EY equity capital markets: convertible market update

Q4/2023 year-end review and 2024 outlook

January 2024

Building a better working world

2023 year-end summary

Convertible volumes increased as volatile capital markets conditions moderated, and issuers refinanced both convertible and straight debt maturities

Convertible issuance for 2023 was US$52b, up ~80% from the US$29b issued in 2022 and ~20% above the 2015–2019 pre-COVID-19 average issuance level of US$40–US$45b. Other than a brief pause in July, activity was remarkably consistent throughout the year, with quarterly issuance of US$12.4b, US$13.7b, US$14.6b and US$11.7b over the course of 2023. While issuers continued to access the convertible market to raise growth financing (CapEx, acquisitions, etc.), the primary driver of volumes in 2023 was issuers utilizing the convertible market to refinance convertible and straight debt maturities. Seventy percent of the convertible debt deals in 2023 had refinancing as a use of proceeds, compared with 57% and 40% in 2022 and 2021, respectively.

A portion of this refinancing activity was for prior convertible debt issuers getting ahead of 2024 and 2025 maturities, but this issuer group was supplemented by a group of issuers that were looking to refinance straight debt. These companies generally sought to leverage the convertible market to preserve cash, manage debt cost of capital, and improve EPS metrics by taking advantage of the lower cash coupons that convertible debt inherently provides. As elevated interest rate differentials remain between convertible and straight debt financing, we expect this trend to continue in 2024.

To kick off the year, we wanted to provide a few additional perspectives on the last 12 months in the convertible market and a preview of what the new year may have in store.

1

Q4 activity was consistent with historical levels, with deals continuing to trade well in the secondary market

Total issuance in Q4 was US$11.7b, relatively consistent with the rest of the year and generally in line with pre-COVID-19 volumes. This volume number was supported primarily by five offerings greater than US$1b in size, with four of those five exceeding US$1.5b. Of note: Three of the five largest deals in 2023 priced in Q4. Issuers that brought deals to market in Q4 benefited from a strong equity market tailwind and all of the deals issued in Q4 were trading above par value at the end of the year. Similarly, buttressed by the aforementioned equity market rally and risk-free rates moving lower on the back of messaging from the Fed, convertible secondary trading levels firmed going into year-end as security valuations benefited from both the equity and credit components of convertible structures. A strong trading environment typically allows investors to be more constructive as they evaluate new offerings, which translates into reduced "cheapness" (i.e., less of a discount to par value at issuance), and in turn better terms for issuers (lower coupon/higher conversion premium). This dynamic evolves based on supply/demand and underlying market fundamentals, but the positive trend over the last couple of months should provide momentum heading into 2024.

2

Convertible market provides alternate financing source for nontraditional issuers, as lower cash interest expense addresses prospective issuer needs

A convertible bond is a debt instrument that investors have the right to convert into shares of an issuer's common stock at a predetermined conversion price (typically set at a 25%-35% premium above the stock price at issuance, though it can be higher or lower). Investors participate in share price appreciation above the conversion price, while retaining a floor value (equal to the principal amount of the bond) if the stock price does not exceed the conversion price at the bond's maturity. This conversion option has value to investors, and in exchange for this value investors price convertible bonds with a lower coupon than a similar nonconvertible debt instrument.

The cash coupon savings can be valuable across market backdrops but is particularly relevant in higher interest rate environments. With interest rates at an elevated level, only about 50% of the underlying rate increase is reflected in convertible coupons, making the security relatively more attractive when compared with straight debt. For example, the average convertible coupon in 2023 was 3.37% compared with the average of the BofA US High Yield index of 8.42%, representing a 500bps+ coupon differential, which goes up to approximately 525bps when factoring in unique dividend pricing considerations from recent investment grade issuers. This 500bps+ differential is meaningfully wider than the average difference between convertible and high yield coupons of 4.10% over the last five years, which is garnering attention across all potential issuers.

Of note: 73% of convertible debt issuers had straight debt in the capital structure at the time of the convertible financing (bonds or term loans), addressing the "myth'" that convertibles are securities only utilized by companies that do not have access to the straight debt markets. As more issuers consider crossing over into the convertible market, the potential cash coupon savings will be a meaningful factor in the decision-making process. These lower coupons may help mitigate the incremental enterprise risk inherent in an elevated cost of capital environment by improving free cash flow and improving EPS metrics, reducing the fixed cost of acquisitions, and in some cases managing pressure on key covenants, including interest coverage. The cash cost benefit of convertibles may also accelerate the refinancing of longer-dated unhedged floating rate securities for similar reasons beyond a pending maturity or "go current" date.

