Convertible Bonds: A Supplementary Exit Path for Private Equity Funds

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Abstract. With the rapid development of China's economy, private equity funds have become an important force to help unlisted small and medium-sized startups quickly become bigger and stronger. As an important financing channel for enterprises, private equity funds can provide a large amount of financial support for target enterprises, and in all aspects of their investment operations, the choice of exit method is particularly important as the core link that directly affects returns. Therefore, this paper takes the case study as the research method, and selects SoftBank Group's gradual reduction of Alibaba shares through the issuance of convertible trust bonds as a case study, and studies the use of convertible bonds as a supplement to the IPO exit method of private equity funds. The study finds that convertible bonds, as a supplement to the IPO exit method, have more efficient, lower risk and low cost financing capabilities, effectively solve the problem of single exit path, improve the speed of private equity fund exit liquidation, and reduce the loss range while retaining the profit growth space.

Keywords: Private Equity Funds; Convertible Bonds; Corporate Finance.

1. Introduction

Private equity funds are fully developed globally and are becoming an increasingly important part of the capital markets. Among the various stages of private equity fund investment activities, the income link (i.e., the exit link) is particularly important. The more income methods can be chosen from, that is, the more exit methods can be chosen from, and the smaller the capital loss caused by the exit method, the greater the momentum for a new round of investment. Therefore, the choice of exit method is particularly crucial. At present, the mainstream exit methods in the market include IPO exit, equity repurchase, and equity mergers and acquisitions. Among them, the IPO exit method has become the most chosen exit method for private equity funds due to its high returns (compared to other exit methods).

All of the above exit methods can enable private equity capital to be liquidated and obtain investment returns, but there are still certain limitations. There is a certain discount loss in the IPO method, and the payback period for IPO exit is long, and discontinuous complete exit accounts for the majority [1]. Although the equity repurchase method can effectively protect the profitability of risk capital, it is still a relatively inferior repurchase method for some high-quality and high-growth enterprises [2]. Equity mergers and acquisitions can lead to conflicts of interest among private equity investment institutions, increased costs, hollowing out listed companies, and other consequences [3]. In view of the above mainstream exit methods, current domestic and foreign studies have not been able to judge which exit method is the best solution. Therefore, given the fact that there are advantages and disadvantages to each exit method, it is necessary to study the complementary ways in which they are available.

At present, the development of private equity funds is still in its infancy, and in order to better protect the interests of private equity funds in the investment process, many scholars have proposed some protective measures to ensure that private equity funds can effectively exit and make profits. Li Qiong and Zhou Zaiqing proposed that private equity capital can exist in different investment vehicles depending on the development status of the invested company, such as bonds, preferred shares, common shares, etc. [4].

There is an investment vehicle in the market that can better realize this idea - convertible bonds. As an innovative hybrid financing tool, convertible bonds give bonds certain option attributes, so that they have the option to convert into shares while retaining their fixed income. The bond nature of convertible bonds makes it possible for private equity funds to recover most of their capital without causing large losses in the short term, and some convertible bonds with additional terms (such as exercising only cash delivery) make private equity funds retain the right to enjoy the benefits of the continued growth of the invested enterprises.

Therefore, the author believes that convertible bonds, through their unique financial attributes and flexible structural design, can be used as a supplement to the IPO exit method of private equity funds. This paper uses a case study to explore the principle of SoftBank Group's use of convertible bonds as a supplement to the IPO exit method of private equity capital and describes how convertible bonds are used in the IPO exit process of private equity capital, and how it can effectively solve the limitations of the IPO exit method, so as to promote the development of the private equity fund industry.

2. Private Equity Funds

There are many translations of private equity funds in China, such as private equity capital, private equity capital, private equity funds, etc. Research institutions generally define private equity funds in terms of investment objects. For example, two of the most important venture capital research institutions in the United States (Venture Economics and Venture ONE) define it as an investment manager that engages in venture capital, management buyouts, fund investments, and secondary investments [5]. Huang defines private equity funds as private equity funds that invest in non-listed enterprises in an equity manner, and market investors will carefully screen before making investment decisions and realize equity value appreciation through exit after investment [6]. There are many relevant definitions in the literature, and this article selects representative examples to illustrate the views of relevant people and institutions at home and abroad. From the above point of view, it can be seen that private equity funds are invested by specific companies with a certain special purpose and expect to liquidate and close them in the future to make a profit. In this regard, the author defines a private equity fund as a fund established by some specific asset management companies to make equity investments in companies that are not yet in the stage of immature development, and the asset management company will choose a certain exit method in the future to liquidate the equity (shares) of the closed investment in order to obtain investment income.

