



Milbank Insights

Global Corporate/M&A Group

Hybrid Equity in Asia: A Deeper Dive into the Role of Convertible Notes

October 2025



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Emergence of convertible notes as an instrument of choice in APAC

Even a decade ago, convertible notes and other hybrid equity instruments occupied a niche middle ground between more traditional private credit and private equity markets, proving effective mainly in special-situation financings. Their scale is now impossible to ignore: market observers report a sharp uptick in the use of convertible notes over the past two years. Feeding that growth is the rapid expansion of private credit, whose assets under management have risen from roughly US\$320 billion in 2010 to somewhere between US\$2 trillion and US\$3 trillion.

What is particularly striking however is the convergence of investor interest: not only private equity sponsors, but also private credit / direct lending platforms and other alternative capital sources are increasingly deploying convertible notes as an important part of their investment toolkit. Asia-Pacific still represents only a slice of that pool, but momentum is building: regional private capital funds now manage many multiples of the assets they held a decade ago and global sponsors such as Blackstone and KKR are pledging to continue expanding their regional quasi-equity portfolios. As a result, capital that once flowed predominantly into vanilla equity or loans is now channeled through bespoke quasi-equity term sheets deploying convertible notes and similar structured / hybrid instruments.

Forces propelling the rise of convertible notes

It is instructive to examine the forces propelling the rise of hybrid equity instruments such as convertible notes as a mainstream financing solution:

- Since 2023, APAC equity markets have grappled with tight liquidity, driven in large part by policy rates sitting near multi-year highs. Although global policy rates began easing in 2025, these constrained conditions (coupled with the relative scarcity of IPO exits) have had a chilling effect on the availability of equity financing.
- Despite tightness in APAC equity markets, a record backlog of private capital dry powder awaits deployment, provided that strong prospects of exit and capital return can be ensured. Convertible notes deliver this certainty.
- APAC's above-average GDP growth forecasts, coupled with increasingly sophisticated financing markets and the gradual removal of local regulatory impediments, are attracting financial investors to deploy capital in the region through increasingly structured instruments.

Against this backdrop, the market has responded with the secured, redeemable convertible note structure built on two pillars:

1. **Lender-style protection:** (i) structured returns, through interest payments, (ii) guaranteed redemption upon maturity, often linked to an IRR floor return; (iii) credit covenants, including financial ratios and liquidity buffers; and (iv) default triggers and acceleration rights, potentially accompanied by collateral and secured creditor rights.
2. **Equity-style optionality:** the noteholder may (i) redeem for cash at maturity (principal plus IRR); or (ii) at maturity or agreed trigger events, convert at a pre-agreed valuation, or at a discount to the next qualified financing, to capture equity growth.

Many would-be equity investors now view structured / hybrid instruments as ameliorating the disadvantages of a long-term equity play while acting as a bridge to the advantages of a debt investment.

The pitch sounds irresistible: equity upside paired with lender-style downside protection. It appeals to equity investors chasing upside and to creditors who may collect an additional windfall in the form of equity gains — a benefit traditionally out of reach for downside-focused lenders.

This paper, however, deliberately explores a contrarian perspective: might the very provisions designed to protect downside risks for investors potentially suffocate the upside in practice? Even assuming an investor can secure lender-style protections without diluting their implied equity stake, each transaction demands independent, careful, objective evaluation of whether these safeguards might constrain the target company's growth trajectory and inadvertently undermine the investor's intended prospects for meaningful equity returns.

Convertible debt offers compelling advantages: it delivers more predictable, risk-adjusted returns that are attractive for many investors and deployment scenarios. This paper focuses on potential limitations of such structured / hybrid equity structures

to advance the understanding of structured investment deployment, strategic positioning across the debt-equity spectrum, and effective management of the risk considerations explored herein.

When do debt covenants erode growth?

Debt covenants are not inherently designed to stifle growth — they are intended to protect lenders by ensuring prudent financial management. However, covenants that are overly restrictive or poorly aligned with a company's growth strategy might act as a brake on the company's growth and strategic flexibility.

