HOW TO RESTRUCTURE A CONVERTIBLE BOND OUT OF COURT

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Growth-oriented companies often issue convertible bonds to obtain low-cost funding. Typically, the coupon on convertible debt is less than what the company would pay if it raised straight debt, and the dilution is less than issuing straight equity.

Convertible bonds are an attractive form of financing for the borrower and issuer, especially when growth assumptions are realized, the stock price rises above the conversion price, and the bonds are converted into equity.

But when growth assumptions aren't achieved and the stock price is inadequate to facilitate the conversion of the debt into equity, the convertible debt is still due at maturity. This presents an existential financial problem for the issuer, because if the convertible bond is not converted into equity, the debt must either be repaid in cash or refinanced. If those alternatives aren't available, the issuer must risk a default and potential bankruptcy filing or restructure the debt out of court.

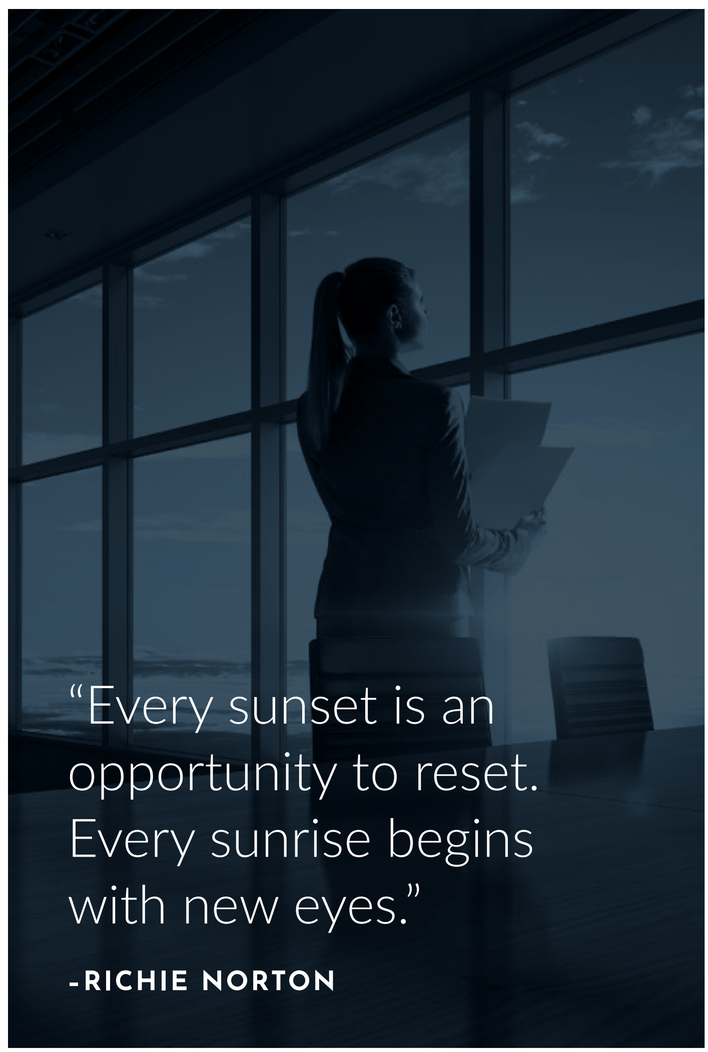
From a board-level perspective, an early sign that a convertible might become a problem is that financial performance targets (especially in terms of growth or margins) are not being realized.[1]

EARLY RECOGNITION OF AN OPPORTUNITY FOR RESTRUCTURING

When performance targets aren't reached, there is a risk that the stock price does not increase above the conversion price and the bond trades only as a fixed income instrument with a lower-than-market-rate coupon rate, i.e., at a discount to par.

However, if the stock hasn't completely bottomed out, or if there's a compelling case for the stock to rise materially in the future, there is still an opportunity to restructure the convertible debt out of court via negotiations with the bondholders.

What should a board do about a convertible bond that is approaching maturity and that won't likely be exchanged into equity? An important first step is to understand the economics of the situation and the consequences if the problem is not addressed on a timely basis. –



A keen understanding of the current enterprise valuation metrics, debt capacity, lien capacity, debt, liquidity, and prospects of the business are essential to renegotiating and resetting the terms, and avoiding default.

