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How to avoid the death spiral of converts

The Canadian convertible debentures market

The Canadian marketplace is home to over $14 billion in publicly traded convertible debentures and is continuing to grow. However, there is little knowledge of the fundamental risks of issuing and owning these complex products, particularly in times of distressed market conditions.

Overview

Over the past decade a wide range of hybrid securities have become available leading to growth in non-traditional financing options including convertible debentures. Factors such as rising equity markets and investor appetite for yield has created an opportunity for Canadian companies to leverage this as an effective financing tool.

Convertible debentures became especially popular amongst investors in the last decade as they provided a source of regular income through interest, had a degree of downside protection not found in equity and offered upside for capital appreciation in rising equity markets.

Today the convertible debenture market in Canada has ballooned to over $14 billion; however, despite the popularity of convertible debentures, few issuers or investors truly grasp the long-term risks associated with these complex products.

What is a convertible debenture?

A convertible debenture is a hybrid facility composed of two components (debt and equity), each bearing a unique risk and reward profile. The debenture can be converted into stock by the holder, usually at their option. By adding the convertibility option the issuer pays a lower interest rate on the loan compared to if there was no option to convert.

Convertibles are priced based on their coupon rate (internal interest rate) and the conversion price (price at which debt is convertible into equity at any time before maturity and is typically 20-40% premium to their current trading price). Some of the advantages and disadvantages of convertible debentures to both the issuer and the investor include:

Exhibit 1: Advantages and disadvantages of convertible debentures

	Advantages	Disadvantages
Issuer	Allows for higher leverage without the cash burden of traditional secured debt; typically no assets pledged as security; flexibility attributable to conversion features	Difficult to restructure at maturity if the company's share price is depressed; potential dilution risk to existing shareholders at maturity if converted while share price is depressed
Investor	Exposure to a company's credit with an equity risk profile; limited downside risk by separating the security from a full decline in the stock price	Subordinated in insolvency proceedings to senior secured debt; loss of inherent premium associated with convertible feature if companies share is depressed

Overview of the Canadian convertible debentures market

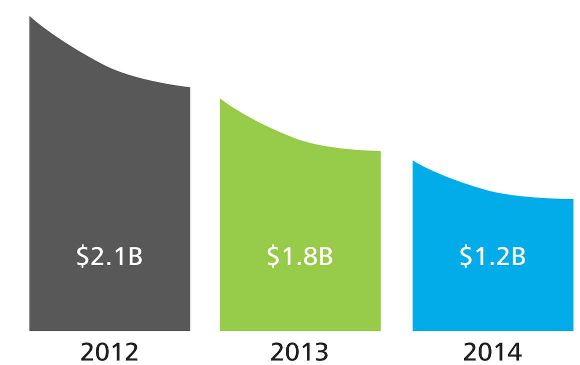
The Canadian convertible debentures market is often viewed as a high yield market generally composed of sub-investment grade securities. The majority of Canadian convertible debentures issuances are not rated by credit rating agencies.

Canadian mid-cap companies and real estate investment trusts have been particularly active using convertible debt in the past decade as an opportunity to finance acquisitions or new projects, enter new markets, or fund continuing operations.

> A cooling of investor interest in these products presents significant challenges to existing issuers looking to refinance their maturing convertible debentures.

However, in recent years the issuance of new convertible debentures has slowed down significantly. A cooling of investor interest in these products presents significant challenges to existing issuers looking to refinance their maturing convertible debentures.

Exhibit 2: Convertible debt issuances by year (Source: FP Infomart)



Note: Quoted figures represent new convertible debenture issuances between January 1 and August 30 of each year.

