An Investor’s Perspective on the Convertible Bonds Market

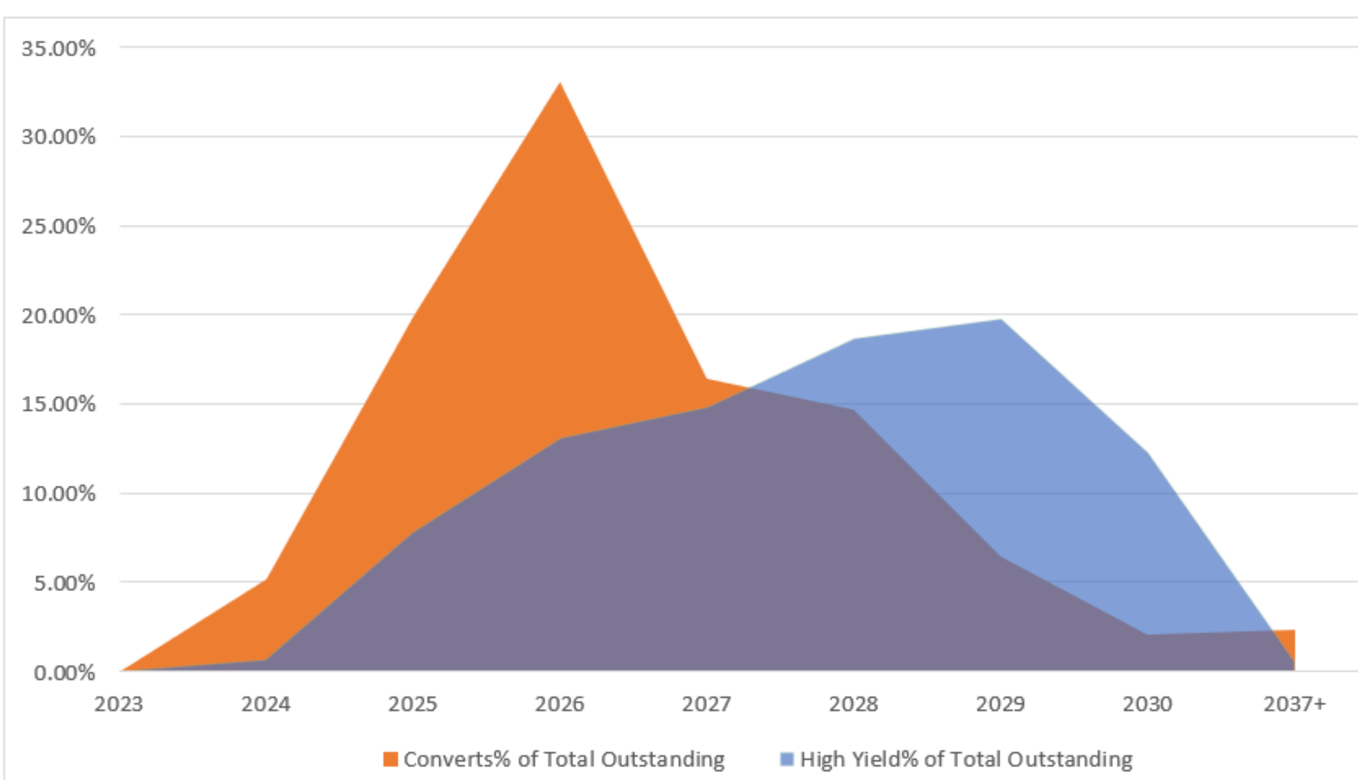
TPG Angelo Gordon’s Gary Wolf, head of the platform’s Convertible Securities business, and Daniel Pound, co-Portfolio Manager of TPG AG Multi-Strategy, explain why now is an attractive time for convertibles.

What makes convertible bonds an attractive option for companies raising capital today?

In the current market environment, many companies face refinancing challenges due to rising borrowing costs. As a result, companies have increasingly turned to the convertible debt market as a way to combat rising interest rates. These companies recognize that they are able to issue convertible bonds at a lower cash interest cost than they would have to pay on traditional bonds, and while they acknowledge that they will give away some equity upside in doing so, many issuers are finding that tradeoff increasingly appealing in the current higher-rate environment.

Over the next few years, we expect there to be significant convertible debt issuance. The convertible bond markets saw recent peak years of issuance in 2020 and 2021, leaving an abnormally large maturity wall to be dealt with by 2025 or 2026. As illustrated in the chart below, it is expected that around 15% of outstanding convertible bonds will reach maturity in 2025 and nearly 25% will do so in 2026. For comparison, under 10% of outstanding high-yield bonds are expected to reach maturity in 2025, and under 15% will do so in 2026.