3

Call spreads were used less frequently, but this is more likely tied to 'issuer profile' than attractiveness of the alternative

As noted, issuers retain upside protection in the convertible up to the conversion price, which is the conversion premium applied to the stock price at the pricing of the deal. Many issuers expect share price appreciation in excess of the conversion price over the life of the convertible, and as such consider alternatives to mitigate this exposure. A common way to achieve this additional protection is to purchase a call spread (via a capped call or bond hedge plus warrant structure). These call spreads are purchased from bank counterparties via negotiated transactions and typically raise the effective conversion premium to 75% to 100% above the stock price at issuance (at a typical cost of ~8% to 13% of deal size). Since the call spread is executed privately between the issuer and the participating banks, convertible investors themselves are not impacted and thus retain all equity participation above the base conversion premium.

The market has seen a decline in call spread use over the last few years, from 59% in 2021 to ~45% in both 2022 and 2023. In previous updates, we have highlighted a number of reasons for the decline in usage, including:

- Fewer growth-oriented companies accessing the market during down market years
- More "mature" IG issuers becoming a larger component of the convertible issuer pool
- Issuers needing to maximize proceeds raised for debt repayment or other uses (vs. spending on a call spread)

While there are several practical explanations for the recent call spread trend, 2024 may bring a pickup in activity for a few key reasons, including:

- The call spread creates a more debt-like cost of capital profile and reduces potential equity dilution. With the expectation that more issuers will evaluate convertibles as an alternative to straight debt, the ability to create a more debt-like profile in the convertible market will be increasingly relevant.
- Issuers that raised convertible capital in 2020 and 2021 have refinancing needs over the next 12–18 months, and many are contending with stock prices that have not fully rebounded from recent declines. As these issuers return to the convertible market for refinancing, we expect most to require call spreads to bridge the gap between current equity trading prices and expectations for future performance.

There are additional benefits to the call spread product, including tax deductibility where relevant and a clear bullish signaling to equity investors. Ancillary benefits include technical trading support during execution, which can result in improved stock price trading during deal execution. These benefits have not changed and are relevant as companies weigh the merits and considerations of the structure.

Importantly, call spreads are priced directly with the banks, which act as counterparties to the issuer on these derivatives. There is material value at risk when pricing these instruments, and the legal documentation contains provisions that can have a material impact on future value delivery and capital structure flexibility. Having an experienced and independent party involved in both the planning and execution of these transactions is critical to achieve efficient pricing (typically via a robust auction process) and establish issuer-friendly, market-leading terms that meet the company's objectives.

