Convertible Bonds: Understanding the Key Benefits

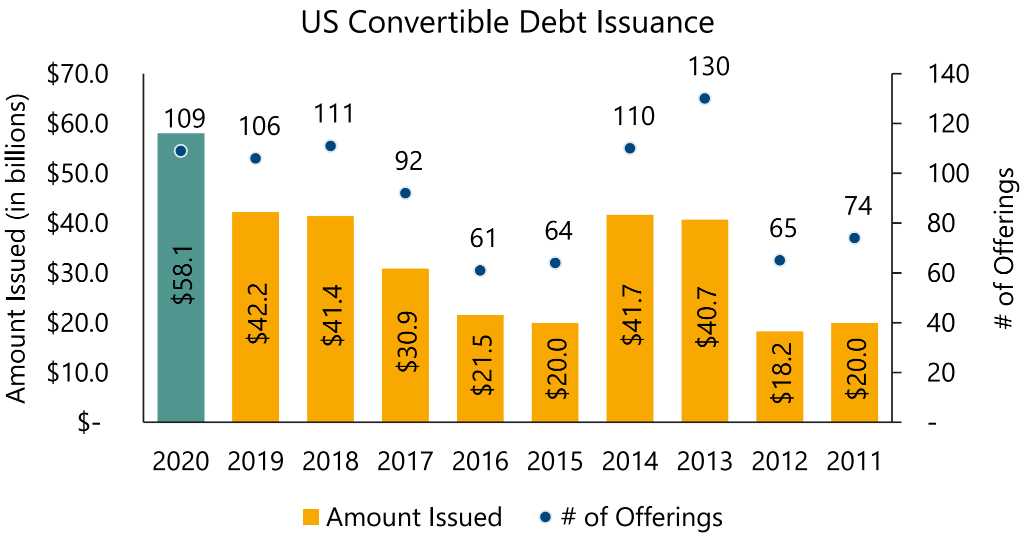
July 23, 2020

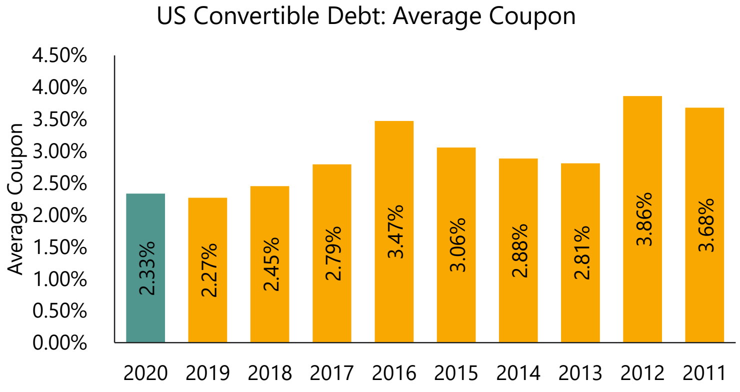
Agenda

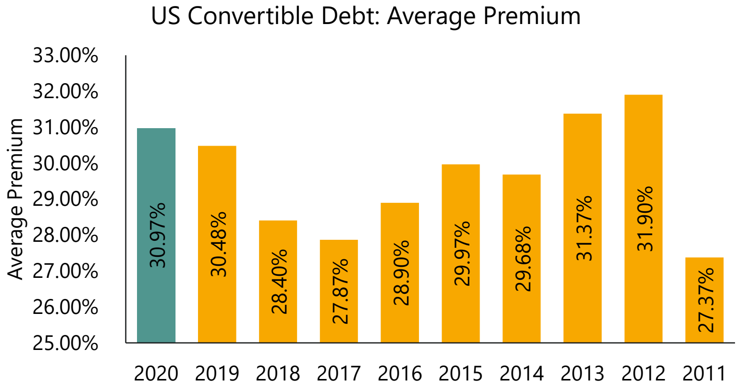
- Understanding converts and the convert market
- Tax considerations
- Securities considerations

