CLIFFORD CHANCE

Briefing note

March 2016

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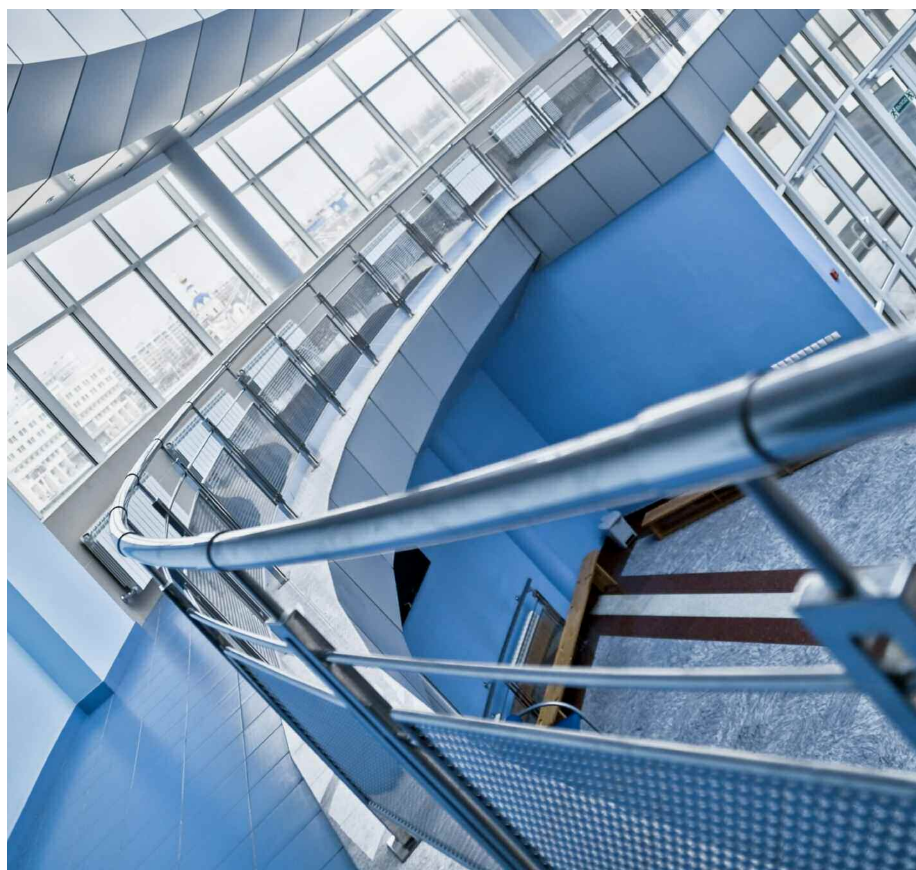
Market Update

In early March European markets were surprised by aggressive policy action as the ECB cut its main interest rate from 0.05% to 0% and its bank deposit rate by 10 basis points to a historic low of -0.4pc, and expanded its quantitative easing programme from €60bn to €80bn a month. The ECB was not alone in easing monetary policy; in mid March the Federal Reserve Open Market Committee confirmed that it is now expecting only two interest rate rises in 2016, compared to the four it had previously forecast, citing a weakness in international markets as one of the factors behind moderating economic growth in the US.



Transactions

In Europe, AB Inbev issued the largest ever euro-denominated corporate bond, issuing over EUR 13 billion in a range of maturities as part of the financing for its acquisition of SAB Miller. Clifford Chance advised AB Inbev on the transaction. The move follows the ECB's announcement that it plans to start purchasing corporate bonds towards the end of the second quarter as part of its expanded quantitative easing programme. The UK also saw some ECM activity including, most notably, the public flotation of Metro Bank (where Clifford Chance acted for the underwriters). J Sainsbury plc also announced its firm cash and share offer for Home Retail Group plc, and Clifford Chance is acting for J Sainsbury in connection with the acquisition.

