NAVIGATING CONVERTIBLES: Demystifying Modern Convertible Notes

A special four-part series: Part I

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Prospect News

PROSPECT NEWS

INTERVIEWS
LATHAM & WATKINS

Greg P. Rodgers,
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Latham & Watkins attorneys discuss their new primer and convertibles business

By Rebecca Melvin

New York, Aug. 30 – Two members of Latham & Watkins LLP's convertibles team have written a primer aimed at gathering in one place as many answers to frequently asked questions on the subject of convertible notes issuance as possible. With that report published earlier in August, its authors, Greg P. Rodgers, partner in the New York office of Latham & Watkins and a member of the Capital Markets Practice, and Arash Aminian Baghai, counsel in the Los Angeles office of Latham & Watkins and a member of the Capital Markets Practice, sat down with *Prospect News* to discuss some of its themes. The following is the first of a four-part series resulting from that discussion.

Prospect News: Let's start with some questions about Latham's own convertibles business and the origins of your report, *Demystifying Modern Convertible Notes*. Was this the first report that you worked on together?

Greg: It is. Both Arash and I have been practicing in this area [of convertibles] for a long time. I am a '97 graduate from law school and did my first convertible deal in '99, so it's coming up on two decades. And I have been doing deals with Arash for quite a long time, including when he worked at another firm and then when he came over to Latham & Watkins. Since then we've joined forces and do a lot of work together. The origin of this piece – and sort of the germ of the idea – is that we get a lot of questions from folks who want to be able to understand convertibles better, so we thought it would be a good idea to get all the answers in one place and direct people there. It was three years in the making, so it feels good to get it out – the feedback has been pretty positive, so it's quite gratifying.

Greg P. Rodgers,
Latham & Watkins

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REGARDING THE AUTHORS' NEW REPORT

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Prospect News: Why did it take that long to publish the piece. Is it because you were gathering a big data set for it?

Greg: Well, it's not our day job; we are deal jockeys by trade, and we were only able to pick up and write during windows of opportunity, and those windows didn't always overlap for us. In addition, there were adjustments and updates in accounting treatment – even as recently as last month. So, we are glad to get it out the door and have something true regarding a period of time, and we plan to monitor it going forward for updates.

Prospect News: Can you describe Latham & Watkins' convertibles business and its emphasis on this niche of the capital markets?

Greg: We have a fairly large group focused on convertibles. We have six or so senior people and a slew of junior attorneys, which is pretty large across the Street, generally speaking. Looking at *Prospect News'* league tables – which, by the way, thank you for putting those out – we always show pretty well, subject to market vagaries, of course. Period over period though, we are usually one or two [in the rankings]. One distinction is that we are equally strong on both the bank side and the company side. We have very strong equity derivatives and tax practices historically, which is absolutely critical for the product. We do cap market converts, restructuring converts, private equity, PIPE style converts, and liability management; so, we practice across the activities that a convert issuer or investor or bank would ever want to do. We do a little bit of all of it. In addition, Latham & Watkins is arguably the preeminent capital markets firm in the world; we are strong across industry groups, including the ones that are most common to convertibles, including high growth, technology and biotech, REITs, and oil and gas, where a lot of the issuance comes from. We are strong there, and that's an enormous help. If you include those numbers, it's huge: we have about 70 capital markets-focused attorneys in the New York office alone

Prospect News: Why is capital markets expertise in those specific industries that are heavy on convertibles issues important?

Greg: Capital markets refers to the primary issuance of a company. Industry expertise is important in the U.S. because the legal work is based on a disclosure regime. When the company puts out a prospectus, it describes all the risks, and

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DEMYSTIFYING MODERN CONVERTIBLE NOTES

Primer explains the regulatory and accounting frameworks applicable to convertible notes as well as the investment strategies that drive them.

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LATHAM & WATKINS LLP

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the risks vary depending on the industry. In a biotech, for example, it is important to know the FDA regime, and that helps us craft things like the next regulatory milestone and what the risks are of it coming to pass or not. That document reads very differently than one for a manufacturing company that produces widgets, for example.