Understanding converts

Convertible Debt Issuance is at a 10+Year High







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Convertible Structures Available to Companies

- While Plain Vanilla Convertible Debt is the most popular security of choice, companies may also have access to structured solutions and convertible preferred options

	Typical Characteristics
Plain Vanilla Convertible Debt	• Senior unsecured • No financial covenants • Cash coupon below comparable maturity non-convertible debt • Conversion price set at a premium to market (option to buy-up premium via "call spread" or "capped calls") • 3 – 7 year maturities; 5-years most common • Flexible settlement upon conversion (cash or shares) to minimize dilution • Issued as private placement via Rule 144A and marketed publicly to QIBs only
Structured Convertibles	• Similar to traditional convertible debt • 3 – 5 years maturities • Likely to contain conditions and structural features that enhance investor protections
True Private Placement Convertible Debt	• Highly structured agented private placement • Structure and terms determined by investors through a competitive process • Typically placed with small group of investors including dedicated convertible, fixed-income cross over funds, and/or private capital providers
Plain Vanilla or Debt-backed Mandatory Preferred Securities	• Equity substitute • Cumulative dividends higher than convertible debt • 3 year automatic conversion into shares

Convertible Debt Allows Companies to Minimize Interest Expense & Dilution

Bond + **Call Option** = **Convertible Bond**

Issuer agrees to...

- Pay periodic cash coupons
- Repay principal in cash at maturity

Issuer agrees to...

- Sell an embedded call option struck at a fixed price set at a premium to the stock price when the bond is issued issue

Result...

- Debt security with lower coupon cost relative to straight debt
- Ability to issue common stock at a premium to minimize dilution
- Principal amount issued must be repaid in cash at maturity if not converted

Straight Debt Cost = X
(Example: 7.50%)

Option Value = Y
(Example: 5.00%)

Convertible Coupon = X – Y
(7.50% - 5.00% = 2.50%)

Why do Companies Issue Convertible Debt

BENEFITS

- Lower coupon cost relative to straight (non-convertible) debt
- Fixed coupon rate eliminates interest rate risk
- Selling common stock at a premium to the current price minimizes dilution
- Conversion settlement flexibility (issuer may deliver cash versus common shares) minimizes dilution
- Can be structured with early issuer redemption features (i.e., call provisions)
- Unsecured debt capital without incurrence or maintenance covenants (as seen in senior bank and non-convertible debt)
- Can be issued via Rule 144A eliminating the need to file a prospectus with the SEC
- No roadshow required
- Broadens long term investor base (long-only convertible investors, income funds, sector buyers, arbitrage investors)

CONSIDERATIONS

- Classified as long-term debt on the balance sheet (increases leverage)
- Periodic cash interest payments
- Obligation to repay principal amount in cash if not converted prior to maturity
- Potential future share dilution upon conversion
- GAAP accounting
- No increase in the public share float prior to conversion
- No equity credit provided by credit rating agencies

When to Consider Issuing Convertibles

Criteria	Comment / Recent Examples
Company has debt approaching maturity / call date	• Refinancing higher cost debt is easily understood and a common use of proceeds
Company recently announced a share buyback program	• Convertibles provide an efficient means to effect a meaningful share repurchase at one price
Company is trading near a 52-week or all-time high	• Company's with high valuations can sell stock even higher through a convertible
Company is trading near a 52-week or all-time low	• See share buyback comment above
Company has a funding need for an acquisition	• Company's with acquisitions that have already been announced (audited financials on the target preferred) can use convertibles to repay any bridge financing
Company has high-cost, floating rate, senior secured bank debt that can be prepaid	• Locking in fixed-rate, covenant free debt with low cash costs
Company with history of successfully integrating acquisitions is building a "war chest"	• A Company with a history of successful acquisitions can raise opportunistic capital with a "general corporate purposes" use of proceeds to potentially "pre-fund" acquisitions
Company has a funding need that can't be efficiently satisfied by one (equity or high-yield) offering	• When a Company's funding need exceeds the amount that one investor group can digest efficiently, it can combine a high-yield or equity offering with a convertible