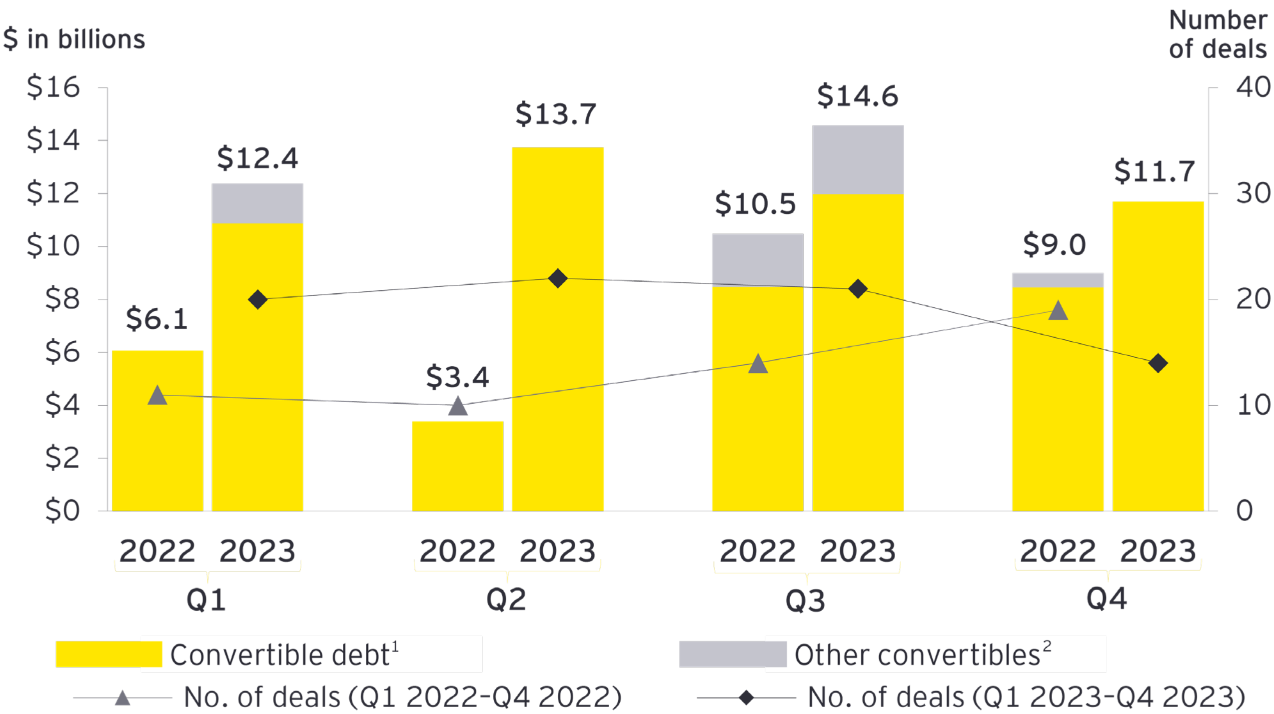
We expect 2024 …

to be an active year for convertible financing as existing issuers manage maturities and nontraditional issuers evaluate the market

Though not without risks, market tone feels constructive heading into 2024 on the back of strong equity market performance and continued moderating inflation. 2023 volumes were above average, and we expect convertible activity to remain robust in 2024. Necessary transactions from issuers that are refinancing their outstanding 2024–2026 convertibles will provide a baseline level of volume, which may be supplemented by issuers that have historically accessed the straight debt market but are attracted to the low cash interest expense obligation of convertible debt. The wild card will be whether there is a meaningful increase in opportunistic growth-oriented financing that returns to the market. A continued stock market rally and improving valuations may be the catalyst that drives activity and volumes higher, though any retrenchment in equities will hold overall transaction volumes in check.

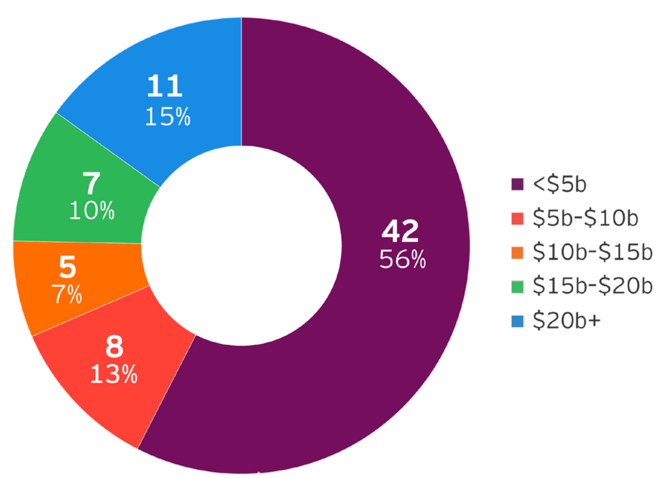
Financing decisions are rarely straightforward, and in a potentially crowded deal market having a carefully considered perspective on security selection, deal timing and execution strategy is critical. Regardless of whether a company is a first-time issuer, or has executed multiple transactions across markets, there is significant value at risk in each transaction. The EY Capital Markets Advisory group is an integrated team of professionals with deep deal experience across all debt and equity products that drives value and reduces transaction costs across their engagements. In a shifting and elevated rate environment, an independent and unbiased perspective on financing and capital structure alternatives can be invaluable. Our team's primary goal in these transactions is to identify value gaps and reduce execution risk, both paramount considerations when banks are increasingly inconsistent across financing views and risk appetite. Please do not hesitate to reach out if we can be helpful.

Quarter-over-quarter volumes remain consistent in 2023 and above depressed 2022 issuance activity