3. Exit Methods for Private Equity Funds and Limitations

At present, the mainstream exit methods chosen by private equity funds in the market include IPO exit, equity mergers and acquisitions, equity buybacks, etc. In terms of applicable objects, the IPO method is generally suitable for enterprises with good development status in the later stage and meeting the IPO standards; On the other hand, equity mergers and acquisitions and buybacks are generally suitable for the later development of enterprises and cannot meet the listing requirements [7]. In terms of return on cost, the IPO exit method has a higher rate of return (generally speaking), and its cost is higher than the other two, which is a typical high-risk and high return. The latter two are lower returns and lower costs, which are typical low risk and low returns.

Since the case companies studied in this article are in good shape and use convertible bonds as a supplement to the IPO method, this article will mainly discuss the IPO method and its limitations.

The IPO exit has higher requirements for the relevant qualifications of the enterprise, so the development cycle of the enterprise is relatively longer, and the accompanying cost will also be higher, so it will have a negative impact on the overall rate of return. Moreover, after the success of the IPO, the way for private equity capital to make a profit is still to sell the equity, so it will be accompanied by the disadvantage of poor yield stability [8]. On the one hand, there is a problem with private equity that cannot be liquidated in large amounts in a timely manner: if the stock is sold off in large quantities, it will inevitably cause the stock to fall so that it will not be able to obtain the expected return. In addition, companies often have restrictive clauses to restrict the sale of the original equity at the later stage of the IPO, which is often referred to as the lock-up period, to prevent large fluctuations in the stock price caused by the sale of a large number of shares. All in all, if the IPO method wants to get a large return in a timely manner, it needs to lose a certain amount of income. On the other hand, publicly traded stocks still face the problem of price volatility caused by other factors, and if the stock price plummets sharply after the IPO, then private equity capital will still not be able to get a significant return.

4. Convertible Bonds

Convertible corporate bonds, referred to as convertible bonds, refer to the right of the holder to choose to convert the bonds into ordinary shares of the issuing company at the agreed price within a specified period, or continue to hold the bonds until the maturity of the bonds to receive the face principal and interest. Compared with simply holding ordinary bonds or ordinary stocks, it gives investors and issuing companies a wider range of choices. For investors, if they are optimistic about the development prospects of the issuing company and have a positive attitude towards the future stock trend, they can choose to convert their convertible bonds into ordinary shares and enjoy dividends and the benefits of rising stock prices by virtue of their status as shareholders, and on the contrary, they can choose not to convert shares and sell the bonds back to the issuing company in exchange for interest income. From the perspective of the issuing company, the interest rate of issuing convertible bonds is lower than that of issuing ordinary bonds, which can effectively reduce the financing pressure of the issuing company, and on the other hand, the issuer raises funds through the issuance of convertible bonds, and its equity structure does not need to be changed immediately [9]. Therefore, convertible bonds, as a hybrid financial instrument with the characteristics of debt, stocks and options, are widely favored by investors and financiers.

Among the private equity funds discussed in this article, the author believes that convertible securities can be used as an effective exit method for private equity funds and solve certain related problems to promote the development of the private equity fund industry.

5. Case Analysis: SoftBank's Exit from Alibaba

SoftBank, or Software Banking Group, is a comprehensive venture capital firm in Japan, and its Vision Fund is a fund company dedicated to investing in the IT industry, including the network and telecommunications industries. In addition, Alibaba is a world-renowned company with the Internet as its core, providing a variety of online services and platforms, and is committed to promoting the rapid development of the digital economy.

SoftBank's financial stress in 2016 was significant, especially after the $21.6 billion acquisition of U.S. telecommunications company Sprint, which saw its debt burden increase dramatically. SoftBank urgently needs an outlet to ease short-term debt service pressures, realign financial leverage and optimize its balance sheet to stabilize its financial position. Given the sluggish tech market and the long-standing stagnation of Alibaba's share price, SoftBank finally decided to reduce its stake in Alibaba. Alibaba's shares were issued through an IPO in 2014. Selling stocks in large quantities on the open market is bound to lead to sharp fluctuations in stock prices, and there is a high probability that the expected return will not be achieved. As a result, SoftBank has opted for a novel approach: convertible bonds.