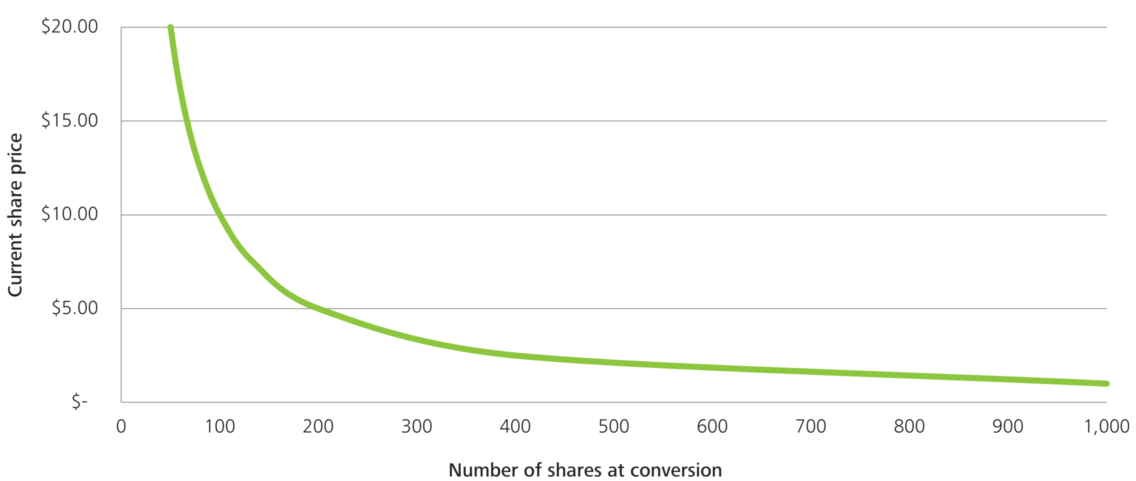
The issue

When the underlying stock price of a company increases, a convertible debenture investor's position is "in the money" because they have the opportunity to convert at a lower conversion price and ultimately sell the equity at the higher market price. As long as the investments leveraging the convertible debenture issuance is accretive then the underlying stock price will generally increase, essentially providing the debenture holder with a higher value call option.

A fundamental risk with convertible debentures is when the underlying stock price decreases materially, which can result in refinancing challenges due to lower share prices. Such an event can considerably limit a company's equity and equity-related options.

Exhibit 3 below demonstrates the dilution effect of redeeming debentures for equity at maturity when a company's current share price is below the conversion price implicit in the convertible debenture. The following is based on a convertible debenture with a $1,000 face value and assumes a conversion price of $20.00.

Exhibit 3: The convertible debenture dilution effect (Source: Deloitte analysis)



As at August 30, 2014 the Toronto Stock Exchange (TSX) reported market values on 195 "series" of convertible debentures. Of these "series":

- 80% were trading below their conversion price
- 26% were trading below 50% of their conversion price and could be considered "busted"
- 9% have a yield to maturity in excess of 20% - an indicator which demonstrates the market believes refinancing may be an issue

The "series" trading as "busted" have several striking similarities:

- The majority face maturities in 2016/2017
- Many companies have more than one "series" compounding the refinancing issue
- Most companies have embarked on a number of acquisitions or development projects that have thus far failed to be accretive to the underlying stock price
- Most companies have been confronted by restructuring realities - dividend cuts, cost reduction and refinancing risks that often plague and cause a drag on the trading price, and
- Discounted trading prices severely limit equity options for the refinancing of the maturing debentures

What are the risks relating to convertible debentures?

For all the advantages that convertible debentures have for issuers, they do come with a level of risk, particularly closer to the maturity date and / or when the company's equity is depressed and credit markets are more challenging. Some of the common risks relating to convertible debentures include:

Refinancing risk

Companies with near-term maturing convertible debentures often face difficulties in refinancing their tranche of debt as there are often no material unencumbered assets for a senior secured lender to lend against. Asset sales and additional capital are often the first claim for senior debt tranches.

Shareholder dilution and effective loss of ownership risk

Companies with near-term maturing convertible debentures will often see a depression in their share price as the market prices in the risks associated with maturity. If a company does not have the liquidity to settle or the ability to refinance their convertible debentures then they may be forced to repay the holders through the contractual conversion of the debentures to equity, which as noted in Exhibit 3, may cause significant dilution to existing shareholders.

Formal restructuring risk

Companies who find themselves unable to amend, extend or refinance their near-term maturing convertible debentures may be compelled or forced into a formal restructuring arrangement. Maturing debenture issuances may also trip debt covenants with senior lenders.

What happens next?

Through consultation with senior executives from companies with outstanding convertible debentures, Deloitte has noted that refinancing options are becoming significantly challenging. In particular, companies that have convertible debentures with a decreased stock price are finding it difficult to refinance at all. Some have gone as far as seeking foreign markets for refinancing.

The result is that the Canadian market has a significant amount of unsecured convertible debt outstanding which will require thoughtful strategic options to refinance. Based on our conversations in the market, it is apparent that credit markets are relatively strong, making it an ideal time to proactively begin considering strategic refinancing options.

