% in 5 years • If conversion price increases with PIK (but not conversion ratio), a higher PIK structure can deliver a larger IRR to an investor while also increasing conversion price – Example: Assuming PIK at 8% or redemption at 147% in 5 years, a security with an initial conversion premium of 20% will have a final conversion premium of 76% (120% x 147% less 100%) – For investors with higher minimum IRR thresholds, a PIK with accreting premium structure may deliver what the investor is looking for while also reducing share dilution • However, it is important to note that in order to reduce dilution, the issuer will then have to deliver cash equal to 147% of par • Alternatively, the issuer can deliver all shares to defease the liability – shares delivered will equal par divided by initial conversion price which is the same as premium redemption amount divided by accreted conversion price • Effectively, deliver the same number of shares as a regular way security but get some incremental marketing benefit of a higher minimum IRR security due to the higher PIK
Qualified IPO Definition	• Public listing definition should capture IPO, direct listing, business combination, de-SPAC transaction, etc. • Investors may ask for a minimum IPO size and / or minimum IPO valuation trigger

Source: ICR Capital, SEC filings, Bloomberg.

Legal Considerations

- Process for going from private pre-IPO convert to public (144A) convert: will this be structured as a mandatory exchange? This affects the ability to tack for Rule 144 purposes
- Clearance and settlement: will there be a settlement agent or placement agent for the pre-IPO private convert so that it can be treated as a 144A-qualifying transaction that can be cleared and can settle through DTC (versus a Section 4(a)(2) debt private placement)
- Note purchase agreement vs indenture: typically in a private convert one might use a note purchase agreement; however where convert will be exchanged on IPO for a traditional 144A convert, an indenture is a better starting point
- Going from pre-IPO convert to post-IPO convert
  - Subsidiary guarantors
  - Collateral and release of liens on consummation of IPO
  - Negative covenants that fall away

Legal Considerations *(cont'd)*

- Plan ahead and negotiate 144A indenture at the time of pre-IPO convert
- Public company will be required to file indenture and related documents
- Governance rights

Precedent Pre-IPO Convertible Securities

	ARCTIC WOLF	RIVIAN	Robinhood	DOORDASH	Spotify	Uber
Date	• October 2022	• July 2021	• February 2021	• February 2020	• March 2016	• January 2015
Size	• $401mm	• $2.5bn	• $2.5bn (1)	• $340mm	• $1.0bn	• $1.6bn
Security	• Notes that become a post-IPO convertible upon IPO	• Notes that convert into equity upon IPO	• Notes that convert into equity upon IPO • Included warrants	• Notes that convert into equity upon IPO	• Notes that convert into equity upon IPO	• Notes that convert into equity upon IPO
Coupon	• 3.0% PIK • ~10% minimum IRR via a premium redemption	• 0.0% for the first 12 months • 5.0% thereafter	• 6.0% PIK	• 10.0% in cash or PIK	• 5.0% PIK • Increases by 1% every 6 months after two years	• 2.5% for the first 4 years; 12.5% thereafter
Conversion Feature	• Survives IPO as a convertible bond • Conversion price is the lower of (i) a modest premium to the last round valuation and (ii) a 25% premium to the IPO price	• 15.0% discount to IPO if IPO is within 6 months • Discount increases by 5.0% every 6 months thereafter, up to a maximum of 30%	• 30.0% discount to IPO if IPO is within 12 months, subject to a negotiated valuation cap	• 0.0% discount to IPO • If market cap at IPO < $10bn, becomes a non-convertible debt security with identical terms	• 20% discount to IPO if IPO is within 12 months • Discount increases by 2.5% every 6 months thereafter	• 18 – 30.5% discount to IPO • Discount increases over time
Maturity	• 5 Years (investor put after 4 years)	• 5 Years	• N/A	• 5 Years	• 5 Years	• 6 Years
Disclosed Investors	• Owl Rock, Viking, Ontario Teachers' Pension Plan, and Neuberger Berman	• Amazon.com, T.Rowe, Ford, D1 Capital, Dragoneer, Third Point, Coatue, Fidelity	• Index Ventures, New Enterprise Associates, Ribbit Capital, Coatue, D1 Capital	• Owl Rock, King Street Capital, Benefit Street Partners, Petrus Yield Opportunity Fund	• TPG Capital, Dragoneer, Goldman Sachs' wealth management clients	• Goldman Sachs' wealth management clients

1. Additional $1.0bn was issued without warrants and with a higher conversion price.

Source: ICR Capital, SEC filings, Bloomberg.

Structured Debt or Nonconvertible Preferred

Nonconvertible Preferred Stock

- Preferred stock that is not convertible, bears a coupon, has a guaranteed rate of return, and a term
- Debt-like and, depending upon the terms of the security, may be debt for accounting purposes and tax purposes
- Term-usually from 5 to 7 years
- Prepayment: may be prepayable at the issuer's option after three years or after a specified guaranteed return
- Seniority: senior to all common and all junior preferred; debt typically only allowed to be incurred with the consent of the holders of the preferred or within negotiated buckets
- Fundamental change provision
- Financial covenants: typically highly negotiated
- Warrants generally will accompany the preferred

Warrants

- Generally provide an equity kicker in connection with a debt or debt-like investment but may also provide an opportunity for a more structured equity investment as well as a means of addressing governance rights
- Terms that often are negotiated:
  - Automatic exercise on a company sale or a fundamental change formulation on automatic exercise
  - For a private company, automatic exercise on an IPO
  - Anti-dilution provisions: typically broad-based, customary provisions
  - Transfer provisions - for private companies, this may need to factor in tag-along rights in connection with a sale of a substantial interest or a sale by a founder
  - Preemptive rights to participate in future equity or debt rounds
  - Redemption rights – redeemable upon the occurrence of certain liquidity events

Warrants *(cont'd)*

- Governance rights – director or observer rights—usually limited to circumstances in which the holder owns at least a specified percentage of warrants or of the underlying on exercise of the warrants
- Affirmative/negative covenants: limitations on the ability to modify the size of the board; merger/consolidation limitations; limitations on debt incurrence and/or incurrence of liens; etc.
- Information rights
- Registration rights

Structured Debt

- Either a straight debt security with a coupon, term, and features similar to all of those discussed in connection with the preferred or first lien or second lien notes—in any event, accompanied by warrants
- First lien or second lien notes
- Typical maturity 5 years
- Cash interest, but sometimes PIK feature is included—PIK may be partial
- Redemption
  - Either redeemable in full at any time provided that the investor receives an amount equal to a multiple of minimum of invested capital or redeemable only after a non-call period and then only subject to payment of a make-whole premium
- Tax redemption provision may be included
- Fundamental change provision—usually at a premium 101%

Structured Debt *(cont'd)*

- Guarantee: will depend on the structure—but often any subsidiary that guarantees or that is a borrower on the issuer's credit agreement, if any, or on any outstanding debt securities, if any (an intercreditor agreement will be required to be negotiated)
- Collateral: again, will depend on the issuer and the circumstances, but it will usually but driven by any existing credit facility
- Covenants: this will depend on the issuer, but generally at a minimum will include negative covenants

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