Prospect News: Can you describe what goes into a convertible deal from the outset? Are all of your deals the result of existing relationships with companies?

Greg: If we are on the company side, often given the scope of our law firm, we have a preexisting relationship with the issuer. For example, all convertible note issuers are definitionally public companies essentially. We may have done their IPO, or we may have taken over representation of them later and take care of their reporting, or an M&A matter. A partner would refer them to us because they know our group has the expertise. Or the investment banks that are helping the companies issue the notes may be talking to the company and realize that their existing counsel doesn't have the necessary expertise to get a deal done on a tight time frame, in a manner that is positive for the issuer, so they will refer them to us. We get a lot of work that way. It's a little more straightforward on the bank side, we like to think we are pretty well known across the Wall Street banks. They will just hire us directly to do the entire transaction or sometimes just the product piece where there is another law firm that has represented the banks in connection with that same issuer in the past, which is product counsel or representation.

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Prospect News: Can you describe what you mean by product counsel?

Greg: Generally, we are either company counsel or bank counsel, where we are doing the product counsel. That is the focus on the terms of the security, and another firm is doing the ordinary capital markets' blocking and tackling, which is what you have to know about the business to be able to do the description of the business. That is less often. More often we are doing the whole deal on behalf of one side or the other.

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Prospect News: Is your convertibles business growing?

Greg: The quantum changes relative to the market. Last year was a really busy year. Compared to last year, this year, we have done fewer deals; but so has everybody. But if you account for overall market issuance, I would say that our business right now is fairly steady.

Prospect News: Thank you so much for outlining the legal end of convertible notes issuance and your firm's work specifically It has given us a much better idea of what the business is about.

Part II: The interview continues

The influence of financial markets, potential stock dilution on deal structures

Prospect News: What are the characteristics of a financial market that is conducive for convertible issuance?

Arash: Convertible notes have been around for ages, and they have survived almost every conceivable economic cycle and environment. We see them as an incredibly resilient financing tool, and if used correctly, they can be used in an up cycle, down cycle or anything else. They are one of those tools that help issuers reduce their overall cost of capital. I would say any market can be right for the right issuer. I would say a market where there is potential volatility is particularly conducive to convertible note issuers; and that is driven in large part by the role that the investment strategies of hedge funds, which are a major player in these kinds of securities, play.

Prospect News: Was there more volatility last year that promoted more deals than compared to this year?

Greg: It's hard to pivot to that exactly. There are all sorts of forces at work. One thing that has remained somewhat of a mystery to us is why last year was as strong as it was, and why this year has gone down a little bit, given that market conditions

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have been relatively the same, including volatility. I'm not one to give a lot of political commentary, but it's not a secret to anybody that there have been a lot of news items that have caused the market to go up and down, [even very recently].

Prospect News: Yes, it's interesting that even though we have had a lot of volatility, we are almost dead, even in terms of the major stock indices right now, compared to last year at this time. Do convertible issuers want to do deals when the stock market is high?

Greg: In fact, it can cut either way as to when a convertible makes sense. You have to analyze the convertible relative to its alternatives. If the company is looking to raise straight, nonconvertible debt, it will always pay a higher coupon, or interest rate, for [that debt] compared to a convertible. That is because the convert has two components of value including the yield from the coupon and the option in the conversion feature. The market is willing to pay them for the option, or in other words, accept lower yield. Some companies perceiving that their stock is high might think doing a convertible is favorable, but there is always the problem that the convert goes into the money. It's a problem if their stock [exceeds the conversion price and] goes into the money. Conversely, a CEO may think their stock is low and issue a convert for the signaling. If you issue a convert with a 30% premium, you are signaling that you think the stock will get there, and so the smart money will buy that. It can go either way.

Prospect News. Are you saying that a convert may be issued to signal confidence to the market?

Greg: This is particularly true if they issue the convertible with one of the equity derivatives like a capped call or a call spread, where they themselves are spending money on that derivative, suggesting that the conversion price to bond is not high enough. It's just a signaling tool that we describe in our piece.

Prospect News: Can you describe the convertible structures that are available and how they would fit different needs?

