

Convertible Bonds & Call Spreads: Executive Overview

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Convertible notes issuances have been surging. The increased activity has been bolstered by the high interest rate environment and macro uncertainty. Convertible notes combine debt and equity, allowing issuers to take advantage of lower interest rates (compared to straight debt) while minimizing dilution (compared to straight equity).

Heightened convertible notes issuance is expected to continue at least through 2025, driven by issuers looking to refinance both existing convertible debt, much of which comes due in 2025 and 2026, and straight debt that would now face materially higher interest rates.¹

Basic Terms

- Convertible notes combine features of **debt** and **equity**.
 - Like straight debt, a convertible note has a fixed maturity and regular interest payments.
 - Like an option for equity securities, a convertible note allows its holder to convert into shares with a predetermined number of shares deliverable for each note (the “**conversion rate**”).
 - Investors accept a lower interest coupon in exchange for the equity upside.
- The share price at which the note converts is the “**conversion price**.”
 - The conversion price is equal to the principal amount of a note divided by the conversion rate.

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¹ Goldman Sachs, Convertible bond issuance jumps as interest rates climb, October 5, 2023, <https://www.goldmansachs.com/intelligence/pages/convertible-bond-issuance-jumps-as-interest-rates-climb.html>.



- The conversion price is virtually always higher than the current stock price.
 - The conversion rate is adjusted upon specified corporate events, such as dividends, spin-offs and stock splits.
3. Convertible notes are usually **contingently convertible**, meaning investors cannot convert at all times.
- Generally, investors may convert only near maturity or if certain events occur, including upon:
 - a fundamental change or other transformative transaction;
 - a significant increase in share price (typically, 130% of the conversion price);
 - the notes trading at a discount to their as-converted value; or
 - the issuer choosing to redeem the notes.
 - Issues often have a “soft call” right to force conversion if the share price exceeds, e.g., 130% of the conversion price for a certain period of time after a specified date.
2. Convertible notes are attractive to **multiple types of investors**, but generally increase short interest in an issuer.
- **Fundamental investors** buy convertible notes for the coupon and the possibility of converting at maturity.
 - **Technical investors** buy convertible notes and seek to make money by hedging the embedded option – which entails shorting the issuer’s shares.
3. Convertible notes can be issued on an **SEC-registered** basis or **privately using Rule 144A**.
- “Well-known seasoned issuers” (“WKSI”) – generally, public companies with a market cap exceeding \$700 million – may use an automatically effective SEC shelf registration statement to offer convertible notes on an SEC-registered basis. There is no delay for SEC review.

Structuring Considerations

1. Convertible notes can be structured with **different settlement methods**. This choice is usually driven by accounting implications. The standard options are:
- full physical settlement (the issuer delivers only shares on conversion);
 - cash settlement (the issuer delivers value of shares in cash);
 - full flex settlement (also called “instrument X”), where the issuer may choose physical or cash settlement or a combination; or
 - net share settlement (also called “instrument C”), where the issuer must deliver the principal amount in cash and may use shares, cash, or a combination for any further value.
- If a non-WKSI does not have already effective SEC shelf registration statement covering convertible notes, the issuer instead may use Rule 144A to allow for faster execution and avoid SEC review.
 - Rule 144A also affords an exemption from Regulation M. This can be useful to manage dilution risk and offset short selling by technical investors, because it allows issuers to buy back shares at the time of issuance of the notes.
 - NYSE and Nasdaq shareholder approval requirements occasionally apply (e.g., if note conversion would result in the issuance of more than 20% of outstanding shares).

Considerations

1. **Fundamental changes** generally allow investors to put their notes to the issuer at par or convert for a temporary conversion rate increase (called a “**make whole**”).
 - A fundamental change generally includes a change of control, disposition of “all or substantially all” assets of the issuer, a transaction in which the existing stock is replaced by consideration that consists of less than 90% exchange-traded securities, or a delisting or insolvency of the issuer.
 - Future M&A, spin-offs and asset transfers may have a variety of consequences under a convertible note, including triggering a fundamental change and requiring the successor to become the obligor under the notes, and must be carefully analyzed.
 - The make-whole conversion rate increase often applies if an issuer exercises its “soft call” right.
 2. Convertible notes typically have **few covenants**, but do require attention to compliance.
 - Failure to fulfill a conversion obligation and failure to give notice of a fundamental change generally allow acceleration.
 - Convertible notes typically limit jurisdictions in which a successor entity can be organized.
 - Failure to file SEC reports or delegend Rule 144A notes at the appropriate time typically incur a step-up in interest rates.
 - Convertible notes may require notice of extraordinary dividends and rights offerings well in advance of distribution.
 3. Issuers typically want to consider liability management in their convertible notes well ahead of maturity—often, **more than a year** in advance.
 - This provides flexibility to address equity volatility and select an optimal market window.
 - When discussing a potential convertible, it is important to consider the timing of any future takeout, which may center around redemption or put dates, and the form of a potential takeout transaction.
 - It also is important to consider the accounting implications of the issuer’s settlement election.
 4. Issuers can offset their obligations under convertible notes by entering into an accompanying **over-the-counter derivative transaction** known as a “**call spread**” with banks.
 - In a call spread, the issuer buys a call option on its shares at the conversion price, offsetting the obligation to deliver shares or cash to investors upon conversion.
 - The call option is subject to a cap price. The dealer does not deliver additional value to the issuer if the share price at conversion is above that cap price.
 - For the issuer, this effectively increases the conversion price of the notes to this higher cap price, mitigating the risk of dilution if the convertible notes are converted.
 - Call spreads can be structured using two derivatives – a bond hedge (set at the conversion price) and warrant (a call option sold at the cap price) or as a capped call (a single call option, subject to a cap). Economically, these are similar, though each has its pros and cons, and the choice between them generally depends on complex tax considerations.
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