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Convertible Notes, Accelerated Share Repurchases and Other Equity-Linked Instruments: Challenges and Opportunities in 2023

Contributing Partner

Joseph (Yossi) Vebman / New York

Counsel

Yan Shurin / New York

Key Points

- With lower stock prices, some companies with maturing convertible debt may be forced to repay or refinance. Issuers with strong balance sheets may be able to exchange or buy back convertible notes at attractive discounts.
- Companies may find terms for accelerated share repurchase programs appealing because of depressed share prices, but the new excise tax on share buybacks starting in 2023 should be taken into consideration.
- Margin borrowers that post equity as collateral may want to take preemptive measures to avoid margin calls.

Increased volatility and reductions in asset values in the equity markets, coupled with rising interest rates and a slowing macroeconomic environment, have affected a wide range of equity-linked products. Continuation of these trends in 2023 will present both challenges and opportunities for publicly traded companies and their shareholders. We discuss trends we have observed and issues we expect to encounter in 2023 with regard to equity-linked products.

Convertible Notes

The convertible note market has seen several years of healthy activity, both pre-COVID-19 and during 2020-21, as convertible notes have provided low-interest, covenant-light financing. The convertible note issuance market slowed considerably in the first half of 2022, falling below 2017-18 levels. While the new issuance market improved considerably in the third quarter of 2022, with activity eclipsing the first two quarters combined, the environment is still less favorable to new issuances than it had been.

A growing number of convertible note issuers face upcoming maturities. Depressed stock price levels mean that a significant number of these convertible notes are unlikely to mature "in the money" (*i.e.*, for the underlying stock to trade above the conversion price so that holders will convert their notes). As a result, issuers must be ready to repay the convertible notes in cash upon maturity.

With rising interest rates, issuing new convertible debt to refinance existing notes has become significantly more expensive. As an alternative to issuing convertible debt in a traditional capital markets transaction, some issuers have been placing convertible notes with concentrated groups of investors, allowing for more negotiation over terms, including with respect to covenants, security packages and, in some cases, registration rights.

Declining prices of outstanding convertible notes have made it possible for issuers, especially those with strong balance sheets, to retire such notes at attractive terms. Issuers have been able to explore repurchases of convertible notes at significant discounts to par, generating meaningful savings. In some cases, repurchases are effected solely with cash, but they can also be structured as an exchange, in which holders that tender their notes receive other securities — often the issuer's shares. Exchanges can also be structured so that holders receive new convertible notes for their existing ones. Alternatively, convertible-for-convertible exchanges may effectively be structured as new issuances of convertible notes alongside concurrent repurchases of convertible notes from existing investors, allowing issuers to attract new investors.

The equity-linked nature of convertible notes makes it imperative that the repurchase not trigger the creeping tender rules.

One Manhattan West
New York, NY 10001
212.735.3000

Whether a particular repurchase plan will give rise to tender offer concerns is heavily driven by facts and circumstances.

Many issuers have entered into hedging transactions in connection with issuing convertible notes, in particular call spread and capped call transactions. Ordinarily, these hedging arrangements would be unwound in connection with the retirement of the associated convertible notes, but careful analysis of the terms of the particular instrument must be conducted to determine the outcome in each case.

Retiring convertible notes and their associated hedging arrangements may have significant tax and accounting consequences, so those must be evaluated carefully at the inception of the process.

Accelerated Share Repurchases

Accelerated share repurchase programs, or ASRs, have seen an unprecedented level of activity in the last several months, far exceeding the volumes in prior years. The surge can be attributed to depressed stock prices, coupled with high volatility and rising interest rates. In a typical ASR, the company makes an upfront payment to the bank counterparty, which concurrently delivers a number of shares (commonly set at 85% of the number equal to the upfront payment divided by the current stock price), which the bank counterparty borrows from stock lenders in the open market. The bank counterparty then purchases shares in the market during the term of the ASR in order to return them to the stock lenders. In the current environment, companies can expect quite attractive ASR terms, with high guaranteed discounts to their volume-weighted average share price over the term of the ASR.

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While structuring ASRs and other buybacks has traditionally not been particularly sensitive to tax considerations, recent legislation imposing a 1% excise tax on buybacks by publicly traded companies beginning in 2023 resulted in a push to enter into ASRs in 2022, with particular focus on upfront delivery of shares before year-end. (See "New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain.")

Bilateral Derivatives

Significant shareholders, oftentimes affiliates, have continued to explore bilateral over-the-counter derivatives transactions, such as variable prepaid forward and collar transactions. These arrangements can be highly customized and may be structured to provide shareholders protection against stock price declines while retaining some appreciation and offering immediate liquidity, all in a tax-efficient manner. We have witnessed a significant increase in interest in these instruments over the course of the last several months and expect the trend to continue.

Margin Loans

A financing tool frequently used by founders, sponsors and other private equity funds, margin loans have been utilized over the last few years to generate liquidity while retaining the economics of equity holdings. While margin loans are invariably overcollateralized, lenders often have no recourse other than to a special purpose vehicle used for the financing and the shares those borrowers own, exposing the lenders to stock price declines.

Declining prices of the pledged equity may result in loan-to-value ratios that trigger margin calls, requiring the borrowers to either post additional collateral or partially repay the loans. In addition, some margin loans include stock price triggers that may result in adjustments to the terms of the margin loan and/or mandatory repayment in the event of specified stock price events.

In light of the market's volatility, borrowers may wish to take proactive measures to avoid margin calls and stock price triggers, including by posting additional collateral before a margin call occurs and seeking preemptive waivers with respect to stock price triggers.