Several companies have begun divesting non-core assets to pay down debt; however, many face restrictions on paying down their convertible debentures prior to that of the more senior tranches.

Deloitte anticipates that a large number of convertible debentures issuers will soon be faced with the need to consider strategic options to refinance their debt, with an expected increase in the following activities:

- Amend and extend agreements between issuers and debenture holders
- Restructuring capital under *Canada Business Corporation Act (CBCA)* sections 191 or 192 (reorganization and arrangements)
- Issuance of higher yield debt and equity
- Increased activity by distressed debt, special situation and other sophisticated investors looking to capitalize on market adjustments, and
- Formal restructuring under the *Companies' Creditors Arrangements Act (CCAA) or the Bankruptcy and Insolvency Act (BIA)*

Not having a refinancing strategy in place can lead to a number of unpredictable and negative effects. To this end, an issuer must take great care to send the correct signal to the market that a well-contemplated and executable refinancing strategy has been put in place.

As maturity nears, available options become more limited. While we believe that each and every refinancing strategy will be dependent on the business, the shareholder base, and the state of the market, these are options that we expect will guide the majority of the strategies:

What options are available?

Amend and extend

An amend and extend is not a true refinancing strategy but rather an option that is available to issuers to reach out to existing holders of the debentures to propose new terms in exchange for an extension of the maturity date. Typically, in Canada most debenture holders are retail investors, making it a widely held instrument. The execution of an amend and extend strategy can be challenging and will often require the company to entice holders with better terms on the coupon and the conversion premium. In addition, an amend and extend strategy may require a concession fee to entice the brokers and investors to support the proposal.

Reorganization and arrangement under the CBCA

Section 191 of the CBCA refers to "reorganization" of corporations often in conjunction with BIA or CCAA proceedings whereby the debt and equity of a corporation can be amended.

Section 192 of the CBCA governs "arrangements" where "it is not practicable for a corporation that is not insolvent to effect a fundamental change in the nature of an arrangement under any other provision" of the CBCA. Where a corporation applies to court for an order under this section, the court may make any interim or final order "it thinks fit".

Examples of recent amend and extend arrangements include:

Company	Royal Host Limited	Royal Host Limited	Royal Host Limited	IBI Group Inc.	Clarke Inc.	Clarke Inc.
Debenture series	Series D: 5.9% coupon; $6.19 conversion price	Series B: 6.0% coupon; $4.76 conversion price	Series C: 7.50% coupon; $4.87 conversion price	7.0% coupon; $19.17 conversion price	6.0% coupon; $7.50 conversion price	6.0% coupon; $7.50 conversion price
Value of debentures	$29M	$24M	$41M	$45M	$62M	$62M
Previous maturity date	30-Jun-14	31-Oct-15	30-Sep-18	31-Dec-14	31-Dec-13	31-Dec-18
Announcement date of intent to amend	13-May-13	13-May-13	29-Nov-13	7-May-14	19-Jun-12	13-Nov-12
Settlement date	30-Jun-2019	31-Oct-2020	N/A	30-Jun-2019	31-Dec-2018	N/A
New maturity date	30-Jun-2019	31-Oct-2020	N/A	30-Jun-2019	31-Dec-18	N/A
Proposed terms	Increase coupon by 0.35%; Reduce conversion price to $3.50; Remove change of control provision	Increase coupon by 0.25%; Reduce conversion price to $3.50; Remove change of control provision	Amend change of control provision	First proposal: Same as old terms with a consent fee equal to 7% to be issued as a promissory note earning 7% interest	Extend maturity	6.50% coupon Eliminate ability to convert; Consent fee equal to 2.5%
Result	Increased coupon by 0.35%; Reduced conversion price to $3.50; Removed change of control provision	Increased coupon by 0.25%; Reduced conversion price to $3.50; Remove change of control provision	Amended change of control provision	Option A - Promissory Note: Equal to $195.65 per $1,000 of principal amount, payable Dec 31, 2016 and bearing 7.0% interest per annum. Option B - Promissory Note + Reduced Conversion Price: (i) Promissory note equal to $86.96 per $1,000 of principal amount, payable Dec 31, 2016 bearing 7.0% interest per annum and (ii) the reduction of the conversion price from $19.17 to $5.00 per common share.	Same coupon; Consent fee equal to 6%; Maturity extended	Plan not approved

However, while section 192 specifically limits use of this provision to corporations that are "not insolvent" the courts have taken a facilitative approach to the application of section 192 and the solvency requirement.