Convertible Bond and High Yield % of Total by Maturity Year



Converts : ICE/BoA Converts Index Constituents (VXA0)
HY : Bloomberg HY Index Constituents (LF98TRUU)

In addition, as a consequence of recent rate increases, we expect to see the return of many issuers that have not been active in the convertibles market for some time, and even some issuers that are new to the market altogether, particularly higher quality issuers that have become accustomed to lower interest costs.

Aside from new issuance, we expect there will continue to be an active secondary market, in large part due to recent underperformance among long-only convertible investors. These investors have begun to experience outflows and, consequently, have begun selling down their convertible bond positions, which has created increasingly attractive opportunities within the secondary market.

We are currently looking to take advantage of both primary issuance and secondary market trades based on the opportunities we see emerging today and that we expect will continue.

Why should investors consider the convertible bond market?

Convertible bonds offer investors bond-like principal protection and cash coupons in downside scenarios, as well as material participation in any increase to the underlying equity price. Convertibles are particularly attractive to investors who are seeking exposure to a company’s upside while giving them some downside protection.

Investors try to identify those sectors and companies where those downside protections will perform as intended through credit analysis and due diligence. For instance, we tend to seek significant exposure to sectors with companies that produce genuine cash flows and have strong credit quality. Right now, we are seeing increased opportunity amongst investment-grade utility and healthcare companies that are accustomed to having access to cheap straight debt. Many of these companies are approaching refinancing deadlines and need to be creative about how they finance their debt given the rising borrowing costs. As a result, some are choosing to issue convertible bonds to reduce their day-to-day cash interest costs. We believe that these companies’ entrance into the convertibles space presents a tremendous opportunity for investors, and expect that companies within other sectors may follow suit given current market conditions.

Convertible bond investors tend to be active traders of bonds and it is interesting to note that, despite the US high-yield market being over five times larger than the US convertibles market, the convertibles market has a higher turnover, which offers investors the opportunity to reposition their portfolio quickly, as the market and economic backdrop evolves.

As noted above, convertibles can offer an attractive risk-reward profile as they provide the downside protection of credit with upside exposure to equities. This asymmetry of risk was particularly accentuated during the Covid-19 market sell-off and subsequent recovery. In 2020, the Global High Yield Index was down 20% in Mid-March, before recovering strongly to close the year at +8%. By comparison, the Global 300 Convertible Index troughed at -16%, yet closed the year with gains of over 30%, with convertible bonds participating in the market rally that we witnessed after April and benefitting from a significant uptick in new issuance during 2020.

Beyond utility and healthcare companies being active convertible debt issuers, what other sectors do you expect to become more active in the space?

Historically, the convertible debt space was mostly made up by lower-rated and unrated companies, as these were the types of companies that were most in need of alternative financing options. Earlier-stage pharmaceutical and technology companies have made up a disproportionate part of the issuance over the last 15-20 years. More recently, we saw increased issuance from cloud software companies and travel companies, including some of the biggest cruise lines and airlines. Many of these companies issued a significant amount of debt both during and in the aftermath of the Covid-19 pandemic, and are coming up on relatively near-term maturities and have an incentive to raise finance as cheaply as possible.

While these types of companies will always be active in the convertible debt space, we've recently seen more investment-grade companies across a number of sectors begin to issue convertible debt. We expect this trend to continue, as we often see high convertible debt issuance when markets are weaker. Take the real estate sector as an example. Following the Global Financial Crisis, we saw a number of investment-grade, publicly traded real estate companies issue convertible debt. Real estate companies, and REITs in particular, are again facing financial difficulties and we expect that high-quality companies in this space will again become active in the convertibles market as a way to keep cash interest costs down.

In our view, investment-grade companies entering the convertibles market only serves to benefit investors like us because these companies carry less risk and volatility and more attractive pricing than their sub-investment grade counterparts, particularly at times of stress.

What types of strategies are investors deploying to gain exposure to the convertible bond market? Are the opportunities that exist most exciting for arbitrage investors, long-only investors, or both?

The convertible bond market is unique because while it is considered to be a relatively niche space, there are two fundamentally different strategies at play in the market: a long-only strategy or an arbitrage strategy.

At TPG Angelo Gordon, we adopt the arbitrage approach and typically hedge the majority of our investments in the convertibles market by taking a short position in the equity of the issuer, effectively increasing the exposure to credit risk and / or volatility whilst reducing the fundamental directional exposure to the equity itself.

Long-only investors who effectively take a view on both the debt and equity elements of the trade benefit from higher upside through greater equity exposure, though accept that their risk profile carries less downside protection by doing so.

We estimate that, in recent years, the number of long-only investors in the space has been roughly equal to, and maybe slightly greater than, the number of arbitrage investors. In our view, this endorses the belief that there are exciting opportunities throughout the market and different approaches to exploiting these opportunities, which should only help the market mature even further.