In Asia, Clifford Chance advised on the first ever issuance of green bonds by a private Korean company and the third ever in the global automotive industry. Hyundai Capital Services, Inc. issued US$500 million of green bonds under its global medium term note program, pursuant to Rule 144A and Regulation S. Hyundai Capital will use the proceeds from the offering to finance automotive loan products for a range of electric and hybrid vehicles manufactured by Hyundai Motor Company and Kia Motors Corporation. The green bonds were listed on the Singapore Exchange.

Thought Leadership

Although firm policy action from the ECB has provided some welcome momentum to Europe's bond markets, the threat of British exit from the European Union continues to weight on market sentiment both in the UK and the wider EU. Clifford Chance has prepared a report, commissioned by the Association for Financial Markets in Europe (AFME), assessing the legal and regulatory impacts of the exit of the UK from the EU on the EU's wholesale capital markets and the arrangements that might exist or be created to mitigate those impacts in the context of a new relationship between the UK and the remaining members of the EU.

Contributors

Michael Dakin, London

Paul Deakins, London

Iain Hunter, London

Richard Lee, Hong Kong

Christopher Roe, London

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Featured Product – Equity Neutral Convertible Bonds

Contacts

Paul Deakins
Senior Associate, London
T: +44 20 7006 2099
E: paul.deakins@cliffordchance.com

Habib Motani
Partner, London
T: +44 20 7006 1718
E: habib.motani@cliffordchance.com

Simon Sinclair
Partner, London
T: +44 20 7006 2977
E: simon.sinclair@cliffordchance.com

Relevance/Suitability

Over the last six months, a number of highly rated European corporates have issued so-called "equity neutral" convertible bonds which offer investors the equity upside of a convertible bond without the potentially dilutive effect of share issuance on existing equity holders. With approximately USD 5bn of issuance already completed, a number of issuers have also been able to execute successful transactions without offering any ongoing coupon payments.

Issuer Checklist

- ☑ Investment grade corporate issuers
- ☑ EUR 350mn+ deal sizes
- ☑ Regulated or unregulated market listing
- ☑ Typically English law
- ☑ Prior transactions in EUR, GBP and USD

Pros

1. Can provide cost efficient financing
2. No dilution of existing shareholders
3. Developing market

Cons

1. More complex than conventional financing
2. Bonds redeemable if call option terminates
3. Counterparty risk

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Overview

Over the last six months, a number of highly rated European corporates have issued so-called "equity neutral" convertible bonds which offer investors the equity upside of a convertible bond, without the issuer having to account for the potentially dilutive effect of further share issuance on existing equity holders. Whereas a conventional convertible bond results in the physical delivery of ordinary shares upon conversion of the bond (or repayment at par if the option is out of the money), in an equity neutral structure the equity option is fully cash settled, thereby avoiding any potential dilution of existing shareholders by the issue of further equity.

In order to hedge the equity exposure arising under the bonds, the issuer will purchase one or more cash settled call options referencing its own equity. With approximately USD 5bn of issuance already been completed over the last few months, a number of these issuers have also been able to execute successful transactions without offering any ongoing coupon payments. The efficiency of the equity neutral structure relies on the ability of the issuer to purchase the call options at a cost which compares favourably to senior unsecured financing or conventional convertible bond issuance.

Key Considerations

Although the equity neutral bond is sometimes described as a synthetic form of straight debt issuance, issuers need to bear in mind that because of the inter-relationship between the bond and option terms the equity neutral convertible bond is terminable in a number of circumstances that would not apply to either conventional senior unsecured financing or a physically settled convertible bond. Whilst events such as delisting, nationalisation or change in law are all familiar termination events for users of equity derivatives, they would not typically result in the early redemption of other more conventional debt instruments.

Issuers should therefore bear in mind that they may be required to repay the full principal value of the bond in certain circumstances, even though the call option is only hedging the equity upside rather than the full principal amount of the bonds. The issuer of an equity neutral bond is also taking performance risk on its option counterparty (or counterparties) for the lifetime of the bond issue, and so if the option counterparty defaults the issuer remains liable to pay any equity upside under the bonds. The bond investor has no direct recourse to the option counterparty, but instead the issuer is expected to manage this risk. As a result, equity neutral convertible bonds would usually be expected to bear the same credit rating as the issuer's other senior unsecured debt securities.