Convertible debt typically imports into its structure three forms of traditional loan protections, as set out in the table below. Companies and investors should carefully evaluate whether and how these downside safeguards might influence management behavior and potentially narrow a company's growth trajectory. The table examines how each protection is structured in practice and its potential operational implications for the business.

Debt protection	How it is documented	Potential adverse effects on the business
Financial covenants	- Minimum-cash requirements and financial or leverage ratios, tested at agreed intervals. - Breach turns into an event of default if not cured within a grace period.	Financial covenants may have a broader chilling effect, restraining management from making bold investment and strategic choices. Every dollar retained by the target company in reserve to ensure satisfaction of financial covenants is a dollar not spent on growth opportunities, whether R&D, marketing, head count or M&A.
Security package	- A convertible note is typically secured by a first-ranking, all-assets charge over the company's key property, including equity interests in material subsidiaries and other core assets such as IP. - Negative pledges typically prohibit <i>pari passu</i> or junior security without the noteholder's consent.	- New indebtedness (including loans or receivables facilities) might require noteholder consent and additional intercreditor arrangements. This would add time and cost and may discourage potential financiers. - Next round investors might discount entry price to reflect their structural subordination, potentially increasing dilution for existing shareholders.
Event of default & acceleration	- Covenant breaches and payment delinquencies are an "Event of Default." - Following an Event of Default, the noteholder may accelerate repayment of the entire debt and enforce any security rights.	Knowing that a single ratio miss could potentially trigger acceleration of the debt may cause management to operate more defensively, adjusting their calculus between short-term liquidity preservation over longer-term value creation.

Each safeguard should be thoughtfully calibrated to strike the optimal balance between prudent financial oversight — tailored to the target company's unique circumstances and growth stage — and managing the risk of constraining the business through excessive cash reserves, limited financing flexibility, valuation compression and management distraction.

A two-path growth test — a hypothetical

We set out below an illustrative comparison between two alternative funding structures — Path A (*Preferred Equity*) vs. Path B (*Secured Convertible Note*) — for a hypothetical regional manufacturing platform seeking to raise US\$50 million at a US\$150 million valuation. Note that this example makes certain assumptions to demonstrate how contrasting capital structures might affect a target company's growth trajectory and an investor's returns.

Key term	Path A: Preferred equity	Path B: Secured convertible note
Instrument	US\$50 million series B preferred shares, no debt covenants	US\$50 million five-year secured convertible note, 5% coupon, 10% PIK interest

Cash available for growth	US\$50 million	US\$45 million (as is common practice, we assume management will set aside about US\$5 million as an additional buffer to cover minimum cash balances, coupon payments and other covenant requirements, smoothing out the impact of irregular revenue inflows)
Security package	None	All-asset lien
Upside mechanism	Unlimited, return rises with valuation	Convert at 20% discount to next qualified financing (or valuation which reflects 15% IRR)

Path A — Equity-enabled growth

With the full US\$50 million deployable, management completes its expansion rollout in Years 1–2. Capacity gains secure volume rebates and attracts incremental customers. EBITDA rises from US\$10 million to US\$30 million over three years ($\approx 44\%$ CAGR). Series C is priced at US\$450 million pre-money, to reflect the tripping of EBITDA. Series B investors more than double their stake and capture the upside.

Path B — Debt-driven, covenant-constrained

US\$45 million of the US\$50 million is deployable due to cash buffers to cover coupon payments and financial covenant compliance. Under our scenario, this would delay the expansion rollout, resulting in EBITDA growth slowing by a third to a CAGR of $\approx 30\%$, going from US\$10 million to US\$22 million in three years. Applying the same multiple used in Path A, the Series C would be priced at US\$330 million pre-money. The noteholder would convert at a US\$264 million valuation which remains greater than its redemption value (principal plus coupon and PIK interest) but lower than the valuation achieved in Path A.