On May 31, 2016, SoftBank announced plans to sell nearly $7.9 billion of Alibaba shares. To coincide with the transaction, SoftBank will establish a new convertible trust fund to issue convertible bonds totaling $5 billion, which can be converted into common shares of Alibaba within three years. On June 2, SoftBank announced that it would increase the size of its convertible bonds to $5.5 billion, while selling an additional $500 million of Alibaba shares to Singapore's Temasek, bringing the cash amount to $8.9 billion. On June 3, SoftBank again announced that it had fully exercised an authority to purchase an additional 20% of the trust securities worth $1.1 billion. These trust securities can be converted into Alibaba shares, bringing the convertible bond to another $6.6 billion. To date, SoftBank holds a negligible stake in Alibaba.

Only a small fraction of the exit options chosen by SoftBank for the sale of Alibaba shares were open market trading, and the majority opted for convertible bonds. It is not difficult to see that SoftBank Group is unable to realize a large amount of cash in a timely manner by means of a large amount of selling (that is, it will bring large losses through a large amount of selling).

Compared with the IPO exit method alone, the author believes that the use of convertible bonds as a supplement has the following advantages:

(1) Faster financing capabilities. By issuing convertible bonds, SoftBank can guarantee that it can raise funds quickly without incurring large losses. The bond nature of convertible bonds gives it a fixed income. Investors prefer bonds that provide stable cash flow over stocks with volatile prices (fluctuating earnings). At the same time, convertible bonds give the buyer certain options, so that investors have a certain degree of choice, and the shares converted at maturity have the potential to rise. The combination of various factors makes the convertible bonds issued by SoftBank extremely attractive to achieve the effect of rapid financing.

(2) Lower financing costs and risks. Compared to ordinary bonds, convertible bonds give investors certain options and therefore have lower interest rates. Lower interest rates mean that SoftBank can use lower-cost, lower-risk capital for investment income, from which it can earn a certain amount of spread income to compensate for the interest paid on convertible bonds.

(3) Preserve profit upside. When a company issues convertible bonds, it usually has a subsidiary agreement to ensure that its profits can rise. SoftBank, for example, issued convertible bonds with a clause that would not exceed a 17.5% premium based on the closing price on June 1. That's 117.5% of the closing price on June 1. If the price exceeds the price during the exercisable period, it will be converted to the investor at that price; If the price is lower than the closing price on June 1 during the exercisable period, the closing price will be converted to investors; If the price is between the two prices during the exercise period, the actual price will be converted. By issuing convertible bonds with affiliate agreements, SoftBank managed to retain upside and still enjoy above-limit gains when Alibaba's shares rose above 117.5% of its closing price on June 1.

SoftBank eventually cashed out more than $10 billion through a series of operations to reduce its holdings. Compared to selling directly in the open market, SoftBank significantly reduces the loss of value through convertible bonds. At the same time, the cash-out funds significantly increased SoftBank's cash reserves, improved the debt-to-asset ratio, increased short-term solvency, and helped SoftBank out of its financial difficulties at that time. At the same time, the transaction also helped SoftBank Group complete its strategic transformation. Since its initial public stake in Alibaba in 2016, SoftBank Group announced that the group has entered "defensive" mode, continuing to liquidate its interests to increase cash flow and enhance its resilience.

It is not difficult to see from SoftBank's case that the use of convertible bonds as a supplement to the IPO exit method can effectively prevent price fluctuations and value losses caused by a large number of equity sales. It provides a more novel and safer way for private equity investment funds to realize value in the short term, and in some respects, it also avoids the obstacles to value realization during the "closed period". At the same time, there are certain conditions attached to the convertible bonds that can retain the possibility of profit growth (such as cash settlement, setting a volatility range, etc.), and increase the value addition of private equity funds [10].

6. Conclusion

Through the above analysis, convertible bonds can be used as a supplement to the IPO method, which can be more efficient and less risky financing. It effectively fills part of the vacancy of the mainstream exit method in the market, makes up for some of the shortcomings of the mainstream exit method, and at the same time improves the speed of the withdrawal and liquidation of private equity funds, and reduces the loss range to a certain extent. However, while convertible bonds bring some innovation, they also present more complex risk management challenges. Since the research on the relevant systems of convertible bonds in China and other countries is not comprehensive enough, there are certain loopholes (such as the normativity of additional clauses), which requires continuous improvement of relevant research to reduce the risks of specific aspects. It is believed that with the use of convertible bonds, the exit method of private equity funds can gradually get rid of the limitations, and the entire industry can enter the next stage of development faster.

Authors Contribution

All the authors contributed equally, and their names were listed in alphabetical order.

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