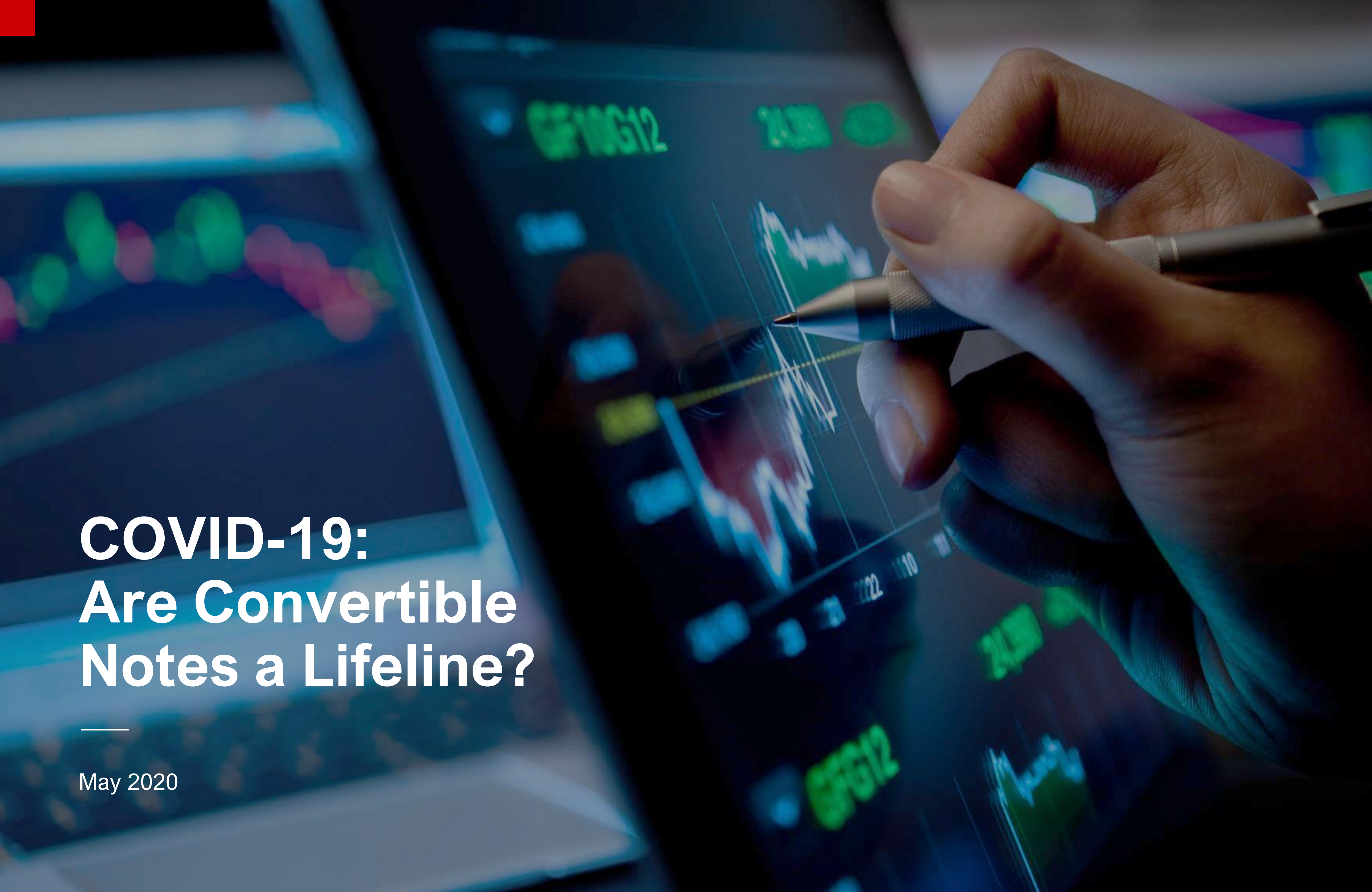


COVID-19: Are Convertible Notes a Lifeline?