Timing and Logistics

Equity-neutral bonds are, in principle, offered and documented in the same manner as conventional convertible bonds. Transactions are usually marketed on the basis of a term sheet and terms and conditions, without the need to produce a prospectus for marketing purposes. Because the option terms are integral to the structure of the equity neutral convertible bond, the option documentation needs to be progressed in parallel with the terms and conditions of the bonds, leading to a reasonably intensive documentation process. The remaining documentation (subscription agreement, agency agreement etc.) does not differ significantly from a traditional convertible bond, and the admission of the bonds to trading on an unregulated market will obviate the need to produce a prospectus or listing document. Transactions can therefore be completed in about 3 weeks with careful planning.

Conclusion

Given the right market conditions, equity neutral convertible bonds can offer an efficient way for sophisticated issuers to diversify their funding options. Potential issuers should be aware that these are relatively complex instruments, which carry a number of potential costs and risks that it is important to understand in full. Recent transactions have however shown that, with the right analysis and advice, issuers can use market conditions to their advantage in pursuing innovative structures.

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C L I F F O R D
C H A N C E

Worldwide contact information
35* offices in 25 countries

Abu Dhabi
Clifford Chance
9th Floor, Al Sila Tower
Abu Dhabi Global Market Square
PO Box 26492
Abu Dhabi
United Arab Emirates
T +971 2 613 2300
F +971 2 613 2400

Amsterdam
Clifford Chance
Droogbak 1A
1013 GE Amsterdam
PO Box 251
1000 AG Amsterdam
The Netherlands
T +31 20 7119 000
F +31 20 7119 999

Bangkok
Clifford Chance
Sindhorn Building Tower 3
21st Floor
130-132 Wireless Road
Pathumwan
Bangkok 10330
Thailand
T +66 2 401 8800
F +66 2 401 8801

Barcelona
Clifford Chance
Av. Diagonal 682
08034 Barcelona
Spain
T +34 93 344 22 00
F +34 93 344 22 22

Beijing
Clifford Chance
33/F, China World Office Building 1
No. 1 Jianguomenwai Dajie
Beijing 100004
China
T +86 10 6505 9018
F +86 10 6505 9028

Brussels
Clifford Chance
Avenue Louise 65
Box 2, 1050 Brussels
T +32 2 533 5911
F +32 2 533 5959

Bucharest
Clifford Chance Badea
Excelsior Center
28-30 Academiei Street
12th Floor, Sector 1,
Bucharest, 010016
Romania
T +40 21 66 66 100
F +40 21 66 66 111

Casablanca
Clifford Chance
169 boulevard Hassan 1er
20000 Casablanca
Morroco
T +212 520 132 080
F +212 520 132 079

Doha
Clifford Chance
Suite B
30th floor
Tornado Tower
Al Funduq Street
West Bay
P.O. Box 32110
Doha, Qatar
T +974 4 491 7040
F +974 4 491 7050

Dubai
Clifford Chance
Level 15
Burj Daman
Dubai International Financial Centre
P.O. Box 9380
Dubai, United Arab Emirates
T +971 4 503 2600
F +971 4 503 2800

Düsseldorf
Clifford Chance
Königsallee 59
40215 Düsseldorf
Germany
T +49 211 43 55-0
F +49 211 43 55-5600

Frankfurt
Clifford Chance
Mainzer Landstraße 46
60325 Frankfurt am Main
Germany
T +49 69 71 99-01
F +49 69 71 99-4000

Hong Kong
Clifford Chance
27th Floor
Jardine House
One Connaught Place
Hong Kong
T +852 2825 8888
F +852 2825 8800

