Client Alert.

January 30, 2013

Convertible Bonds – an Overview

By Melody He-Chen and Robyn Nadler

Since 2009, approximately 10 issuances of convertible bonds ("CBs" or "bonds") have been made by Hong Kong-listed companies. CBs are useful financing tools for companies, especially for small- to mid-sized fast-growing companies. This article provides brief guidance in relation to CBs.

ADVANTAGES OF CBS

A CB is a hybrid security with both equity and debt features. The bondholder can convert the bonds into shares of the issuer at any time or wait until maturity and receive cash at the principal amount. If the CB is issued with a coupon, bondholders can also enjoy interest payments throughout the life of the bond. Alternatively, if the bondholder elects to convert the CB into shares, then the holder will be entitled to dividends with respect to the shares. The price of a CB is closely linked to the share price of the issuer; however, volatility is typically lower than that of the underlying shares because of the debt feature.

One of the main benefits to an issuer of issuing a CB rather than straight equity is the ability to raise funds based on the strength of the issuer's "equity story", whilst being able to minimize dilution of existing shareholders. Although there is typically some downward impact on share prices at the time of issuance due to anticipated future dilution when the CB is converted, share prices typically normalize fairly quickly.

Another merit of issuing CBs is that they enable issuers to raise money with a lower interest burden compared to straight debt. In exchange, the issuer grants to the bondholders the option to convert the CBs into shares. From an investors' viewpoint, they are able to protect themselves from volatility in the issuer's shares by buying the CB and shorting the shares. If the share price falls, the bondholders will benefit from their short position. On the other hand, if the issuer's stock price rises, an investor can convert the CBs into shares and sell them at market value, thereby benefitting from its long position, and, ideally, compensating for any losses on their short position.

CB issuance globally has been low for the last couple of years. As reported in the *Financial Times* on 16 January 2013, the market has so far seen a flurry of convertible bond issuance in Europe, making it the strongest start to the year on record for volumes. This sharp pick-up comes as companies seek to benefit from increased investor appetite for risk and recoveries in share prices and are making issuers more comfortable that CBs can be issued at prices which adequately reflect the value of the company.

BASIC FEATURES OF CBS

Although there are domestic markets for some countries (such as the United States and Japan), CBs are often issued offshore in the "euromarket", i.e., to investors in European and other non-U.S. markets and are typically governed by English law and issued pursuant to Regulation S, the offshore exemption from the registration requirements under Section 5 of the U.S. Securities Act of 1933. Although similar in economic substance, there are significant differences between the form and structure of English law Euromarket documentation and New York law U.S. documentation. The discussion that follows outlines English law practice only.

Typically, a trustee is appointed to oversee the interests of bondholders pursuant to a trust deed. Paying and conversion agents are also appointed to facilitate payments to, and conversion by, bondholders. The bonds can be in either bearer or registered form, although developments in U.S. tax law applicable to bearer bonds has recently led to the registered form being more common. The tenor of a traditional CB typically varies from 5 to 20 years, although based on recent Hong Kong precedents, a tenor of three to five years is more common in this market. Depending on the relative needs of the issuer and investors, CBs are sometimes structured with call or put options.

Below are some of the principal terms and conditions of CBs:-

- **Conversion**

Bondholders are able to convert their CBs at any time subject to certain limitations provided in the terms and conditions. The procedural aspects of conversion are typically handled by the conversion agent. Once the conversion agent receives the conversion notice from the bondholder, it calculates the number of shares issuable to the bondholder and notifies the issuer of that number, together with certain other matters needed to effect delivery of shares to the converting bondholder. The number of the shares issuable to the bondholder is calculated by dividing the principal amount of the CBs presented for conversion by the bondholder by the conversion price. Fractions of a share are generally not issued and no cash payment made with respect to any such fraction but this calculation is made by reference to the aggregate principal amount of bonds presented for conversion and not separately in relation to each bond. The conversion price is fixed at the time of the issuance of the CBs based on the share price of the issuer at the time. Typically, the initial conversion price represents a premium of between 5% and 30% above the market price of the issuer's shares. The principal amount of the CBs being converted is applied to the subscription of the shares, such that bondholders need make no further payment. Upon conversion, amounts booked on the issuer's balance sheet as debt with respect to the principal amount of the CB is reduced by the principal amount of the CBs being converted, and a corresponding increase is made to shareholder's equity.

