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CONVERTIBLE DEBT ISSUANCE SURGES DESPITE COVID-19 MARKET VOLATILITY

When the shock of the COVID-19 pandemic hit U.S. capital markets in March 2020, it caused credit spreads in debt markets to widen and equity markets to experience significant volatility. On January 2, 2020, the ICE BofA US High Yield Index Option-Adjusted Spread (HY Index), which calculates spreads over U.S. Treasuries for high yield debt with five-year terms, had an implied credit spread of 356 basis points. By April 1, 2020, implied credit spreads for the HY Index jumped to 911 basis points. The CBOE Volatility Index (VIX), which represents the market's expectation of 30-day forward-looking volatility based on S&P 500 index options, rose from 12.5 to 57.1 during the same period. The widening of credit spreads made offering straight debt costly for many technology, life science and other high-yield debt issuers. At the same time, equity market volatility and deflated share prices made pricing a common stock offering challenging or unattractive. Many companies that needed to raise capital determined that their best option was to issue convertible bonds. Convertible securities are a "plain vanilla" bond with an embedded call option on the issuer's common stock.

In the right market conditions, convertible securities can provide a cheap form of debt capital by enabling companies to benefit from volatility in their share price. To be sure, credit spreads for convertible bonds have widened along with straight debt as a result of the pandemic. By some estimates, in April 2020 convertible investors used credit spread assumptions for approximately 500 basis points versus 200 basis points in January 2020. The following dynamics, however, helped partially offset the higher coupon that investors would have otherwise required from issuers to account for increased credit spread assumptions:

- **Share price volatility:** All other inputs remaining constant, higher levels of equity volatility result in better convertible bond pricing for issuers;
- **Resilient secondary market:** The convertible secondary market performs better than equity markets on the downside, which has caused many investors who would normally choose pure equity investments to seek out convertible investments, thereby driving demand and better pricing; and
- **Return profile of convertible bonds lends itself well to challenging market backdrops:** Bond maturity affords investors downside protection, while the option to convert creates significant equity upside.

Convertible bond terms since the COVID-19 outbreak have not been quite as favorable to companies as they were pre-COVID-19, but they remain quite attractive from an historical perspective. As a result, issuers have been able to raise convertible debt capital with low coupon rates and higher conversion prices. These market conditions led to an explosion in convertible bond issuance in the second quarter of 2020.

Through June 30, 2020, U.S. companies raised over $64 billion in 114 convertible bond offerings with most of the surge occurring in the second quarter. May 2020 saw a record $20.7 billion of convertible debt issued. The previous record monthly high for convertible issuance was $19.2 billion in May 2001. The volume of new convertible bond issuance in 2020 is particularly striking when compared to the $22 billion raised in 55 convertible bond offerings in the first half of 2019. These levels of issuance are particularly notable in light of the fact that 2019 represented the most active year in the convertibles market since before the 2008 financial crisis.

While convertible bonds have become attractive across industries, they continue to be most popular among publicly-traded technology and life sciences companies with market caps north of $500 million. Well-known technology companies such as Okta, Inc. (OKTA), Lyft, Inc. (LYFT), Snap Inc (SNAP), and Slack Technologies, Inc. (WORK) have successfully priced convertible bond offerings in the first half of 2020. OKTA priced a $1.15 billion convertible debt offering with a 0.375% coupon. LYFT priced a $747.5 million convertible offering with a 1.50% coupon. SNAP priced a $850 million offering with a 0.50% coupon, and WORK priced a $750 million offering with a 0.50% coupon. OKTA, LYFT, SNAP and WORK were each able to substantially raise the effective conversion prices for their notes by entering into capped call transactions. Capped calls serve to hedge the risk of equity dilution by raising the effective conversion price for equity-linked notes. In the first half of 2020, over 50% of convertible bond offering included capped calls with technology companies the most frequent users of capped call hedges.

No one can predict the future of the U.S. markets while the impact of the pandemic makes itself felt across the globe, but we expect that conditions for convertible debt issuance will continue to be optimal relative to other forms of debt and equity capital. With the HY Index and VIX still at relatively high levels (633 basis points and 28.6, respectively, on July 1, 2020), and companies emerging from black-out after earnings announcements, issuers that have not already considered convertible debt are likely to consider convertible bonds in the second half of 2020.

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