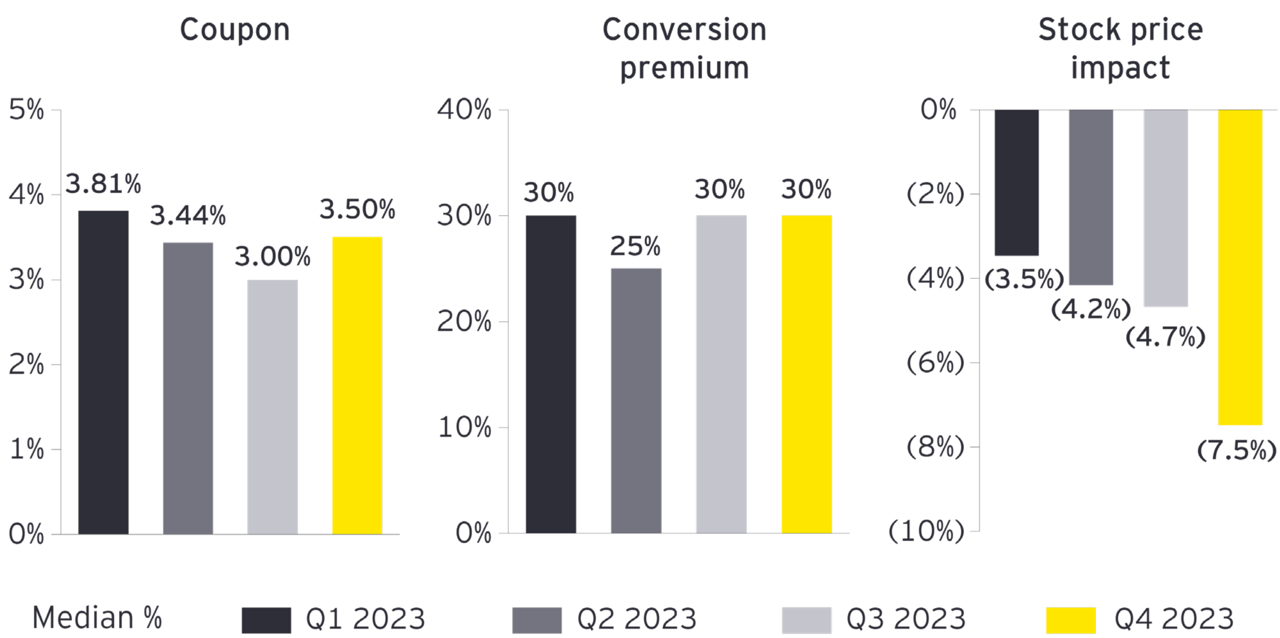
Market historically driven by smaller issuers, with larger companies utilizing convertibles opportunistically[1,3]

Number of issuers by market cap

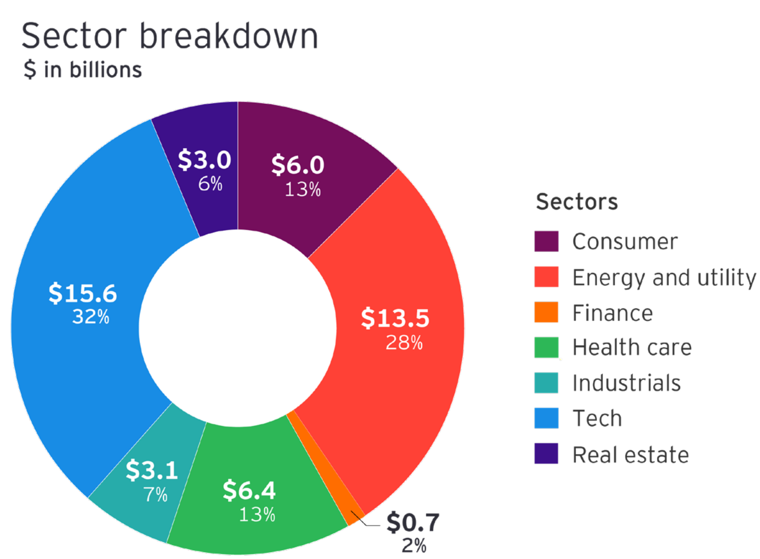


Sources: Dealogic; Prospect News; press releases; SEC filings, Ice Data Indices, LLC, retrieved from FRED, Federal Reserve Bank of St. Louis
[1] Data for convertible debt transactions.
[2] Other convertibles include convertible preferred, mandatory convertibles and exchangeable transactions.
[3] Includes data from last four quarters.

Convertible terms remained steady through 2023 in spite of higher interest rates[1]



More balanced issuance as historically less active sectors rotated to the convertible market[1,3]



Sources: Dealogic; Prospect News; press releases; SEC filings, Ice Data Indices, LLC, retrieved from FRED, Federal Reserve Bank of St. Louis

Ernst & Young Capital Advisors, LLC

David A. Brown
Head of Equity Capital Markets Advisory
+1 917 647 8415
david.brown1@ey.com

Daniel Josephs
Head of Equity-Linked Capital Markets Advisory
+1 267 408 8533
daniel.josephs@ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

US Score no. 22191-241US
2401-4410327
ED none

eyinvestmentbanking.com