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Companies Tap Convertible Debt In Droves Amid Pandemic

By **Tom Zanki**

Law360 (May 1, 2020, 12:49 PM EDT) -- A breakneck surge in convertible bonds is keeping capital markets practices busy amid the coronavirus pandemic, as more companies find that these hybrid instruments that blend features of debt and stock can be an efficient way to raise cash during volatile times.

According to Dealogic, 24 listed U.S. companies raised $13.6 billion from convertible bonds in April. That's a big jump from March, a month in which markets stalled as investors sorted the economic fallout from the pandemic, when only six convertible issuers raised $3.1 billion.

"Since then, it has been gangbusters," said Latham & Watkins LLP partner Greg Rodgers, whose firm steered several convertible offerings in April.

Rodgers compared work in April to a year's worth of convertible deals. The increase comes as more companies seek to bolster their cash positions in order to weather economic uncertainty.

Most issuers raise capital through traditional debt offerings, by which they generate cash without diluting their stock. But convertible notes, which are debt-like instruments that allow investors to convert their holdings into stock if shares rise to a certain point, can benefit certain companies.

For the issuing company, a convertible bond can provide a quick way to raise capital without immediately diluting its stock as in an equity offering. Companies are also less likely to issue stock if they believe their shares are trading below their value, which is common during a downturn.

Convertible bonds also tend to pay lower interest rates to offset the value of allowing investors to convert their holdings into stock, potentially saving companies money. Such notes may appeal to investors seeking safety upfront while reserving the option to capture a rising stock later.

Baker Botts LLP partner Sam Dibble said convertible bonds can fill a "happy middle ground" for companies that don't want to sell stock while their shares are trading at low prices but also want to avoid complex agreements with bondholders that accompany conventional debt offerings.

"They tend not to have very much in the way of restrictive covenants," Dibble said of convertible notes. "So they can be pulled together relatively quickly and can be sold at an interest rate that's more in the realm of reasonability."

Select companies are finding value in convertible notes, where current activity well exceeds 2019 levels. Through April, 47 U.S. listed companies raised $28.1 billion in convertible bonds, compared with 33 offerings that raised $14.6 billion by this time last year, according to Dealogic.

"We have been seeing a pickup in convertible notes the last few weeks," Goodwin Procter LLP partner Rick Kline said. "Unlike equity offerings, the convertible debt market remains open for business with companies able to opportunistically raise money on solid terms."

The mix of issuers flocking to convertible debt is broader than usual. Young technology and life sciences companies, which need regular capital to fund their growth and offer investors a potentially appreciating stock, typically dominate the convertibles market. The technology sector alone accounted for 51% of convertible issues in 2019, according to Stifel Financial Corp.

Technology companies continue to play a strong role in the current landscape. Social media giant Snap Inc. and workplace messaging app Slack Technologies Inc. have joined the parade of convertible deals with respective offerings of $850 million and $750 million.

But recent convertible issuers also span the retail, e-commerce, sporting goods, energy, leisure and airlines industries. Dick's Sporting Goods Inc., American Eagle Outfitters Inc., Callaway Golf Co., British fashion retailer Farfetch, natural gas company CNX Resources Inc., Booking.com and Southwest Airlines Co. are some household names that raised convertible debt in April.

Perhaps the most notable was Carnival Corp., which raised $1.75 billion in convertible notes earlier this month as part of a more than $6 billion capital-raising package to help the battered cruise line navigate the pandemic. While companies may use convertible notes to fund growth during normal economic times, many issuers now are looking for financial breathing room.

"Right now, we are seeing more protective uses, putting cash on the balance sheet just to make it through this period of turmoil," Rodgers said, describing the reasons companies are raising funds. "It's become attractive to issuers in a variety of industries."

The market's recent volatility may also draw investors looking to spot opportunities. Convertible notes come with what is known as a conversion premium — or the difference between the conversion price and the current stock price.

For instance, Southwest Airlines issued a $2 billion convertible offering that allows investors to convert their bonds into stock once Southwest shares hit $38.48. That's about a 35% increase from its recent stock price, a common percentage in many recent convertible deals. Southwest shares closed above $38.48 as recently as March 13, so a rebound to that level is not far-fetched.

Dibble notes that, given recent market swings, a gain of about 30 percent in the stock of many companies could simply return their shares to where they traded before the pandemic. "So it's not really a bet on rapid growth, but a return to pre-coronavirus levels," he said.

Companies selling convertible bonds have tools they can use to prevent rapid stock dilution if they believe their shares are trading at low levels and are likely to trigger a conversion. Companies can use proceeds from a convertible offering to buy derivatives products — sometimes called "derivative overlays" — which have the effect of raising the conversion price to a higher level.

Lawyers note that buying a derivative can also signal that has a company has confidence in future stock appreciation and could reduce short-selling pressure.

"I would expect that companies that are not happy with their stock price, but want to raise capital, would consider a derivative in connection with a convertible," Cooley LLP partner Mischi a Marca said.

Capital markets attorneys anticipate they will remain busy with convertible offerings for the time being. Cooley partner Jason Savich notes that convertible deals have enduring appeal for growing technology and life sciences companies that don't have positive cash flow or hard assets.

Such companies may not have the same access to credit as mature, larger companies that can tap high-yield bonds or institutional term loans.

"If there is a need to shore up the balance sheet, they don't necessarily have the same options as other companies," Savich said.

Plus, current economic uncertainty is drawing a wider swath of issuers to the table. Having just launched Calloway's convertible deal and many more in April before that, including Calloway, Dick's Sporting Goods, Slack, and Booking.com, Rodgers said Latham has more in the hopper.

"It's no rest for the weary over here," Rodgers said.

--Editing by Rebecca Flanagan.