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The convertible bond market

Key takeaways

The convertible bond market, though small relative to the overall fixed income market, offers diverse opportunities for investors.

Companies can have different motivations for issuing convertibles, and the pace of issuance is sensitive to equity market and interest-rate trends.

Given changes in the global market, such as increasing non-rated issuance, the expertise of institutional investors can be valuable.

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The convertible bond market has evolved over time due to a range of factors, including issuer needs and investor demand. When evaluating convertible securities, it is important to analyze and understand the potential implications of portfolio exposures, including geographic exposure, sector, and quality, among other characteristics. In this paper, we touch upon the size and evolution of the convertible market, its key characteristics, and the types of companies that issue convertible securities.

This white paper is the second in a series on convertible securities. See our website for the first installment, “The basics of convertible securities.”

Market size

Convertibles constitute a niche market, representing a small portion of the approximately \$127 trillion in fixed income securities outstanding across the globe.¹ They can provide unique opportunities for investors familiar with the distinctive features of the asset class. As of June 30, 2022, the global convertible market was valued at US\$376 billion.² This is down from \$525 billion a year ago, a decrease primarily attributable to the market correction experienced by all risk assets over the past year rather than to convertible issuers leaving the marketplace or issues expiring. The dynamics and size of the convertible market, like all asset classes, changes over time due to market and economic factors, as well as issuance trends.

1 SIFMA Research Quarterly — 2Q22, July 2022.

2 BofA Sourcebook, BofA Global Research.

Increased issuance in recent years (prior to 2022) has created more diverse investment opportunities, a benefit to the broader convertible bond market.

Leading issuers and their motivation for issuing convertible bonds

The convertible market provides access to capital for a wide variety of companies, and those companies issue convertible securities for a number of reasons. Convertibles are typically offered with a lower coupon than comparable non-convertible debt, so a company pays less in interest by issuing convertibles. Companies may also favor issuing convertible bonds over other forms of financing, because if converted, they can provide a means of shifting debt to equity, a more favorable presentation on a company’s balance sheet.

Convertible financing is particularly attractive for companies with high growth expectations. Many growth companies have negative cash flows, and as a result, need access to financing to pursue growth opportunities. Additionally, issuing convertibles has become beneficial to small and midsize companies with low (or no) credit ratings or a small market capitalization, which may limit their ability to access the straight equity or debt markets at attractive levels. The market has become increasingly enticing to investment-grade companies as well, given the relatively low cost of capital associated with issuing convertibles and the diversification of funding sources that convertibles provide. Overall, convertible securities are an increasingly popular method of financing, allowing the issuing companies to raise capital at relatively low cost.

Who issues convertible securities?

- Companies with high growth expectations
- Companies with lower-tier investment-grade credit quality ratings or below-investment-grade ratings

Why?

- Access to capital at a lower cost than conventional debt
- Ability to repay in stock rather than cash

For use with institutional investors and investment professionals.

Geographies

When viewing convertibles from a geographical lens, there are four regions that comprise the majority of the marketplace — the U.S., Europe, Asia ex-Japan, and Japan. While the U.S. is the dominant issuer in the market (as shown in Figures 1 and 2), convertibles are a global asset class supported by encouraging issuance trends worldwide. Regional trends have varied over time. Japan’s dominance in the convertible market during the 1980s ended in the late 1990s with the deflationary spiral that ensued. Figure 2 demonstrates how the market cap of the Japanese convertible bond market dwindled from over a third of the market in 1998 to roughly 4% today.

Meanwhile, the U.S. convertible bond market has continued to grow and now makes up approximately two-thirds of the market. Although the U.S. has represented — and will likely continue to represent — a meaningful portion of the universe, an encouraging trend for the geographical breadth of the market is that emerging market issuers are starting to become more prevalent. Emerging market companies are decreasing their reliance on bank financing, as emerging economies continue to mature. Despite the large U.S. market share, global convertible investors can pursue additional opportunities in the remaining one-third of the marketplace, which may present an opportunity to add incremental alpha through investments in less-researched, sometimes overlooked companies outside of the U.S.