For completeness, we now consider a downside scenario where the company suffers a serious downturn in Year 2. The secured convertible noteholder under Path B will be feeling considerably more protected. While the preferred equity investor under Path A can rely on liquidation preferences, the secured convertible noteholder enjoys superior protection: it can declare an event of default, accelerate repayment and enforce security interests. Once breach notices are served, management cannot raise fresh equity while a default remains outstanding, and the noteholder may appoint a receiver. On paper, the noteholder's downside appears well-protected, principal plus accrued interest should be recoverable given that the aggregate debt represents only a fraction of the company's enterprise value. We note, however, that there are significant factors and risks to consider prior to embarking on any enforcement process, namely that the process of enforcement itself could lead to limited recovery due to fire sales of assets and extended timelines for enforcement, thereby diluting residual value.

Bottom line: the secured convertible noteholder has superior downside protection (over and above the liquidation preference of a preferred equity investor), but the triggering of such creditor rights via an enforcement recovery process may itself be a lengthy and value-sapping process.

Improving market conditions & the recalibration of noteholder protections

While debtor status and secured claims may provide comfort to noteholders, they can become stumbling blocks for a company seeking fresh capital. Sweeping liens over operating subsidiaries, intellectual property and bank accounts often leave little unencumbered collateral for subsequent secured lenders or trade-finance providers. Prospective equity investors, in turn, may demand that the company accept a valuation discount to reflect the structural risk of sitting behind more senior, secured debt. Both scenarios are potentially costly – risking either a value-eroding pause or forced refinancing just when momentum should be building.

Against this backdrop, market participants are closely monitoring the loosening of financing conditions in 2025. The European Central Bank cut its rate to 2.00% in June 2025 and has held since, with inflation near the 2% target. The U.S. Federal Reserve delivered a 25 basis point cut in September 2025, lowering its target range to 4.00%-4.25%, with markets pricing two additional cuts by end 2025. Meanwhile, the Reserve Bank of Australia has cut 75 basis points year-to-date to 3.60%, while the Bank of Japan has held rates at 0.50% since January 2025.

These monetary policy shifts are contributing to renewed capital markets activity. Asia-Pacific equity issuance reached US\$21.3 billion in H1 2025 (up 44% year-on-year), with Hong Kong processing US\$14.0 billion – a 700% surge – reclaiming the #1 global IPO ranking. As financing conditions ease, a critical question emerges: will convertible notes and hybrid equity with extensive protection structures remain justified? Or will issuers increasingly push back on terms misaligned with

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improving market conditions? We anticipate heightened focus on tailoring safeguards to specific contexts, aligning parties' interests, preserving flexibility, and ensuring structures support rather than constrain value creation.

Secured convertible notes are well-suited to periods of scarce liquidity, elevated rates and economic uncertainty - they offer the promise of downside protection and more structured, predictable returns. But these protective features come at a cost, potentially limiting the issuing company's growth potential or ability to secure additional capital. Accordingly, issuers usually adjust for such opportunity cost – most often by reducing the investor's implied equity stake. This is commonly achieved through tighter conversion discounts or caps on investor IRR.

While macroeconomic uncertainty persists around inflation, trade policy and geopolitical risks, the anticipated loosening has begun materializing in developed markets. It is increasingly common to hear of borrowers waiting for potentially cheaper and "covenant-lite" capital seemingly just beyond the horizon.

Milbank insight — navigating the middle ground

Milbank routinely acts for both growth-stage companies and institutional investors across Asia-Pacific. Our mandate is not to promote or dissuade the use of secured convertibles, but to design capital solutions — whether straight equity, secured notes or hybrid structures — that fit the commercial context while minimizing unintended franchise drag. Where a convertible note is the right instrument, we work with clients to calibrate covenants, security packages and redemption mechanics so that downside protection is preserved without stifling the very upside that justifies the investment. Where terms have already been established, we are available to advise on pragmatic refinements — including liquidity step-downs, focused holdco security, warrant-for-trigger swaps — to rebalance risk and reopen financing pathways before stress becomes distress. If a fresh look at your existing or proposed structure would be helpful, our team would be pleased to discuss practical options from the company and investor perspectives.

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