Istanbul
Clifford Chance
Kanyon Ofis Binasi Kat. 10
Büyükdere Cad. No. 185
34394 Levent, Istanbul
Turkey
T +90 212 339 0000
F +90 212 339 0099

Jakarta**
Linda Widyati & Partners
DBS Bank Tower
Ciputra World One 28th Floor
Jl. Prof. Dr. Satrio Kav 3-5
Jakarta 12940
T +62 21 2988 8300
F +62 21 2988 8310

London
Clifford Chance
10 Upper Bank Street
London
E14 5JJ
United Kingdom
T +44 20 7006 1000
F +44 20 7006 5555

Luxembourg
Clifford Chance
10 boulevard G.D. Charlotte
B.P. 1147
L-1011 Luxembourg
T +352 48 50 50 1
F +352 48 13 85

Madrid
Clifford Chance
Paseo de la Castellana 110
28046 Madrid
Spain
T +34 91 590 75 00
F +34 91 590 75 75

Milan
Clifford Chance
Piazzetta M. Bossi, 3
20121 Milan
Italy
T +39 02 806 341
F +39 02 806 34200

Moscow
Clifford Chance
Ul. Gasheka 6
125047 Moscow
Russia
T +7 495 258 5050
F +7 495 258 5051

Munich
Clifford Chance
Theresienstraße 4-6
80333 Munich
Germany
T +49 89 216 32-0
F +49 89 216 32-8600

New York
Clifford Chance
31 West 52nd Street
New York
NY 10019-6131
USA
T +1 212 878 8000
F +1 212 878 8375

Paris
Clifford Chance
1 Rue d'Astorg
CS 60058
75377 Paris Cedex 08
France
T +33 1 44 05 52 52
F +33 1 44 05 52 00

Perth
Clifford Chance
Level 7
190 St Georges Terrace
Perth WA 6000
Australia
T +618 9262 5555
F +618 9262 5522

Prague
Clifford Chance
Jungamannova Plaza
Jungamannova 24
110 00 Prague 1
Czech Republic
T +420 222 555 222
F +420 222 555 000

Riyadh
Clifford Chance
Building 15, The Business Gate
King Khalid International Airport Road
Cordoba District, Riyadh, KSA.
P.O.Box: 3515, Riyadh 11481,
Kingdom of Saudi Arabia
T +966 11 481 9700
F +966 11 481 9701

Rome
Clifford Chance
Via Di Villa Sacchetti, 11
00197 Rome
Italy
T +39 06 422 911
F +39 06 422 91200

São Paulo
Clifford Chance
Rua Funchal 418 15ºandar
04551-060 São Paulo-SP
Brazil
T +55 11 3019 6000
F +55 11 3019 6001

Seoul
Clifford Chance
21st Floor, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
T +82 2 6353 8100
F +82 2 6353 8101

Shanghai
Clifford Chance
40th Floor, Bund Centre
222 Yan An East Road
Shanghai 200002
China
T +86 21 2320 7288
F +86 21 2320 7256

Singapore
Clifford Chance
Marina Bay Financial Centre
25th Floor, Tower 3
12 Marina Boulevard
Singapore 018982
T +65 6410 2200
F +65 6410 2288

Sydney
Clifford Chance
Level 16, No. 1 O'Connell Street
Sydney NSW 2000
Australia
T +612 8922 8000
F +612 8922 8088

Tokyo
Clifford Chance
Akasaka Tameike Tower
7th Floor
2-17-7, Akasaka
Minato-ku
Tokyo 107-0052
Japan
T +81 3 5561 6600
F +81 3 5561 6699

Warsaw
Clifford Chance
Norway House
ul.Lwowska 19
00-660 Warsaw
Poland
T +48 22 627 11 77
F +48 22 627 14 66

Washington, D.C.
Clifford Chance
2001 K Street NW
Washington, DC 20006 – 1001
USA
T +1 202 912 5000
F +1 202 912 6000

*Clifford Chance's offices include a second office in London at 4 Coleman Street, London EC2R 5JJ. **Linda Widyati and Partners in association with Clifford Chance. Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

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