Factors Impacting Convertible Debt Pricing

Factor	Note
Public Equity Float	• A larger public equity float benefits pricing because convertible investors perceive better common stock liquidity
Registration Statement	• Companies with an effective shelf or with WKSI status will get better pricing, on the margin • Long-only investors can take larger positions; opens offering to broadest set of potential investors
Average Daily Trading Volume	• Average daily trading volume in the common stock is a measure of liquidity which, as noted above, is a positive for convertible buyers. Convertible investors want to know, "how many days will it take to trade the stock underlying this convertible?"
Short Interest as a % of the Public Float	• Higher short interest as a percentage of the public float reduces the number of shares that can be lent to investors and increases the cost to borrow shares
Borrow Cost	• Higher borrow cost impacts pricing terms negatively
Common Stock Volatility	• Higher stock volatility increases the value of the embedded conversion option allowing issuers to get better terms
Credit Profile	• A longer history as a financially sound growth company leads to better pricing • A stronger credit profile lowers the credit risk premium and leads to lower interest rate (coupon) on a convertible note
Offering Size	• Noticeable breakpoints exist in the convertible market as the deal size moves above $75 million, and then again above $100 million – $150 million to $200 million deal size opens the transaction to ~100% of potential investors • Smaller deals are possible, but the universe of investors is smaller and pricing terms are higher – additional "credit enhancements" may be required
Use of Proceeds	• A clearly defined use of proceeds, such as funding an accretive acquisition, gives investors greater comfort with the story and leads to better pricing, especially for first-time issuers

Convertible Investors are Split between Long-Only Fundamental Investors and Convertible Arbitrage Investors

Long-Only	Arbitrage
ADVENT CAPITAL MANAGEMENT	AQR CAPITAL MANAGEMENT LLC
ALLIANZ GLOBAL INV OF AMERICA LP	ARISTEIA CAPITAL
CALAMOS ADVISORS LLC	CAMDEN ASSET MANAGEMENT LP
CAPITAL GROUP COMPANIES INC	CITADEL ADVISORS LLC
COLUMBIA MANAGEMENT INVESTMENT	CSS LLC
DELAWARE MANAGEMENT COMPANY	D E SHAW & COMPANY LP
FIDELITY MANAGEMENT & RESEARCH	GEODE CAPITAL MANAGEMENT LP
FRANKLIN RESOURCES	GOLDMAN SACHS ASSET MANAGEMENT
GAMCO	HBK INVESTMENTS LP
INVESCO LTD	HIGHBRIDGE CAPITAL MANAGEMENT, LLC
KORNITZER CAPITAL MANAGEMENT	LAZARD LTD
LOOMIS SAYLES & COMPANY LP	LINDEN ADVISORS
LORD ABBETT & CO LLC	PALISADE CAPITAL MANAGEMENT LLC
NEW YORK LIFE GROUP	POLYGON MANAGEMENT LTD
NICHOLAS INVESTMENT PARTNERS LP	SHAOLIN CAPITAL MANAGEMENT
OAKTREE CAPITAL MANAGEMENT LP	SOROS FUND MANAGEMENT
PENN CAPITAL MANAGEMENT CO INC	STATISTICAL SCIENCE INCORPORATED
PUTNAM INVESTMENTS LLC	STEELHEAD PARTNERS LLC
SHENKMAN CAPITAL MANAGEMENT INC	SUSQUEHANNA INTERNATIONAL GROUP
SOROS FUND MANAGEMENT LLC	TENOR CAPITAL MANAGEMENT
T ROWE PRICE ASSOCIATES	UBS O'CONNOR
WELLESLEY INVESTMENT ADVISORS	WEISS ASSET MANAGEMENT LP
WELLINGTON MANAGEMENT COMPANY, LLP	WHITEBOX ADVISORS
ZAZOVE ASSOCIATES LLC	WOLVERINE ASSET MANAGEMENT