FIGURE 1

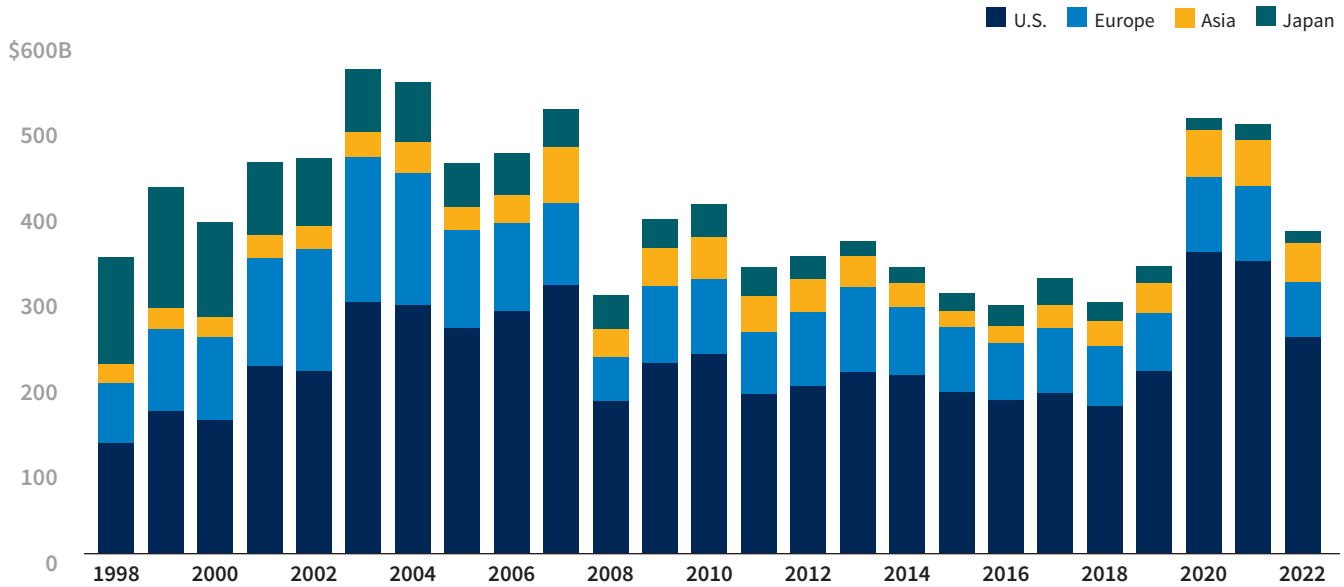
Convertible market in 2022 by region

Region	Market cap	Percent
U.S.	251,923	66.93%
Europe	64,394	17.11%
Asia-ex Japan	45,826	12.18%
Japan	14,236	3.78%
Total	376,379	100.00%

Source: ICE BofA Global 300 Convertible Index, as of 6/30/22. For illustrative purposes only.

FIGURE 2

Global convertible market cap by region since 1998



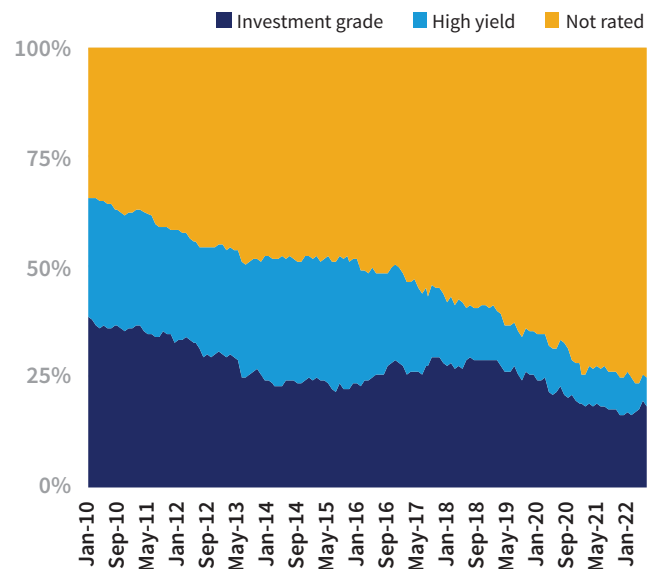
Source: ICE BofA Global 300 Convertible Index, as of 6/30/22. For illustrative purposes only.

