Turkish convertible bonds: an alternative path to raising capital

June 2020

Covid-19 pandemic continues to have financial impact in the markets and forces public companies to consider use of alternative financing methods. Market volatility and current share prices may provide Turkish listed corporates[1] and banks with opportunities to secure financing through convertible bonds instead of Eurobonds, reserved equity offerings or rights issues, all of which may have certain commercial and time contstrains given the current economic outlook for the markets. There is not viable window for Eurobonds or equity investments through new share offerings, and shareholders seem to be relatively reluctant to capitalise companies through rights issues.

Although there is a sound and flexible legal framework, convertible bonds are historically not common in Turkey. There has been only few convertible bond issuances in Turkey over the years and such market is not active for Turkish companies due to the fact that traditional bonds market in debt financing has been very much established and active, and there has not been convincing commercial justification for such borrowing to be considered as an alternative financing tool.

This note takes into consideration a convertible bond offering structure where they are offered to investors outside of Turkey, as the general market expectation and tendency in Turkey has always been for a potential convertible bond to be issued to investors outside of the country. Therefore, specific requirements such as a Turkish prospectus and other offering materials as well as conversion price/ratio report for a convertible bond issued in Turkey through public offering or private placement are not covered in this note.

1 It is important to note that convertible market is also available for non-investment grade or speculative grade companies which can raise money from convertible bond investors who are institutional long-only investors as well as hedge funds.

What is a convertible bond?

Convertible bonds are senior and unsecured fixed-rate bonds which allow their holders to convert them into new shares of a company at a prescribed conversion price during a certain conversion period. Therefore, convertible bonds carry charasteristics of both debt and equity and thus can be seen as a combination of two separate securities – a bond and an embedded equity call option. In other words, a convertible bond offers investors a type of hybrid security that has features of a bond, such as coupon payments, while also and equity option to own the underlying shares of the issuer company.

Here's a simplified example: suppose a company whose share is trading at TL50 issues a TL1,000 convertible bond. Investors who purchase one of those bonds are entitled to the opportunity to buy 20 shares of the company (TL1,000 divided by TL50 = 20).

If the share price of this company rises to TL75, investors could convert the bond into share and realize a gain of TL25, or 50%. However, if the share price drops to TL25 by the bond's maturity, investors probably would not convert – instead they would let the bond mature and receive the TL1,000 principal they initially invested, plus interest payments.

What benefits do they offer issuers?

There are more benefits than disadvantages for companies to issue convertible bonds. The most important advantage is that the company receives upfront payment for the shares to be issued later, and therefore the embedded share purchase value (i.e. equity call option) for investors lowers the coupon payment on the bond component of a convertible bond compared to a plain vanilla bond. Therefore, another key benefit of raising money by selling convertible bonds is a reduced coupon payment, essentially a cheaper means to borrow from a broader investor base, namely hedge funds and long-only investors. Also, another advantage for companies of issuing convertible bonds is that, if the bonds are converted to shares, the company will not need to repay the principal amount (i.e. borrowed amount).

Advantages for investors

Hybrid feature of convertible bonds offers distinct benefits, as they provide investors with the potential upside of conversion into equity due to potential value increase of the shares as well as a protection for lower but capped income throughout the life of the bond from the coupon payments and plus the return of principal upon maturity[2]. Lower coupon is normally not appealing for the investors, but they agree to it and sacrifice a higher coupon for the benefit of equity call option considering potential increase in the share price.

Although there is equity component to a convertible bond, it will rank senior to an investment in equity/shares as a matter of Turkish law in case of insolvency and will further rank pari passu with the company's other unsecured debt.