A convertible bond has two components of value, which at issue usually add up to the par value of the bond:

1. Fixed income value is the value of the debt measured as if there was no conversion feature. The factors that affect the fixed income value are:
    a. Maturity of the debt
    b. Coupon rate/payment dates (usually semi-annual)
    c. The market rate of interest for the debt (usually based on a comparable analysis of similarly risky debt/for similar companies)
2. Equity option. The conversion feature in the bonds can be valued as an equity call option assuming there is no fixed income component. The primary value drivers for an equity call option (using the Black-Scholes option pricing model) are:
    a. The market price of the common stock
    b. Strike price of the conversion feature
    c. Maturity of the option (time)
    d. Volatility of the underlying stock

At issuance, a convertible bond's par value (100%) consists of the value of these two components.

Example: The fixed income value may only be 60% due to the lower coupon rate versus what the market would demand for non-convertible debt. That value is supplemented by the value of the call option embedded in the conversion feature, which in this case would theoretically be 40% of the face amount, for a total of 100%.

When convertible debt matures and the market price of the stock is below the conversion feature, the value of the embedded call option will be de minimus, owing to the out-of-the-money strike price and limited time for the option to be exercised.

Without a valuable call option in the bond, the convertible bondholders will likely ask to have their debt redeemed for cash (at 100%). Convertible bonds with stock prices far below their strike price often trade a significant discount to face value and are referred to as "busted converts" by bond traders and portfolio managers.

OPTIONS FOR RESTRUCTURING TO AVOID DEFAULT

For companies whose stock price did not increase enough to reach the conversion price, there is often an associated inability to make good on this redemption for cash (at 100%) either with cash on hand or by refinancing.

The good news is that there may be a way to negotiate an economic settlement that provides a meaningful recovery to the convertible bondholders and avoids a maturity default ("Amend and Extend"). This solution involves increasing the value of the call option (i.e., the conversion feature) by:

1. Resetting the strike price lower so the debt is convertible into more shares per face amount; and
2. Extending the maturity of the bond and thereby the maturity of the call option.

Other potential changes include increasing the coupon rate (thereby increasing the fixed income value) or offering a security interest in the issuer's assets (increasing the fixed income value). These changes can frequently be negotiated incrementally with bondholders on a discrete, consensual basis to avoid default, and present the issuer with more time to achieve success.

KEY FACTORS TO REWORKING THE CONVERSION TERMS

In many cases, while existing shareholders will have economic dilution from resetting convertible bonds, it will likely be less than the dilution in an uncured default or Chapter 11 process. But shareholders may still act and object to the resetting, so having a defensible process should also be part of the issuer's strategy.

A critical ingredient in successful negotiations is having a realistic business plan that shows the company's strategy has a likely chance of generating stock price increases above the new conversion price, so the reset convertible bond has an opportunity to be in the money by the revised maturity date.

This plan may be shared with the convertible bondholders (or their advisors) on a confidential basis to induce resetting the conversion terms, or the bondholders may be left to develop their independent views; but, from a board perspective, realistic financial projections are an essential part of the calculus of resetting the terms of the convertible debt.

The timing and strategy used to approach convertible bondholders are important. A few relevant questions on this topic include:

- Will the maturity of the convertible debt trigger a going concern audit opinion and potential cross-default on the company's debt?
- What are management and investors' expectations about the future financial prospects of the business?
- How widely held are the bonds?
- What is the investment thesis (growth vs. value vs. distressed) of the holders and the sophistication level of the creditors?

The answers provide some basic considerations in formulating a comprehensive approach to resolving the situation.

Understanding the legal and regulatory framework for making these changes. Consulting with securities counsel or financing counsel is a basic first step. Issues such as listing exchange requirements, solicitation and exchange offer rules (public vs. private exchange transactions), and tax consequences are all important considerations in resetting convertible bonds.

SUMMARY

The keys to enjoying a successful out-of-court resetting and minimizing the prospect of litigation are to follow the securities rules, and understand the agenda of creditors and the dilutive impact to shareholders. In coordination with this information, creating a record of creditor negotiations on an arm's-length basis that highlights the business rationale for the transaction, as well as considering the economic consequences of not resetting the terms of the debt, presents the opportunity to defend the board's business judgment.

While the reset alone may not increase the stock price, removing the pressure of a going concern and debt quoted at astronomic yields can help companies execute their business plan by minimizing balance sheet distractions for senior management, customers, suppliers, and other stakeholders.

For more information on these concepts and the math involved in resetting convertible notes, please contact Steven Strom of Odinbrook Global Advisors at steven@odinbrook.com or 203.918.4500.

[1] *See also "Addressing Early Signs of Financial Distress" by Steven Strom.*

STEVEN STROM

Managing Director

Investment banker, board member and expert witness with more than 30 years of experience in advising companies, creditors and other stakeholders in special situations, business transformation and financial distress.

Direct: 203.918.4500 | Office: 844.634.6456 | Email: steven@odinbrook.com | www.odinbrook.com