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Valuation and analysis of performance sensitive debt with contingent convertibility

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Abstract

We develop a new type of performance sensitive debt (PSD), called contingent convertible PSD (CPSD), which can be converted into equity in financial distress. We address the pricing of corporate securities and optimal capital structure including CPSD. Most of the results are given explicitly and numerical analyses are provided. The results explain that CPSD is a valuable security in increasing the value of tax shields while keeping default risk in a low level. The firm value is increased due to the issuance of CPSD. **The risk-compensating feature of CPSD can alleviate the inefficiencies arising from debt overhang and asset substitution. On the contrary, if equity holders benefit from a conversion, the contingent convertibility will aggravate them. The inefficiencies decrease with the conversion ratio of CPSD.**

Keywords: performance sensitive debt, contingent convertibility, debt overhang, asset substitution

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