Ratings and the large non-rated space

Non-rated issues make up a significant and growing percentage of the global convertible market (Figure 3). The reason why many companies do not have their issues rated is to avoid what can be an expensive and often lengthy process. As of June 30, 2022, non-rated issues composed 75% of the convertible market, while investment-grade and high-yield issues made up 19% and 6% of the market, respectively. For an experienced asset manager, the non-rated market can provide significant opportunity, as asset managers have the internal resources and teams needed to assess non-rated issuers and find opportunities within the significant non-rated universe. Sophisticated credit and equity research teams thoroughly analyze these securities and associated risks. As a result, they find many opportunities that may be overlooked by other investors that are either less willing or too constrained by investment guidelines to venture into lower- or non-rated issues.

FIGURE 3

Global convertible ratings landscape since 2010



Source: BofA Chartbook, BofA Global Research, as of 6/30/22. For illustrative purposes only.

Industries and styles

Historically, companies in growth-oriented sectors have dominated the convertible market. Though sectors vary across regions, the largest sector within the convertible landscape is the technology sector, which is just under 25% of the global universe and over 30% of the U.S. index (Figure 4). As discussed earlier, natural issuers of convertibles are companies with high growth expectations and low or negative cash flow, who need access to capital at a lower cost than conventional debt. For this reason, it is no surprise that technology makes up a large portion of the market. Other large, growth-oriented sectors representing a meaningful portion of the market include health care and consumer discretionary.

It is also important to recognize that there are noticeable sector variations across regions. While technology makes up the largest portion of the U.S. convertible market, consumer discretionary is the largest sector in Europe and Asia ex-Japan, while materials is the largest sector in Japan's convertible bond market. The U.S. convertible market more heavily comprises growth issuers than the global universe, which is more balanced in terms of style with a near 50/50 split: 51% value vs. 49% growth (BofA, as of 6/30). Investing globally within the convertible universe can benefit investors, as it provides a broader array of sector opportunities than investing only in U.S. convertibles, where technology and health care alone make up almost 50% of the universe.

FIGURE 4

Sector landscape

Convertible issuance by sector (%)

Sector	Global	U.S.	Europe	Asia ex-Japan	Japan
Consumer discretionary	14.4%	12.2%	20.7%	26.0%	10.4%
Consumer staples	0.7%	0.5%	1.8%	2.1%	3.4%
Energy	4.9%	2.8%	3.5%	0.0%	0.0%
Financials	13.6%	12.2%	11.2%	14.5%	9.1%
Health care	12.6%	16.7%	8.0%	4.7%	8.6%
Industrials	6.0%	5.0%	13.6%	3.7%	7.1%
Materials	3.5%	1.3%	7.8%	4.8%	23.6%
Media	7.7%	8.5%	2.6%	21.2%	6.8%
Technology	24.5%	30.5%	12.1%	14.3%	7.7%
Telecommunications	2.9%	1.5%	4.0%	4.4%	0.0%
Transportation	3.8%	2.0%	6.0%	3.9%	21.0%
Utilities	4.9%	6.2%	8.2%	0.0%	1.9%

Source: BofA Sourcebook, BofA Global Research, as of 6/30/22. For illustrative purposes only.