Arash: We like to think of the convertible as having a standard set of features that you can look at as a kind of menu, and then pick and choose the right ones that work for a particular issuer. In a general sense, a convertible note is a debt instrument that carries with it the right to convert into the equity of the issuer. The dilution point is one that issuers are focused on as it affects the trading price and recorded earnings per share of the company. There are several tools that an issuer can use to manage the risk. While it's a high-quality problem, it's still a problem where you issue a convertible note and find yourself at maturity with a convertible that is well into the money. That is where the potential dilution problem kicks in, and there are many ways to deal with that. The first way is with settlement options to settle conversions. A decade and a half ago, what was the most common was what we refer to as physical settlement, where conversions are settled only in shares of common stock. That, for obvious reasons, leads to the largest amount of dilution for an issuer. Nowadays, we have what we call flexible settlement, which allows the issuer to settle conversions in any combination of cash and shares, based on the trading price of those shares. What is most

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often the case now, and for accounting reasons, will become the norm in the near future, is what's called net share settlement. This is where the issuer sells the conversion value of the note in cash up to the principal amount and then any excess is settled in shares. This can go a very long way in reducing dilution that conversions at maturity may result in.

Prospect News: So, are you saying that there are two ways to settle conversions?

Arash: Net share settlement is a subset of a larger settlement mechanic that is called flexible settlement. [It is also referred to as] Instrument X, and all that means is that an issuer has the flexibility to choose how it will settle conversions. It can do so in any combination of cash and shares. The flexible settlement would cover physical settlement, which is settlement completely in shares. It would also cover the other end of the spectrum, which is cash settlement where the entire conversion value is issued in cash, and which results in no dilution whatsoever, but carries treasury management risk, for obvious reasons. In the middle would stand what we call net share settlement, where the conversion value is settled in cash up to the principal amount and only the "in the money" portion of the conversion value is settled in shares. This limits the shares issued and is one way that issuers can manage potential dilution.

What is most often the case now, and for accounting reasons, will become the norm in the near future, is what's called net share settlement.

This is where the issuer sells the conversion value of the note in cash up to the principal amount and then any excess is settled in shares. This can go a very long way in reducing dilution that conversions at maturity may result in.

Prospect News: What were some of the other structures or features to do that?

Arash: Another way would be for the issuer to purchase an equity derivative overlay on top of the convertible note issuance and that is when the issuer repurchases shares, usually from one of the banks participating in the convertibles note issuance or an affiliate. It is a derivatives instrument that entitles the issuer to receive from that counterparty some of the shares that it may have to deliver upon conversion of the notes at maturity That instrument serves to reduce the total number of new shares issued because on the one hand, the issuer will be issuing the shares to settle the conversion, and on the other hand, it will be receiving those shares back from the bank from the equity overlay. They conduct the convertible note offering simultaneously with a stock buyback, and that is a pretty interesting structure that takes advantage of the fact that a lot of the purchasers of the notes are hedged investors and they will want to hedge some of the price volatility risk of their convertible notes by taking a short position in the company's common stock. The unique thing about that is that if the issuer conducts a share repurchase at the same time as a convertible

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note offering it will usually buy shares from those very investors that are selling short as part of their investment of their convertibles.

Prospect News: Are there concerns or issues related to this structure?

Arash: It is actually looked on very favorably from the standpoint of both the issuer and the investors. In fact, some of these structures are colloquially known in the market as a "happy meal," for that very reason. For the investors, they get the benefit of being able to sell what they want to sell to establish their initial delta hedge at a fixed price without having to go into the market and take market risk for their short sales. From the issuer's perspective, it's exactly the same advantage, that they are able to buy shares without going in the open market and are able to execute them at a fixed price, and it is usually the price at which the convertible note offering is being priced. It's really a win-win scenario when you look at it that way.

Prospect News: Can you tell me the percentage of hedged investors to outright investors in the market?

Greg: That will depend on the issuer. When I am describing the convert market to a new client, as a rule of thumb it's relatively equal. It may be described with a finer brush, but I think it is roughly equal. The exact mix will differ according to the issue. The more volatile the stock, the riskier the investment and that will probably skew the investment base toward hedge funds. The more stable clients will attract more outrights.

