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Issue Brief

A Crash Course in Convertible Securities

Convertible securities are tools which combine features of debt and equity financing that companies can use to help raise capital. These securities come in many forms. Convertible notes, convertible bonds, and convertible preferred shares are a few common examples.

In general, these securities are debt-like securities that are convertible into common stock of the issuing company. Holders have two options. One is to hold the original security and collect a steady cash flow from coupons or dividends culminating with the eventual repayment of principle. The other option is to convert the security into shares of common stock, giving up on both the remaining coupons and the security's principal repayment.

Benefits of Convertible Securities

The combination of key features of both non-convertible debt and stock options or warrants into a single instrument can be attractive to investors. If the stock price increases, the holder can convert the security into common stock and capture the same unlimited upside that an option investor is entitled to. If the company fails to increase in value, however, an investor can redeem the instrument for its principal balance at the end of the securities term, unlike an option holder who would be left with an out-of-the-money worthless option.

Of course, the investor's valuable conversion benefit comes at a cost. Because issuers give up more value if the company fares well, investors earn a lower interest rate than they would on similar, non-convertible instruments. The issuer benefits by reducing its burden of interest payments, which are paid whether or not the company succeeds, by providing additional value only when the company succeeds. This form of "risk sharing" can serve as a useful compromise for cash constrained companies and/or companies looking to save on debt expense.

Performance

Convertible securities are generally riskier (and offer higher potential returns) than non-convertible debt due to the potential benefits of conversion. At the same time, they're less risky than common stock thanks to their guaranteed payments.

Given the way they're constructed, it's fairly easy to understand how convertible securities perform. If the underlying company is increasing in value, the probability of conversion will increase, and the security will perform more like common stock. If, however, the underlying company is falling in value, the debt component will take over, and the security will move based on interest rates.

Accounting Considerations

Convertible instruments are classified as either debt or equity. Reference is generally made to Accounting Standard Codification Topic 480 (ASC 480), ASC 815, and ASC 470. Liability classification may require a quarterly mark-to-market process, whereas equity classification will generally lead to fixed accounting.

Due to the many features available in convertible securities, an important upfront step involves carefully analyzing the key terms and conditions to determine whether the instrument contains embedded options or other features requiring bifurcation or periodic valuation updates. In general, the security will need to be reviewed for embedded derivatives, cash conversion features, and beneficial conversion features.

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The first consideration for a convertible security is whether you can, and want to, take the "fair value election" under ASC 815-15-25-4 through 25-6. If there is a cash redemption or beneficial conversion feature, as described below, you need to allocate a portion of the value of the contract to equity. As a result, the fair value option is not available for the instrument under ASC 825-10-15-5.

Assuming you don't use the fair value election, you need to evaluate whether the security is deemed to have embedded derivatives under ASC 815-10-15-83. If these exist, they are bifurcated from the host debt contract and accounted for separately as a derivative, resulting in periodic revaluations. These may arise due to features involving redemption, anti-dilution protections, or call and put provisions.

Absent any embedded derivatives, a security with a cash redemption feature needs to be accounted for under ASC 470-20, which requires separating the equity and liability components of the debt for financial reporting purposes. In general, this requires valuing the debt component based on a coupon rate which would be applied to non-convertible debt with otherwise identical terms.

A security may also have a beneficial conversion feature if the conversion price at issuance date is lower than the current stock price. In these cases, the as-converted value of the debt will be above the face value. This beneficial conversion feature is to be accounted for in additional paid-in capital.

If debt with attached warrants are issued in place of convertibles, even though the economics may be similar to a hybrid instrument, the accounting treatment will differ as the two must be accounted for entirely separately.

Ultimately, small details can make a big difference. So when issuing a convertible instrument, always formulate the accounting policy early. In our experience, post-issuance surprises can lead to internal friction that could often have been avoided if the downstream accounting had been better understood upfront. Even if the instrument design ends up unchanged, internal stakeholders would have known what to expect from the very beginning.

Key Terms

As convertible instruments contain features resembling both options and debt, there's more flexibility available in designing and negotiating an instrument design. Key terms from both options and debt can include the interest rate, conversion ratio (or the price at which the principal converts to common stock), term, which party controls the conversion decision, and whether the security can be converted at any time or only during a fixed time period.

One feature which is specific to convertible securities is forced conversion. This allows the company to require investors to convert the security into common stock, for example if the value of common stock as a result of conversion is sufficiently above the principal balance. In this case, when the company knows the security will likely be converted in the future, they can force investors to do so early and save the future interest payments.

Not surprisingly, investors looking to purchase privately negotiated securities may be able to work with the companies themselves to work out more nuanced terms than are generally customary. In contrast, securities issued publicly usually contain more standardized terms developed by the company and the underwriter of the securities.

Hypothetical Payouts

We believe that in today's sustained low interest rate environment, convertible securities will continue to be particularly attractive to buyers.

For more mature companies, investors unable to generate large returns in the fixed income space while still investing in companies with good credit will see a benefit in upside participation offered by convertibles. Meanwhile, investors with reduced risk tolerance following the stock market decline and recovery will appreciate the downside protection offered by the protection of their principal balance.

For early stage companies, convertibles continue to offer an attractive method of financing by offering both capital protection and participation in a business' success.

Who Uses Convertible Securities

Convertible securities can present a good fundraising alternative for companies with strong growth opportunities but limited credit or cash constraints. That could be a startup, a company in a turnaround situation, or an established company looking for funds to break into a new market. For example, a specialty electronics manufacturer may hold the patent to a lucrative new product but be reluctant to take cash from its existing businesses. An offering of convertible securities can give the company the boost it needs to ramp up production.

Earlier stage companies may also be unable to borrow without giving upside to lenders. Convertible securities may be the only viable option they have, absent directly selling equity (at a potentially steep discount).

Drawbacks of Convertible Securities

The main benefits of convertible securities can also be drawbacks. The lower coupon rates can hurt income-focused investors, while equity investors will experience lower rates of average return. In addition, just like any other forms of debt, if the company exhausts all its cash and assets investors may lose all of their investment. Convertible securities, which offer higher risk and potential reward than non-convertible debt, are often subordinate to non-convertible debt classes.

There are drawbacks for sellers, too. A convertible security requires you to potentially give up equity while burdening the business with fixed payments. They can also diminish value for your common shareholders, since preferred share and bond holders generally have more seniority in liquidation. Also, accounting for these securities may require bifurcating the debt and equity related components of the instruments. Finally, due to the variability in value of the security, convertible securities may introduce volatility in earnings that is higher than either debt or equity financing.

Other Interesting Strategies

Many issuers of convertible debt are companies that are cash-poor but bullish on their longer-term prospects. They view convertibles as the most efficient way to raise capital but are concerned there may be excess dilution if/when their stock climbs. To manage this risk, they invest in call options in their own stock. While this adds to the cost of issuance, it prevents the company from losing value if the company value increases and the issuers are forced to dilute their equity stake due to conversion.

Finally, some hedge funds and other holders use a trading strategy called "convertible bond arbitrage," which focuses on holding the convertible and short selling the company's common stock to profit from the perceived relative mispricing between the two.

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