Many Convertible Debt Issuers use Capped Calls or a "Call Spread" to Increase the Premium

- A separate, over-the-counter derivative transaction that synthetically increases the conversion price of a convertible security
- The Issuer's pays for the derivative at issuance; the net cost is treated as an immediate reduction to shareholders' equity and is not periodically marked-to-market
- The derivative is worthless at maturity if the common stock is not traded above the conversion price

	Bond Hedge + Warrant ("Call Spread")	Capped Calls
# of Contracts	• 2 (purchased call option, sold warrant)	• 1
Cost	• Cheaper than Capped Calls due to longer-dated expiration of warrants	• More expensive than "Call Spread" because entire contract expires at the same time
Tax Deductibility	• Entire cost of the purchased calls ("Bond Hedge") is treated as Original Issue Discount ("OID") for tax purposes and deductible over the life of the security	• Net cost of the Capped Calls ("Bond Hedge") is treated as Original Issue Discount ("OID") for tax purposes and deductible over the life of the security
GAAP Dilution during Reporting Periods Prior to Conversion	• Dilution benefit is ignored for the calculation of GAAP diluted shares • Additional dilution above the warrant strike price calculated using the Treasury Stock method	• Dilution benefit is ignored for the calculation of GAAP diluted shares • No additional dilution above the "Cap Price"

SMID Cap Companies are the Most Active Issuers

Trailing 12 Months Convertible Debt *($ amounts in millions)*

	Total				Average			
Market Cap Range	**# Deals**	**%**	**Amount Raised**	**%**	**Deal Size**	**Market Cap**	**Coupon (%)**	**Premium (%)**
Sub $500 MM	7	*4.2%*	$ 824	*1.0%*	$ 118	$ 278	4.70	22.14
$500 MM - $1.0 B	30	*18.2%*	4,507	*5.7%*	150	733	3.58	28.37
$1.0 B - $2.5 B	47	*28.5%*	13,390	*16.8%*	285	1,691	2.73	29.41
$2.5 B - $5.0 B	25	*15.2%*	10,451	*13.1%*	418	3,494	1.34	31.04
Greater than $5.0 B	56	*33.9%*	50,361	*63.3%*	899	14,428	1.14	36.23

	Total				Average			
Offering Size Range	**# Deals**	**%**	**Amount Raised**	**%**	**Deal Size**	**Market Cap**	**Coupon (%)**	**Premium (%)**
Sub $50 MM	2	*1.2%*	$ 96	*0.1%*	$ 48	$ 575	5.45	25.82
$50 MM - $75 MM	4	*2.4%*	280	*0.4%*	70	668	3.42	21.44
$75 MM - $100 MM	11	*6.7%*	991	*1.2%*	90	894	3.82	24.91
$100 MM - $250 MM	44	*26.7%*	8,193	*10.3%*	186	1,225	3.03	29.25
$250 MM - $500 MM	49	*29.7%*	17,943	*22.6%*	366	3,521	2.02	31.84
$500 MM - $1 B	36	*21.8%*	26,727	*33.6%*	742	11,622	1.27	35.07
Greater than $1 B	19	*11.5%*	25,303	*31.8%*	1,332	17,195	1.11	35.34

Technology & Communications and Health Care Companies are the Most Active Issuers

Trailing 12 Months Convertible Debt ($ amounts in millions)