Conversion price

Pricing a convertible bond is comprised of two elements: the coupon and the conversion price. The coupon rate is determined no different than as per valuation in a traditional bond and is based on prevalent market interest rates, among others, at the time of the issuance. It is set at the lower side in a convertible bond due

2 The minimum value of a convertible bond is therefore investment value of its bond component: bondholders do not necessarily have to convert to benefit. They can get their initial investment (principal amount) back at maturity along with interest income.

to the call option reason as explained above. The conversion price, on the other hand, is the sum of the weighted average price of the shares of the company (between announcement of the issuance and pricing and a conversion premium[3]. In other words, conversion price will have to be set at a premium to the market price of the shares at pricing.

When to convert?

A bondholder will convert its bonds when the conversion price is lower than the market price of the shares, which is referred to as the conversion (i.e. equity call option to be in-the-money[4]. If the share price of the company does not increase, then the conversion will not take place and bondholders will continue to receive periodic coupon payments and finally principal amount at maturity.

Setting the conversion premium on the higher end will mean longer time for the share price to appreciate, leading the convertible bond to be treated as debt-like instrument, unlikely for conversion. A small premium to the market price, on the other hand, will require a shorter time period for the share price to increase, bringing the convertible bond closer to an equity instrument, and therefore likely to be converted.

Conversion in the first year

When structuring a Turkish convertible bond, it is crucial to know that Turkish securities law does not, as a general rule, allow conversion within the first one-year from the date of issuance. Certain investors may ask for protection in case of specific events which is addressed in other jurisdictions through a contingent conversion feature that allows the conversion upon such events. Turkish convertible bond rules on the other hand provides, subject to prior consent from the Capital Markets Board of Turkey (CMB, with an exemption from such general rule if the convertible bonds are issued and sold to investors outside of Turkey or they are issued in Turkey through a private placement[5].

Price restriction for new shares under Turkish law

CMB regulations refer to wholesale market rules of Borsa Istanbul in determining the price limit for sale of new shares when conversion is triggered. Such rules envisage that the underlying new shares that will be delivered to investors at the time of conversion to be determined by applying -/+20% to the base price at the time of conversion[6].

This price limit to be known at the time of conversion poses an issue in determining a conversion price at the time of pricing a convertible bond (i.e. at issuance). However if the convertible bonds are issued and sold to investors outside of Turkey or they are issued through a private placement in Turkey, convertible bond rules provide with an exemption from this price limit if a prior consent is obtained from the CMB[7].

3 This tends to be typically between 5% to 35%.

4 The upside of holding a convertible bond is the option to convert the bond into shares if the share price rises above the conversion price. As the underlying share price rises above the bond's conversion price, the convertible becomes "in-the-money."

5 Article 23 of the Debt Securities Communique of the CMB (VII-128-8) that was introduced in February 2017.

6 The base price for the sale is determined by calculating the average of the weighted average price of past ten business days either starting from the last business day of the previous week before the application date to Borsa Istanbul for sale of new shares or starting from the last business day before such application date, and by rounding such average price to the nearest price tick.

7 Ibid, footnote 5.

Which shares to deliver at conversion

Underlying shares for the conversion should be, as a matter of general rule, new shares issued through a capital increase. Shares coming from existing shareholders, e.g. majority shareholders, may play an important role in regulating delivery of underlying shares, but that needs to be structured delicately to overcome some legal and market risks, and a prior consent from the CMB should also be secured before drafting transaction documents reflecting such structure.

Registered/authorised capital system

New shares can be issued through a registered capital system under Turkish law which delegates the board with the authority to raise capital. An important aspect of public companies in Turkey is that most of them have adopted this system, which provides considerable flexibility during the capital increase process. Turkish law provides that companies that have adopted the registered/authorised share capital system increase their share capital up to the authorised capital ceiling without the need to convene a shareholders meeting. Such ceiling or authorised limit is upto five times of the paid-in capital of the company. Companies that have adopted a registered capital system are also entitled to give power to the board of directors in the articles of association to restrict pre-emption rights of existing shareholders, enabling to place increased shares to new investors under certain justified reasons that are stated under the law on a non-exhaustive basis[8]. It would not be a concern for a Turkish listed company to give a covenant for delivery of shares if such company has adopted registered capital system and has sufficient level of authorised capital that allows the board to easily issue new shares when conversion is exercised.