Recently, there has been an increase in use of the arrangement provisions of the CBCA to restructuring companies and groups that are effectively insolvent. For example, in 2012 Yellow Media, with approximately $200M issued tranches of convertible debt, successfully recapitalized under the CBCA following approval from the Superior Court of Quebec.

Interim and final orders issued by courts have included: provision for the compromise of debts; share and warrant issues; sale or investor solicitation processes; conversion of debt to equity; and, court-ordered stays of proceedings against parties from terminating contractual arrangements or enforcing their rights as creditors.

Perceived advantages of section 192 arrangements are the avoidance of formal insolvency proceedings under the BIA or CCAA, a potentially streamlined restructuring process, and reduced court and stakeholder supervision.

We suggest that if consensual arrangements to amend and extend with convertible debenture holders cannot be achieved, then the arrangement provisions of the CBCA could be used to propose a compromise, organize and hold meetings of note holders to vote on the arrangement, obtain court approval of the arrangement, and to have the benefit of a stay of proceedings during the process to prevent creditors from taking action which could destroy enterprise value.

Convertible debenture issuance

Companies may have the ability to replace their existing series of convertible debentures with a new offering given that there is an existing holder base. The issuance of new convertible debenture series for companies with shares trading below the original conversion price is often expensive as the markets are not willing to price the coupons at the same rate as before and the conversion price is very dilutive. Resets of conversions prices may also be required.