May 2020

Commercial considerations

TERM	COMMENTS
Secured or unsecured? Note: convertible note investments in investment grade ASX-listed companies are generally unsecured and rank pari passu with the senior lending syndicate	Unsecured notes are increasingly prevalent given issuers are likely to already have highly utilised debt capital structures. Any security offered is likely to be substantially subordinated to the main finance facility(s), or rank *pari passu* with existing senior financiers. The moratorium on personal liability for directors for insolvent trading may have the effect of increasing credit risk and eroding security values as directors of distressed companies may feel more confident in continuing to trade as they approach insolvency.
Anti-dilution protection	The issuer could issue further equity to parties other than the lender which would dilute the lender's equity position upon a conversion unless appropriate protections are negotiated. Issuers will not want to agree to a prohibition on issuing further equity, rather, a right for the lender to participate in further equity issues to avoid dilution is usually bargained for.
Capital re-organisation events protection	If the number of total shares on issue alters, then the number of shares into which the notes are convertible should also be adjusted.
Early repayment and early conversion	A lender will usually want to retain control over the ability of the issuer to initiate the repayment / redemption or conversion of the notes prior to the expiry of their agreed term.
IFRS and credit agency classification	For distressed issuers, the likely IFRS and credit agency classification of the notes is important. Most notes will be counted as debt for IFRS and credit agency reporting purposes. To be treated as equity: ▪ the note terms would need to provide the issuer with an alternative within its control that could, if exercised, avoid the issuer paying cash to the subscriber during or at the end of the redemption period. eg, an option for the issuer to convert the note into equity at a fixed rate (e.g. 1 to 1). Whereas an option to convert the note at the then market price of securities of the issuer is not likely to satisfy the equity test. ▪ The terms of the note could provide for redemption or buy back, provided that this is at the option of the issuer.
Other key matters	▪ Financial covenants (ratio testing, restrictions on new debt, restrictions on dividends) ▪ Transferability of note ▪ Quotation of notes on ASX (usually not) ▪ Interest (Cash, PIK or combination) ▪ Voting rights (usually none until conversion) ▪ Priority on winding up

Key regulatory considerations

In order to be used effectively, lenders and listed borrowers need to first be aware of the impact of ASX and Corporations Act requirements in order to be able to structure the terms of the notes effectively.

Shareholder approval

	ASX Listing Rules		Corporations Act	
% interest	Converts within issuer's 15% placement capacity	Converts above issuer's 15% placement capacity	Converts into less than 20% of shares on issue	Converts into 20% or more of shares on issue
Approval?	No shareholder approval required	Shareholder approval required	No shareholder approval required	Shareholder approval required

In assessing what size tranche of notes can be issued under the issuer's existing 15% placement capacity without shareholder approval, the relevant calculation is what is the maximum number of potential securities to be issued under the proposed tranche of notes at the date that the issuer issues or agrees to issue such notes.

If shareholder approval is required for Listing Rules or Corporations Act purposes, this raises timing issues because the company will need to convene a shareholders' meeting with 28 days' notice.

If shareholder approval is required for Corporations Act purposes, then this raises additional timing and risk issues because:

- ASIC will need to review the notice of meeting in advance;
- the notice of meeting will need to be accompanied by an Independent Expert's Report (this typically takes about 3 weeks to prepare); and
- ASIC policy is that this approval is not evergreen, but rather valid for so long as circumstances of the issuer do not materially change. (12 months is a good rule of thumb).

Key regulatory considerations

ASX rules

ASX requires that notes must convert into a number of shares (application of certain formulae is permitted) and not be over a floating percentage of the issuer's equity.

ASX may challenge note terms that:

- convert by reference to a variable other than the market price of the shares or the value of a foreign currency;
- convert into other convertible securities rather than ordinary shares, although it may be possible to issue options/warrants in conjunction with notes; or
- specify that the right of conversion cannot be exercised if it would require shareholder approval under the Listing Rules.