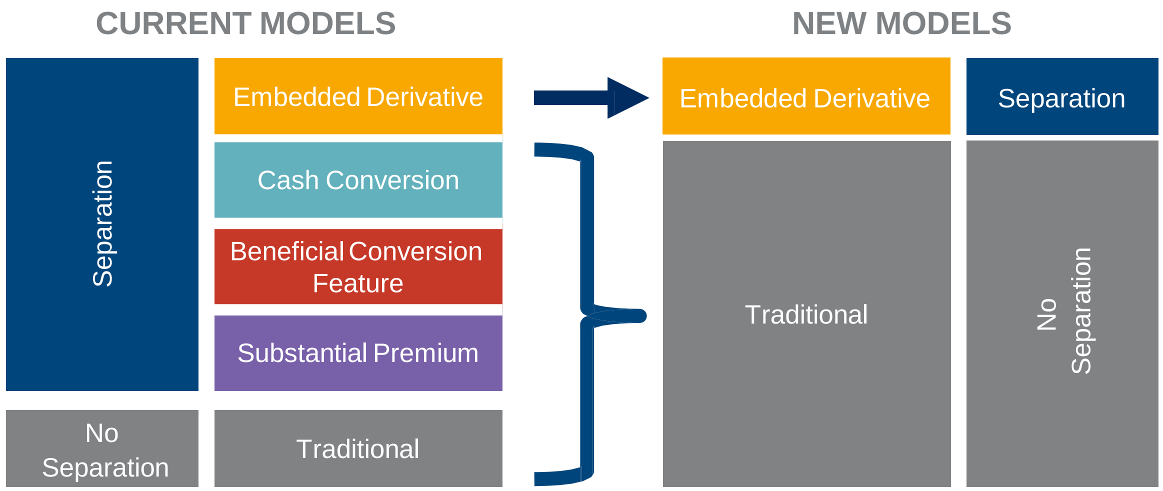
	Total				Average				
Sector	**# of Deals**	**Deals with Call Spread**	**Amount Raised**	**% of TTM Issuance**	**Deal Size**	**Coupon (%)**	**Premium (%)**	**Call Spread (%)**	**Maturity (Years)**
Information Technology	50	37	$ 28,688	36.1%	$ 574	1.11	35.18	102.97	5.53
Health Care	51	24	17,687	22.3%	347	2.33	30.23	83.72	5.82
Consumer Discretionary	21	9	13,186	16.6%	628	2.55	30.83	105.56	4.89
Communication Services	12	8	9,293	11.7%	774	1.54	36.67	104.38	5.35
Industrials	10	5	5,311	6.7%	531	3.15	26.50	90.62	4.82
Energy	3	3	2,168	2.7%	723	1.42	22.94	68.33	5.68
Financials	8	1	1,439	1.8%	180	5.44	20.59	30.00	4.00
Materials	4	1	933	1.2%	233	4.32	35.75	85.00	5.56
Real Estate	3	-	425	0.5%	142	4.58	21.83	-	5.43
Consumer Staples	2	1	323	0.4%	161	2.19	32.50	100.00	5.00
Total	**164**	**89**	**$ 79,452**	**100%**	**$ 482**	**2.21**	**31.47**	**95.03**	**5.40**

Refinancing "Busted Convertibles"