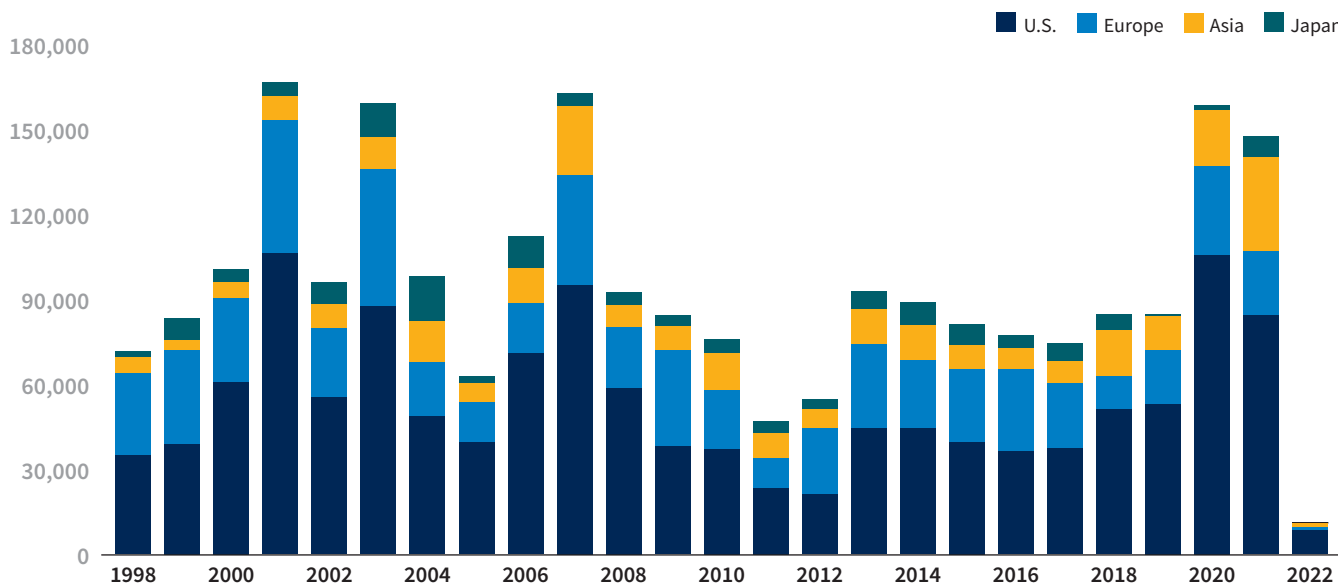
New issue activity

Convertible bond issuance ebbs and flows over time and is generally closely tied with economic growth. An environment in which equity markets are rising can make companies more comfortable with issuing debt that includes an option on their equity. If a company is confident that its equity will be higher in the future, this can provide a catalyst for issuing convertible securities over non-convertible debt. Corporations can then retire their debt through the equity conversion rather than pay it off using cash or refinancing. For example, as Figure 5 illustrates, the convertible market experienced strong issuance in 2020, as companies issued debt for liquidity needs following the sharp market correction experienced in March. Companies may have also viewed 2020 as an opportune time to issue convertible debt with the increased probability of their equity rising higher in the future following such a large equity sell-off. Strong issuance continued in 2021, fueled by the economic reopening and optimism that the worst of the global health crisis had passed.

Rising interest rates are another catalyst for issuing convertible debt. Since convertible securities provide some of the upside of equities, they can offer lower coupons than non-convertible debt. Thus, convertibles may be an attractive financing option when interest rates are rising, though this has not been the case in 2022 due to a myriad of other factors, including significant and ongoing market volatility. In general, market volatility negatively impacts convertible issuance. In volatile markets, investors may need more incentive to purchase securities, and uncertainty around investor demand typically leads to a decrease in new issuance. The volatility experienced thus far in 2022 has led to a steep decline in convertible bond issuance this year. As of June 30, 2022, convertible bond issuance was down 85% year to date. Though the decline in new issuance this year due to market volatility is meaningful, this correction does provide opportunities to enter positions in seasoned issues from 2020 and 2021, years of strong issuance, at more attractive price points.

FIGURE 5

Convertible issuance by region since 1998



Source: BofA Sourcebook, BofA Global Research, as of 6/30/22. For illustrative purposes only.

The value of institutional expertise

As discussed in the prior white paper, “The basics of convertible securities,” the convertible market represents a unique opportunity for investors. Given the various types of convertibles and their functions, these securities need to be evaluated carefully. The same holds true when considering convertible issues from across the global landscape, the majority of which are not rated by the major rating agencies. Though convertible securities may be considered a niche marketplace, much smaller in size than traditional equity or bond markets, they provide diversification across market caps, geographies, and industries. Sophisticated credit and equity research teams are typically needed to thoroughly analyze these securities and their risks. As a result, using an institutional asset manager is often the best option for investing in convertible securities. Remember to also consult the other papers in this series, in which we expand upon the behavior of convertible securities, and how they can be used in the context of a portfolio.

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