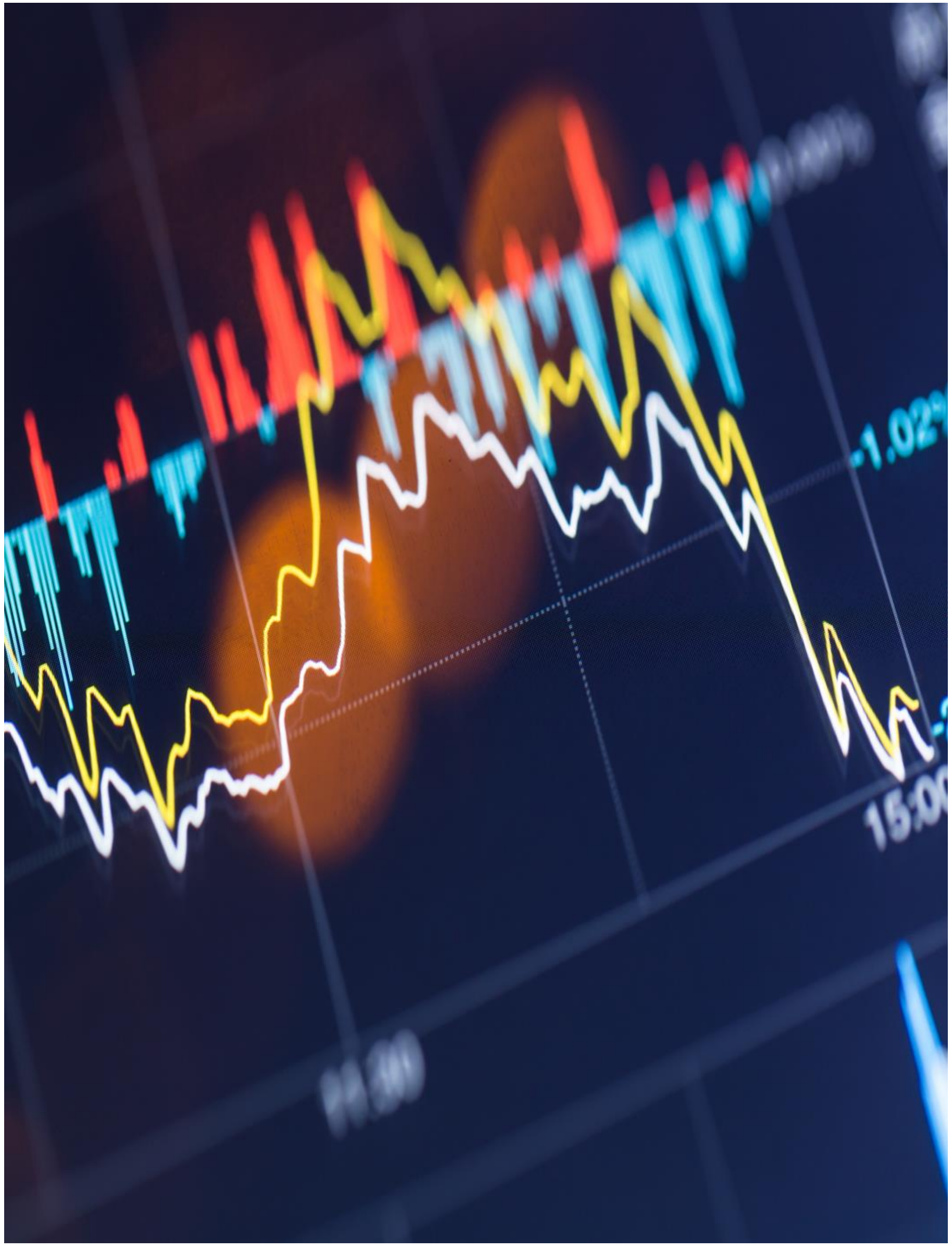
FIRB

There is a divergence between FIRB's own view on the requirement to obtain FIRB approval before entering into a note, and the market practice.

FIRB's view is if the lender under a note needs FIRB approval to acquire the shares on conversion, then that approval needs to be obtained prior to entering into the note (ie not later when conversion takes place).

Note that the lender will need FIRB approval where the note converts into 20% or more of shares on issue if the lender is not a government investor. That threshold is 10% for foreign government investors.

However, market practice is that conversion of the notes must be conditional on obtaining FIRB approval (if the lender would otherwise require FIRB approval).



How to address the timing and risk issues raised by the regulatory considerations

Lenders and listed borrowers using notes have developed strategies to deal with the timing and risk issues raised by the need for shareholder approval and the ASX's rules.

Shareholder approval

As many listed issuers of notes are usually in some kind of financial stress or may otherwise be unable to raise funds from other sources, the ability of lenders to provide money quickly is an important consideration for borrowers in considering the relative attractiveness of entering into a note fundraising versus other competing sources of capital.

Therefore strategies to deal with shareholder approval issues have focussed on addressing the timing impact, and include:

Strategy	Comments
Enter convertible notes but seek shareholder approval for conversion later	If shareholder approval is not obtained the notes would remain as simple debt instruments – this strategy pushes the risk of non-approval back onto the lender. In order to account for this additional risk, it is common for the loan to initially be at a relatively high rate of interest, with all transaction costs to be paid by the borrower and: ▪ if shareholder approval is obtained, the loan would reset to a lower rate of interest; or ▪ if shareholder approval is not obtained, then the loan could be repayable within a short period. (This would have to allow the borrower time to refinance (ie a period from 1 – 3 months) and is more acceptable to a lender if the note is secured.) However, this approach has an added downside, as even if shareholder approval is obtained, ASX may require that the notes convert within 3 months of obtaining such approval, which may not be commercially advantageous. It may be possible to obtain an ASX waiver from this restriction.
Investment tranches	The investment could be in tranches: ▪ tranche 1: the full 15% placement capacity or up to 19.9% without shareholder approval (with a potentially higher interest rate); then ▪ tranche 2; following receipt of shareholder approval (with a stepped-down interest rate to incentivise obtaining shareholder approval).

The above strategies demonstrate the tension that exists for lenders between spending time in order to obtain certainty of outcome in relation to shareholder approvals versus funding the borrower more quickly but having relatively less certainty. The investment tranches strategy above provides a reasonable trade off of those conflicting investment imperatives for lenders.

ASX rules on note terms

Notes that convert, either 1 for 1 or based on the market price of the issuer's shares, into ordinary shares are most common and low risk.

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