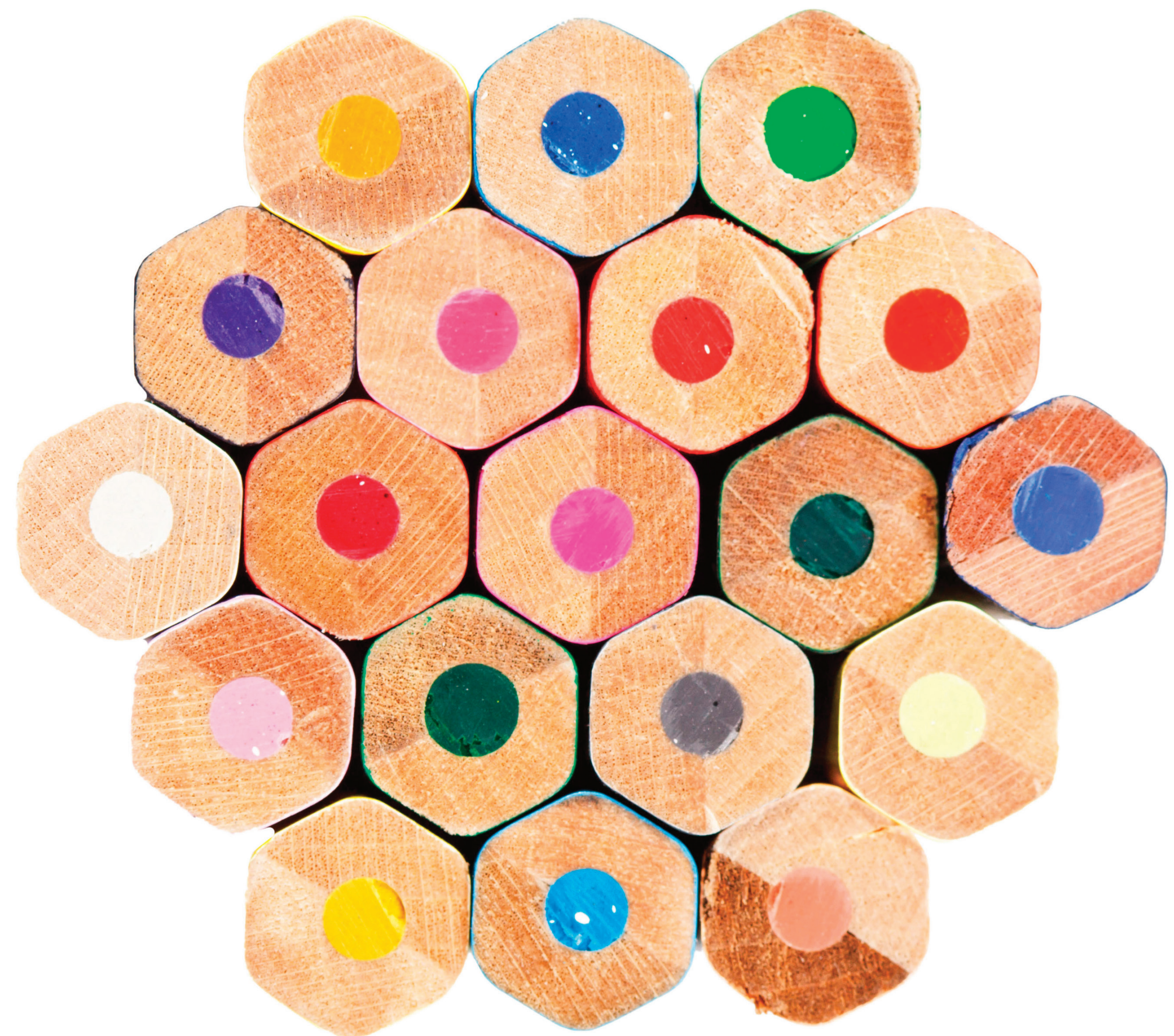
Equity issuance

Companies may have the ability to issue additional equity if the market is receptive; however, this form of refinancing is often costly in terms of fees and results in the dilution of the existing shareholder base. This option is typically only available to companies with an existing market capitalization well above the level of convertible debentures to be retired.

Private equity sponsor

Having a private equity sponsor, as a standby facility to refinance convertible debentures is an advantageous tool to restore market confidence that the issuer will be able to meet the obligation when it becomes due. This will reduce the dilution effect and allow the company a longer window to find a permanent solution.

However, timing is an important factor. Identifying when to seek out a sponsor is crucial as it will affect the magnitude of stand-by fees on the back-stop facility and the market pricing and equity options of the underlying facility. If the balance sheet of the issuer is heavily levered with secured debt, this will add additional risk premium to the pricing of the refinancing.



CCAA

The CCAA is a effective restructuring mechanism for insolvent companies. The CCAA has very broad powers and can be effectively leveraged for companies facing much larger restructuring issues than simply convertible debentures. Some of the events which typically lead to a filing include:

- Missed debt or interest payment or a looming
- inability to pay
- The expiry of a debt facility without
- replacement available
- Class action-law suits, and/or
- General business conditions which render the current operating model unsustainable

The CCAA can be used to facilitate or implement various restructuring measures, such as the sale of surplus or obsolete assets, the disposition of an unprofitable business segment, the disclaimer of unsustainable contracts or leases, and the compromise of secured and unsecured debts. For debenture issuers, the CCAA allows companies to negotiate amended payment terms, including debt reductions, or equity conversions with convertible debt holders.

The CCAA is by far the most comprehensive restructuring mechanism available to larger, more complex companies and groups to respond to an event triggered by maturing convertible debentures. Yet, the CCAA can be expensive; it is a court driven process, requires significant time and energy from management and eventual buy-in from all stakeholders.

The Deloitte approach

Frame
Develop a tailored strategic option analysis framework from which to identify, collate, diligence, and evaluate options available depending on the company's current financial health and refinancing opportunities.

Model
Leverage a flexible financial model from which the company can evaluate the financial efficiency of available options over time. Develop specific output criteria to evaluate options and model sensitivities/scenarios to stress test the various options.

Explore
Perform exploratory market soundings to validate model inputs and assumptions. Determine if a formal or informal restructuring initiative is required and help management understand the implications and chain of events which come into play with each alternative.

Select
Outline supportable and independent recommendations to management pursuant to the refinancing or restructuring initiative selected. Provide management with a description of the pros and cons of alternate options in the event of a restructuring event and how each stakeholder group may be affected.

Implement
Drive the implementation of the optimal strategy selected from each work stream, including, but not limited to:
- Capital markets solutions
- Solvency opinions
- Informal restructuring and formal filings
- Implementing arrangements, and
- Other performance enhancement initiatives.

Provide management with a description of the pros and cons of alternate options in the event of a restructuring event and how each stakeholder group may be affected.

Choosing a path

Companies must act quickly – they must thoroughly contemplate available strategic options and develop an executable plan to send a clear and positive signal to the market. As this paper illustrates, there is no one way to respond to the challenges related to convertible debentures. However, proactive management of pending debt maturities is essential to ensuring there is sufficient time to address issues before they become a crisis.

Deloitte can help
Deloitte's multi-disciplinary team of professionals has a deep understanding of the convertible debentures market. We can help to independently assess your company's position, and work with you to identify and develop a range of executable options in a comprehensive and integrated call to action.

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