	Registered Exchange	Privately 4(a)(2) Exchange	Privately 3(a)(9) Exchange	"Modified" Amend and Extend
Description	• Publicly announced exchange offering that allows the Issuer to exchange new registered convertibles (and/or common stock or non-convertible) securities for existing convertibles o Registration statement filed on form S4 o Exchange offer is made to investors by prospectus o Offer is kept open for 20 days after it is announced publicly	• Confidentially negotiated and marketed transaction that allows the Issuer to exchange new unregistered convertible securities for outstanding convertibles held by a small group of existing investors.	• A transaction direct between the issuer and existing security holders that allows the Issuer to exchange outstanding securities for new securities without registration requirements **Requirements** o New and old securities are issued by the same issuer o Holder cannot be asked to give anything of value other than outstanding securities o Exchange must be done with existing holders only o No commission can be paid for soliciting the exchange o Exchange must be done in good faith	• Confidentially or publicly negotiated and marketed transaction that allows the issuer to repurchase outstanding convertibles while simultaneously issuing new registered or unregistered securities
Benefits	• Targets all current Note holders • Potential to maximize the amount of debt refinanced • Ability to incentivize investors to participate in the exchange	• Stock price not impacted during confidential marketing and negotiations • Transaction can be terminated without public disclosure • Minimal disclosure and documentation required given private placement	• No registration requirements • Stock price not impacted during confidential marketing and investor negotiations • Low transaction fees and expenses • Potential to price on an overnight basis	• Potential to increase size of offering and repurchase after public announcement
Considerations	• Common stock price is exposed to impact of exchange announcement • Must be kept open for minimum of 20 days, exposing stock price to market risk • No guarantee that investors will participate in the exchange • S4 filing subject to SEC review	• Cannot target the entire class of investors given tender offer rules • No broad marketing effort • Investors may need to buy/sell stock to adjust existing hedges • Some holders may not agree to negotiated "over the wall"	• Cannot target the entire class of investors given tender offer rules • Investors may need to buy/sell stock to adjust hedges • Issuer negotiates terms and conditions directly with investors	• Cannot target the entire class of investors given tender offer rules • Repurchase price and amount • Some investors may need to buy/sell stock to adjust hedges • Some investors may not agree to NDAs

Convertible Accounting Getting Simpler

- The FASB recently voted unanimously to proceed with a simplified model for convertible debt accounting
- The staff is drafting a final Accounting Standards Update which is expected to be enacted in short order
- Early adoption will be permitted, though the official effective date is for filers with fiscal years beginning after December 15, 2021



Tax considerations

Convertible debt

- Interest deduction for issuer, holder includes interest income
- Conversion is not a taxable event. Rev. Rul. 72-265
- The right to convert into the stock of the issuer (or an affiliate) is not a "contingency" within the meaning of Reg. Section 1.1275-4. Reg. Section 1.1275-4(a)(4). So, not a contingent payment debt instrument.
- The holder does not allocate any of its purchase price to the conversion feature. Reg. Section 1.1273-2(j).
- Issuer does not recognize gain or loss when stock is issued upon conversion. Section 1032.
- Issuer cannot deduct repurchase premium to the extent it exceeds adjusted issue price plus a normal call premium. Section 249.

Section 163(l)

- No deduction for interest on disqualified debt
- Disqualified debt
  – Payable in equity of issuer, related party or equity held by issuer (or related party)
- Payable in equity?
  – Substantial amount of principal or interest required
    - To be paid or converted, or at issuer's option is payable or convertible in such equity
    - To be determined, or at issuer's option is determined by reference to value in such equity
  – Part of an arrangement reasonably expected to result in foregoing
- Holder option?
  – Is there "substantial certainty" option will be exercised?
  – Answer: no, if "traditional" convertible bond

Convertible bond call spread

- Integration Election: Reg. Section 1.1275-6 – the convertible bond and only the purchased call are integrated
  - Hedge identification requirement
- Creates a synthetic debt comprised of the convertible bond and the purchased call
  - Face: $125 mm
  - Cost of the call option: $25 mm
  - Issue Price for tax purposes: $100 mm
  - OID: $25 mm
  - Warrant price: $10 mm
- The written warrant is not integrated with the convertible bond or the purchased call
  - Warrant price
  - Section 1032
- AM 2007-014

Convertible bond capped call

- Integration Election: Reg. Section 1.1275-6 – the convertible bond and the capped call are integrated
- Creates a synthetic debt comprised of the convertible bond and the capped call
  - Face: $125 mm
  - Cost of the capped call option: $15 mm
  - Issue Price for tax purposes: $110 mm
  - OID: $15 mm