Arash: And as you can see, the number of hedge fund investors will dictate how big a repurchase an issuer can do in a particular offering.

Greg: Right, because it is matching the size of the shorting activity. The repurchasing activity also helps the issuer side by offsetting the stock price dip that typically occurs with the announcement of a convert. When an issuer announces a convertible, many times, but not always, the stock dips a bit, because of the anticipation of the eventual dilution and the shorting activity of the hedge fund investors as they set up their shorts. The repurchasing activity can go toward offsetting that.

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Prospect News. How many deals are done with a concurrent stock repurchase?

Greg: I would say about a quarter of the deals to maybe a half use a derivative of the call spread.

Prospect News: Thank you so much for those explanations and insights.

Part III

Proposed accounting change reopens discussion on convertible debt settlement

By Rebecca Melvin

New York, Sept. 4 – As part of the interview with the co-authors, the topic turned to an in-depth discussion of a proposed accounting change.

Accordingly, the co-authors of the new primer *Demystifying Modern Convertible Notes* are aware that the clock is ticking on the comment period regarding a proposed accounting standards update (ASU) affecting convertible debt.

The Financial Accounting Standards Board published the proposed ASU on July 31, and comments on it are due by Oct. 14.

Billed as a simplification of the accounting treatment for certain financial instruments with characteristics of liabilities and equity including convertible instruments, the proposed ASU would amend many aspects of accounting treatment. Of particular interest is the proposed amended guidance related to computation of earnings per share (EPS).

Currently there are two main methods to calculate diluted earnings per share for convertibles. They are the if-converted method and the treasury stock method.

The if-converted method assumes conversion of convertible securities at the beginning of the reporting period, and this applies to traditional convertible debt. The treasury stock method assumes that proceeds that would be received are used to purchase common shares at the average market price during the period and it applies to convertibles that allow the issuer to cash settle some or all of the conversion.

Under the proposal, the if-converted method would apply to all convertible instruments. The treasury stock methods would no longer be available.

These potential changes have some wondering if the market is about to face something of a "ground hog day" and how convertible issuers will respond to any changes that occur.

Structuring changes in convertibles have been closely tied to changes in accounting practices. "It's highly accounting driven, and it takes people who understand the accounting to properly advise the issuers and banks so that it is okay to the investors," Greg Rodgers said during the interview with *Prospect News*.

Both Rodgers and Aminian Baghai note that the Financial Accounting Standards Board proposal could take years to adopt.

But, in the meantime, there are questions that are raised. For one, the ASU leaves open the question whether the proposed changes will apply retroactively or not.

Applying the changes retroactively

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would be a big complication for issuers, many of which were part of a wave of exchange offers that were done to take advantage of favorable accounting treatment in the last large shift in accounting practices in 2008.

Those 2008 rules led to a large switch, with issuers swapping out of existing notes because the treasury stock method was more favorable for EPS, Rodgers said.

But even if the FASB reverts to the if-converted accounting method and does away with the treasury stock method it wouldn't be devastating for issuers, the lawyers said.

The market was smart enough to anticipate further potential changes in accounting and safety valves were built into convertibles indentures to say that issuers may irrevocably elect the method of conversion used in settlement.

The market was smart enough to anticipate further potential changes in accounting and safety valves were built into convertibles indentures to say that issuers may irrevocably elect the method of conversion used in settlement.

"We think that many issuers will take advantage of these provisions and elect irrevocable net-share settlement. But it's not the best for all issuers," Rodgers said.

Net share settlement allows the issuer at settlement to pay the par value of the convertible in cash and any remaining value in cash or shares.

A lot of convertible structuring has been geared around how issuers calculate their diluted earnings per share figures to report for U.S. GAAP purposes.

Nevertheless, the proposed changes may not be all negative, and it may just lead to new structures, Rodgers and Aminian Baghai agreed.

"It's may not be all bad because there's a chance of getting rid of bifurcation," Rodgers said, referring to the debt/equity bifurcation under the cash conversion subsections of the existing accounting standard.