- **Exercise Period**

Bondholders are subject to certain limitations with respect to the exercise of conversion rights. For example, the exercise by an issuer of a call option will cause the bonds to be redeemed before maturity, thereby eliminating the holder's conversion right. In consideration of the loss of the value of the option embedded in the CB, bondholders are given notice of the prospective exercise of a call option so that they may convert into shares before redemption. Sometimes, the terms and conditions are structured so that bondholders can only convert the CBs when the share price exceeds a fixed threshold, for example, 120% of the conversion price for a certain period (so-called contingent convertible or "CoCo" bonds). In this way, the issuer is assured of being able to treat the CB as a "straight bond" for a certain period, thereby mitigating the dilutive impact of conversion and the computation of EPS (earning per share).

- **Adjustments to the Conversion Price**

The conversion price is typically adjusted upon the occurrence of certain corporate events which dilute the value of shares in the company, for example, equity issuances at less than market value. Such events typically also include consolidation, subdivision or reclassification of the share capital, rights issues and capital distributions by way of an extraordinary dividend. There are several ways of defining an extraordinary dividend. One common definition treats any excess distribution over a threshold based on the average of recent "normal" dividends as an extraordinary dividend. As a result of the adjustment to the conversion price, bondholders will receive more shares on conversion to compensate for the dilutive event.

These anti-dilution provisions are extremely detailed and intended to be comprehensive. Issuers should carefully review them to ensure they are workable and do not provide unintended protections in favour of bond investors which are not enjoyed by shareholders and may be considered by existing shareholders to be overgenerous.

- **Early Redemption**

The terms and conditions of CBs frequently contain provisions dealing with certain events upon which the issuer is permitted to redeem the CBs before maturity, with a premium to compensate bondholders for the loss of the conversion option. One common event is the likelihood of additional taxes being payable where the issuer is required to "gross up" payments to bondholders as a result of a change of law or regulation (bondholders can typically elect that their bonds not be redeemed in those circumstances by waiving their right to gross up payments). In addition, the issuer can redeem the remaining CBs if more than 90% of the CBs have been converted (a "sweep-up call" or "clean-up call"). The issuer is also allowed to redeem early if the share price exceeds a certain threshold, for example, 130% of the conversion price (a "soft-call"). This feature protects an issuer by capping the premium able to be captured by bondholders upon conversion when the bonds are in the money (i.e., the conversion price is cheaper than the prevailing market price of the underlying shares).

Bondholders are also typically given the option of early redemption (a "put option"), requiring an issuer to redeem the CBs before maturity, in certain circumstances, such as a change of control. In some cases, a put option is also structured to permit redemption at the election of bondholders without any condition on a specified date sometimes at a premium which reflects the cost of a fixed rate straight bond.

- **Corporate Events**

When a change of control occurs, or the issuer transfers all or substantially all of its assets to another company, bondholders are frequently given the choice of exercising a put option to have their CBs redeemed, or electing to convert the CBs into the shares of the issuer (or, subject to provisions of local law applicable to the issuer, the shares of the successor company).

It is important for issuers to ensure that the rights and obligations of the parties to the CB are spelled out clearly in the case of all corporate events. Where there is uncertainty and especially in cases where the CB is out of the money (that is, where the share price is lower than the conversion price), specialist funds have acquired CBs and sought to make money out of such uncertainty (for example, by threatening to frustrate the corporate event). At the same time, it is necessary for corporate event protection to fairly compensate investors for the loss of the time value of their options or a significant change to the equity story which forms the basis of their investment.

- **Negative Pledge**

The negative pledge prohibits the issuer from creating security over its assets to secure other indebtedness without giving equivalent security to the CB holders. The scope of indebtedness which may be subject to a negative pledge clause is a matter for negotiation; however, it is not uncommon for the restriction to extend only to indebtedness of a similar nature to the CB – i.e., in the form of notes or other securities which are listed on a stock exchange. If the issuer creates such security in favour of lenders under other indebtedness, then the same or equivalent security is required to be created in favour of the holders of the CBs on a *pari passu* basis. A negative pledge clause is sometimes extended to encompass indebtedness of the entire issuer group, or certain material subsidiaries, in which case the issuer will typically be required to provide the names of such material subsidiaries annually to the Trustee in accordance with the terms of the Trust Deed.

- **Events of Default**

Typically, upon an event of default, CBs will be redeemed at 100% of their principal amount (sometimes with a premium) immediately. Common events of default include non-payment of interest, breach of obligation by the issuer, cross default on the issuer's other indebtedness, or winding-up and similar insolvency events. Where a trustee is appointed, the trustee is usually required to declare an event of default by bondholders whose holding of the bonds exceeds a specified percentage (25% is common) of the total principal amount of the issuance, or if so directed by an Extraordinary Resolution of the bondholders. Trustees are recently increasingly unwilling to exercise any discretion with respect to the declaration of an event of default reflecting the increasing influence of U.S. practice and litigation concerns which manifested themselves in the fall out from the global financial crisis. For this reason, although still market practice, some have questioned the value of trustees in convertible bonds.