Conditional capital increase

Another route for issuing new shares would be to utilise the conditional capital increase system provided under Turkish law which connects well with the existence of convertible bonds or similar debt instruments. The capital increase system entitles bondholders to the right to demand an exchange of convertible bonds with company shares or simply allow the holders to buy company shares as envisaged by the terms of such convertible bonds. In order to allow this to happen, the shareholders of the issuing company will have to decide to conditionally increase the share capital of the company by way of amendment in the articles of association, setting forth relevant details such as nominal value of the conditional capital increase, and the number and type of each share to be conditionally issued.

Treasury shares

Although the general rule for conversion of shares is to come from the new shares under Turkish law, the ability of companies to acquire their own shares (i.e. treasury shares) allows a basis for shares to be delivered in conversion, as share buyback regulation refers to possibility of such shares to be delivered to convertible bondholders[9]. There are however limits to treasury shares, too, which restricts such shares to represent only up-to 10% of the paid-in capital of the company. In other words, only up-to 10% of the share capital of the company can be held for an unlimited period in the financials of the company, and excess shares will have to be sold or disposed in three years.

---

8 Pre-emption rights of the existing shareholders are completely restricted under the Debt Securities Communiqué. Therefore, convertible bondholders already have a recognised pre-emption right over the issuer's shares when converting their bonds into shares.

9 Unlike the price limit restriction explained above, there is an exemption (under share buyback regulations) from the regulations of Borsa Istanbul in relation to disposing shares, which means that -/+20% price limitations referred to above may not be applicable if the bought-back shares are used/disposed as underlying shares for convertible bonds.

Protecting the investors

Investors are protected through various means including the negative pledge covenants that are by large the same as covenants customarily given under Eurobonds. They are further protected through events of defaults which are boadly in line with events of defaults found in Eurobonds. Issuers also undertake not to take any action that does not correspond to a price adjustment described below. Another investor protection shield which is again mentioned below is the stock borrow mechanism.

Conversion price adjustment

As mentioned, investors pay a premium to the market price of the shares, namely a conversion price, when buying equity call option. Therefore, they will ask for an adjustment to the conversion price, effectively a compensation through the return of such premium, if the share price of the company is negatively affected by events or actions of the company. Issue of bonus shares, rights issue below market price, share split, spin-offs, buyback at a premium and dividend payments will count among actions/events that would trigger a downward adjustment to conversion price and therefore will cause the bondholders to potentially convert their bonds to a more number of shares as means of compensation.

Stock borrow – hedging

Convertible bond investors, particularly hedge funds, are allowed to utilize the convertible bonds they hold to monetize the volatility of the underlying shares by shorting the company's shares, seeking to benefit from the price fall in company's shares. This is customarily done simultaneously to the convertible bond bookbuilding process being executed. It is a critical aspect of the investment strategy of hedge funds that use a conversion arbitrage in order to achieve an equity neutral position with the convert and the hedge (short sell, so investors is not betting if stock price will go up or down.

Although this is one of the protections provided to investors in convertibles, the CMB prohibited the short selling transactions on the Equity Market of Borsa Istanbul as of 28 February 2020 in the wake of pandemic in order to ensure that the capital markets function in a secure, transparent and stable environment and that the rights and interests of equity investors are protected. Such ban may be removed soon.

Early redemption

Early redemption provisions in a convertible bond documentation are not much different than early redemption features that exist in a traditional bond transaction.

Early redemption for the issuer (Call rights/features)

This is the ability of the issuer to call a bond early for redemption more like in traditional bonds. Therefore, this should not be mistaken for a call option which relates to equity element of a convertible bond.