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Combination settlement and equity derivative overlays

By Rebecca Melvin

New York, Sept. 5 – Part of the conversation with the authors focused on combination settlement and equity derivative overlays, a topic they address in the primer.

Accordingly, while it may be tempting to think about the interests of convertible note issuers as being at odds with the interests of convertible notes investors, the instrument necessarily accounts for both sets of interests or it wouldn't get much traction in the marketplace.

The convertible note is essentially a straight debt instrument combined with a call option on the underlying common stock of the issuer.

Traditionally, convertibles settled physically in shares.

Cash settlement also exists, and as one might suspect, this means that the conversion value of the notes is paid only in cash.

Over the past 15 years, though, new structures have developed to address changes in regulations, accounting and investing.

One of the most common structures used to settle convertibles today is called combination settlement, according to the Latham & Watkins lawyers who authored *Demystifying Modern Convertible Notes*.

Combination settlement, as the name implies, means some portion of the conversion value is paid in cash and the remaining portion is paid in shares.

A common variety of combination settlement is net share settlement, where the conversion value, up to its principal amount, is paid in cash and any excess over the principal amount is paid in shares.

A convertible note that permits the issuer to elect physical, cash, or combination settlement is often called Instrument X. According to lawyers Greg Rodgers and Arash Aminian Baghai, this term, which is an extension of references to instruments A, B, and C in early Financial Accounting Standards Board literature on convertible notes (EITF 90-19), can be attributed to Robert Comerford in a speech he gave at the AICPA National Conference on Current SEC Developments in 2003. At the time, Comerford was a Professional Accounting Fellow at the SEC's Office of the Chief Accountant.

In their report, Rodgers and Aminian Baghai, write, "Convertible notes issued in U.S. capital markets behave, for the most part, like American options (including Instrument X notes with conditions to conversion). However, convertible notes are more expensive to 'exercise' than a traditional American option, because conversion forces the investor to forgo future interest payments on the notes. Furthermore, an increase in the issuer's dividend rate from the rate prevailing at the time the notes were issued will usually result in an upward adjustment to the conversion rate, which helps offset the downward impact the increase will have on the value of the conversion right."

"These factors, coupled with the market forces described above, will generally ensure that even for convertible notes of dividend-paying issuers, investors will not have an economic incentive to convert early, except in relatively uncommon circumstances, such as where the market for the notes is highly illiquid or the cost of stock borrow is high, " according to the report.

In theory, investors don't care how convertible notes are settled, and in practice there is a relatively minimal impact among the options, Aminian Baghai told *Prospect News* in the interview.

The goal of both long and hedged investors is to reduce their securities positions into cash, and to earn a positive return at maturity in cash. The settlement method will not change the total cash that the investor has at the end of the day, and is roughly the same in both physical and net-share settlement, Aminian Baghai said.

The conversion value is usually determined by reference to the conversion rates and volume-weighted average prices (VWAPs) per share of common stock over an "observation period" spanning multiple trading days.

What is known as flexible settlement covers physical settlement and cash settlement.

In addition to settlement methods, issuers are using equity derivative overlays, which are derivative instruments transacted with counterparties, and they have to do with some of the shares that a company would have to deliver at maturity.

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Combination settlement and equity derivative overlays

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The instrument settles the conversion, receiving some or all the shares back to the equity derivative overlay. One other management tool is to conduct the convertible note offering with a stock buyback, which is "a pretty interesting structure, takes advantage of the fact that a lot of purchasers are hedge investors, and they will want to hedge some of the principal," Aminian Baghai said.

The structure is a win-win for investors and issuers and is in fact nicknamed a "happy meal," because from the investor's standpoint they get the benefit to sell what they want to sell for their delta hedge at a fixed price. And from the issuer's standpoint, they are able to buy shares without going into the market and executing at a fixed price.

Regarding how many deals are done with these overlays compared to the simple convertible note issue is roughly about half and half, Aminian Baghai said.

It will be interesting to see if ongoing changes in regulation, accounting and investing spur further development of convertible structures.

The primer addresses all of these topics and more and can be found at www.lw.com/modernconvertiblenotes.

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