Other considerations for issuers

Offering methodology

- Converts can be issued:
  - Pursuant to Rule 144A in a traditional Rule 144A offering to initial purchasers
  - In certain instances, such as, for example, in the event that the issuer is offering the convert to finance an acquisition, it may not be possible to structure the transaction as a traditional Rule 144A offering. The investment bank may act as placement agent and introduce the issuer to QIBs that will purchase directly from the issuer in a Section 4(a)(2) private placement; however, the transaction will be a Rule 144A-qualifying transaction. The notes will settle through DTC and bear a Rule 144A CUSIP. Either the placement agent or the trustee will act as settlement agent to facilitate the closing
  - In a registered offering

Offering methodology

- More often than not, convertible notes will be issued in a Rule 144A offering
  - The repurchase strategies can be executed without Regulation M concerns arising
  - Of course, for Rule 144A, the convert must have a conversion premium (to avoid fungibility issues)
  - Registration rights generally are not required; issuer will covenant to provide “current information” and the indenture will provide for the Rule 144A restricted CUSIP to be moved to a non-restricted CUSIP on the one-year anniversary of issuance
  - To the extent that the issuer was formerly a SPAC, registration rights may be necessary due to the more limited availability of Rule 144

Conversion price adjustments

- Anti-dilution adjustments
- Adjustments for distributions like dividends, spin-offs
- Adjustments for other in-kind distributions
- Adjustments for the issuance of rights, warrants
- Adjustments for issuer self-tenders

Change of control

- Converts will have a make-whole fundamental change provision
- The provision will adjust the conversion rate upon the occurrence of:
  - A merger
  - The delisting of the issuer’s stock
- Typically a merger in which the convert becomes convertible into the acquirer’s listed stock may be excluded from the fundamental change provision
- An issuer redemption may also trigger the fundamental change provision

Redemption features

- In certain instances, after a specified period, the notes may become redeemable at the issuer's option subject to a make whole payment, determined based on the make whole table that will be set out in the offering document
- The issuer redemption option also may be more limited—it may be available after a specified period, and in the event that the notes are trading above a specified premium to the conversion price for at least a minimum time period
- Notes also may be structured as contingently convertible instruments

Securities exchange listing rules

- Both the NYSE and the Nasdaq listing rules require shareholder approvals with respect to certain transactions
- Generally, the initial issuance will not require shareholder approval given that the convert will be issued at a premium (assuming, in the case of a Nasdaq issuer, it is not offered and sold in connection with an acquisition)
- The NYSE also has an exemption for "bona fide private financings"
  - Applicable to a sale in which either a registered broker-dealer purchases securities from the issuer with a view to the private sale of such securities to one or more purchasers, or the issuer sells the securities to multiple purchasers, and no one such purchaser has the right to acquire upon exercise or conversion of the securities, more than 5% of the shares of the issuer's common stock or more than 5% of the issuer's voting power before the sale

Securities exchange listing rules

- Both exchanges consider as well the potential, in the case of exchangeable securities, for shares to be issued in excess of the 20% threshold. As such, a blocker provision may be required to be included in connection with certain conversion adjustments

Offsetting anti-dilutive transaction

- The call overlay/call-warrant structures will be documented with standard ISDA style confirmation documents; often frequent issuers will have a preferred starting point and dealers also have their preferred forms
- As is the case with the convert offering itself, the issuer will have to take care to consider disclosure matters, including potential material nonpublic information
- The dealer counterparty will expect representations from the issuer regarding no MNPI
- Depending on the repurchase alternative that the issuer is considering undertaking, there may be additional requirements to take into account

Offsetting anti-dilutive transaction

- For example, if the issuer chooses to undertake open market repurchases, it will need to consider the Rule 10b-18 conditions. Even an accelerated share repurchase will analogize to Rule 10b-18, and may be implemented with an issuer Rule 10b5-1 plan
- It will be useful for the issuer to understand how a dealer will approach its own hedging (in connection with any of the offsetting transactions we discussed) as it affects the documentation and has the potential to affect the issuer’s stock