DOCUMENTS

Standard documentation for CBs is as follows:

- **Offering Circular**: Disclosure document to be distributed to investors at the time of the launch. In addition to the terms and conditions of the CB, the Offering Circular contains matters such as the risk factors applicable to the issuer, a description of its business and the issuer's management, matters relevant to the investors, such as taxation and selling restrictions. Compared to the offering circular of a standard straight bond issue, the offering circular of a CB issuance contains more detailed information about the issuer and its equity story reflecting the equity nature of the investment.

- **Subscription Agreement**: The managers and the issuer agree on the terms pursuant to which the managers will underwrite the CBs and pay the principal amount to the issuer. The Subscription Agreement covers matters such as the fees and commissions payable to the managers, representations and warranties of the issuer and selling restrictions applicable to sales activities of the managers in the jurisdictions in which they will market the bonds.

- **Trust Deed**: The issuer appoints the trustee to act in the interests of the bondholders; unlike fiscal or paying agents used for straight bonds, the trustee is not the agent of the issuer. The CBs are constituted pursuant to the trust deed, which includes the form of the CBs, including the terms and conditions, and sets out the process for convening and holding bondholders' meetings. The trustee should be a professional trust corporation, typically based in Hong Kong or London.

- **Paying Agency Agreement**: The issuer appoints one or more paying and conversion agents as its agent. The paying agency agreement sets out the procedures and mechanics for conversion, transfer and payment on the bonds. The form of conversion notice is also included in the paying agency agreement.

- **Comfort Letter**: The issuer obtains a comfort letter from its accountants with respect to the accuracy of the financial statements contained in the offering circular. The accountants are required to review or read the issuer's books and records from the date of the issuer's last audited or reviewed financial statements and consult with the relevant officers of the issuer in relation to any material changes since the last audited or reviewed date.

In recent years in Asia, well-known issuers have been able to launch CBs solely on the basis of a term sheet, with due diligence and preparation of a listing document being done at a later stage (“term sheet launch CBs”).

CB issuance without any offering circular is also possible if the issuance is targeted only to institutional investors and no listing is contemplated (a so-called “undocumented offering”). In that case, the offering will be launched by the managers on the basis of a term sheet, setting out only the principal terms and conditions and applicable selling restrictions. In such case, investors receive no direct representation as to issuer’s condition, and must rely only on publicly available information of the issuer, such as its annual reports, financial statements, regulatory disclosures and press releases. Typically, managers obtain an investment letter from investors (a so-called “big-boy” letter), to the effect that they are not relying on any representation made by the managers and that their investment in the CBs is at their own risk.

LISTING

Since the difficulties with EU listings in the early 2000s, it has become common for CBs to be listed on the Singapore Stock Exchange (SGX). Following the changes made in 2011 by the HKEx, which largely brought Hong Kong requirements into line with the SGX, it is probably more convenient for Hong Kong-listed issuers to list their CBs on their home exchange.

DUE DILIGENCE

Managers conduct due diligence of the issuer to ensure that all information contained in an offering circular is true in all material respects and does not omit any material information. A certain amount of high level due diligence is desirable even for undocumented offerings, and even if a big-boy letter is obtained from investors, to mitigate the reputation risk of going to market on the basis of incorrect or inadequate disclosure. For CB issuers whose shares are publicly listed, there are generally existing public disclosures and filings with the relevant stock exchange available. The due diligence exercise thus typically focus on new development or material changes of the issuer’s business, operations and financial conditions.

TIME TABLE

A timeframe of four to eight weeks from the initial kick-off meeting to the launch of the CB offering is typical in the case of documented offerings. If the offering is unlisted and launched without an offering circular, the schedule can be shortened. The process includes at least one due diligence meeting with the issuer, a management interview of the senior executives at the issuer and an auditor due diligence meeting.

On the launch date, the offering circular is distributed to the investors and a subscription agreement is signed. On the closing date, the CBs are issued to the investors and the principal amount of the bonds is received by the issuer into its bank account. The trust deed and paying agency agreement, as well as the form of the note comprising the CBs (which is typically in global form held by a depositary, with investor interests cleared through a clearing system) are signed.

CONCLUSION

CBs are useful financing tools for issuers, and popular with investors. After a quiet few years, 2013 may well see the return of CBs to the Asian markets.

Contact:

Melody He-Chen
852 2585 0887
mhechen@mofo.com

John Moore
852 2585 0869
johnmoore@mofo.com

Ven Tan
852 2585 0836
vtan@mofo.com

Gregory Wang
852 2585 0856
gwang@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.