Convertible bonds are typically callable, meaning the issuer company has the right, but not the obligation, to buy the bonds back from bondholders at a defined call price before the bond reaches its maturity. This option is exercised by the issuer to bring an end to the upside potential of the bonds which, as explained above, is the most important attractive point for investors to invest into a convertible bond.

Turkish law provides the flexibility for such call to be structured as a soft call or hard call where the call right can be exercised under certain circumstances or after a specific date. In a soft call structure, exercise of call right is customarily based on the underlying share price performance where, for instance, share price is continuously above 130% of the conversion price for a number of days in a prescribed time period. If the share price is performing extraordinarily well during such number of days, the issuer can call the bond, capping the upside appreciation of the shares and thus limiting the upside potential for investors when the call option is in the money. This cap feature on the upside potential may affect marketeability of the convertible bonds, and will lure discussions between the issuer and underwriting banks on a case by case basis, as it allows the issuer to withdraw or repeal upside potential in its shares from the bondholders at a price above the 130% barrier. This, on the other hand, also serves as a tool to limit the diution of the existing shareholders, some of the features of which are explained below.

Early redemption for the bondholders (Put rights/features)

Put right in a convertible bond gives the bondholder the right, not the obligation, to redeem the bond at a premium before its maturity date – therefore bondholder has the ability to force the issuer to repay the bond at a date earlier than the maturity. These rights are negotiated on a case by case basis, but the common provisions provide them to occur as windows of opportunity, every three or five years, and allow the bondholders to exercise their right to an early redemption. There are also some events that trigger an investor put such as delisting or change of control of the issuer.

Dilution of existing shareholders and playing it out

The forward selling of shares by the company through the equity call option will, if exercised, lead to dilution of existing shareholders' shareholding, which is a disadvantage, concern and sensitive area for the existing shareholders in view of disapplication of pre-emptive rights. Such dilution possibility may further put downward pressure on the company's share price. Therefore, the issuer company will want to mitigate such dilution possibility in one of the following distinct routes as part of its structuring of a convertible bond:

Cash settlement

This is the most used structure for the issuer company who wants to keep away the existing shareholders entirely from dilution, where it gives an election right to the company to settle its share conversion obligation (i.e. physical settlement) with cash settlement instead. This structure therefore somewhat recharacterizes the convertible bonds to traditional bonds at the time of conversion at a cash settlement amount, a price equal to the average of the market price of the shares underlying the relevant bonds during a prescribed calculation period.

Net share settlement

This feature provides somewhat the seperation of principal amount of the bond and excess value, where principal amount is paid in cash at the time of conversion and the excess of the conversion value delivered in shares instead of paying the entire bond in shares upon conversion, therefore reducing dilution of existing shareholders.

Share repurchases

Some of the bond proceeds may be concurrently used by the company to repurchase its own shares from the market with an aim to reduce the dilution of existing shareholders at the time of conversion. This reduced dilution is realised by delivery of repurchased shares to the convertible bondholders rather than new shares, which will normally result in full diution of exisiting shareholders.

Call spread overlays

This is a mechanism facilitated by the company at the time of pricing the convertible bonds to eliminate dilution of the existing shareholders. Accordingly, the company purchases a hedge from one of the affiliates of the underwriting banks of the convertible bond, which entitles the company to purchase shares from such affiliate at a strike price equal to the conversion price, thus resulting in delivery of such shares purchased from the affiliate to the investors rather than new shares – thus eliminating any dilution of the existing shareholders.

Another method under this mechanism is to achieve anti-dilution is to sell warrant/option to an affiliate of the underwriting banks to enable it to purchase shares at a price substantially higher than the conversion price. This structure allows the company to sell its new issued shares to the affiliate at a higher price than conversion price, and using such proceeds to purchase shares in the market to meet delivery obligation of shares at the time of conversion.

Ömer Çollak
Partner
+90 212 366 4732
ocollak@paksoy.av.tr

Ökkeş Şahan
Counsel
+90 212 366 4790
osahan@paksoy.av.tr