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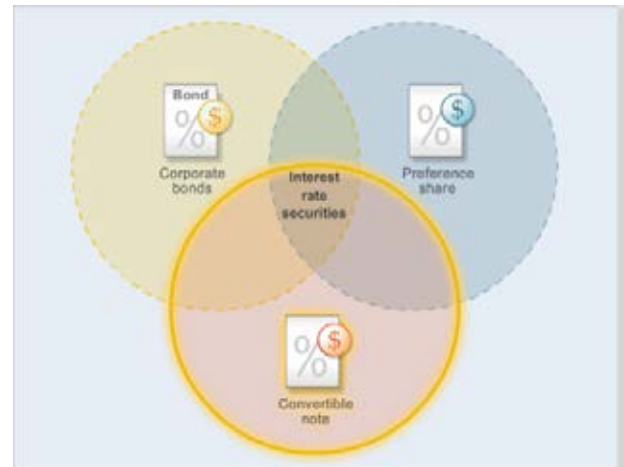
Topic 1: Overview

Three main types of interest rate security are traded on ASX:

- corporate bonds/notes
- preference shares, and
- convertible notes.

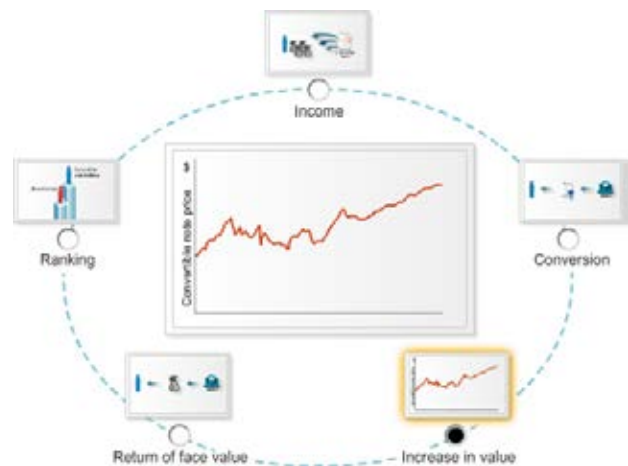
Convertible notes are the focus of this module. In this module we look at their features, benefits and risks.

At the end of the module there is a case study of a convertible note listed on ASX.



Why invest in convertible notes?

- You receive a defined income, generally at a higher rate than the interest paid on bank deposits.
- You can convert your notes into ordinary shares at a future date.
- Convertible notes usually increase in value if the price of the ordinary shares rises.
- If you don't convert your notes, you will receive the notes' face value in cash at maturity.
- You rank ahead of shareholders for the payment of interest.
- You rank ahead of shareholders for recovery of capital if the company becomes insolvent.



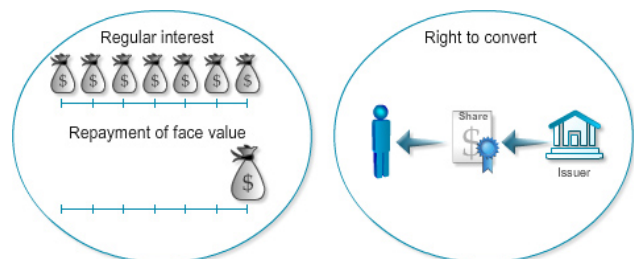
What is a convertible note?

You can think of a convertible note as a bond with a conversion feature.

Like a bond, a convertible note:

- pays a defined income stream
- repays face value at a specified future date.

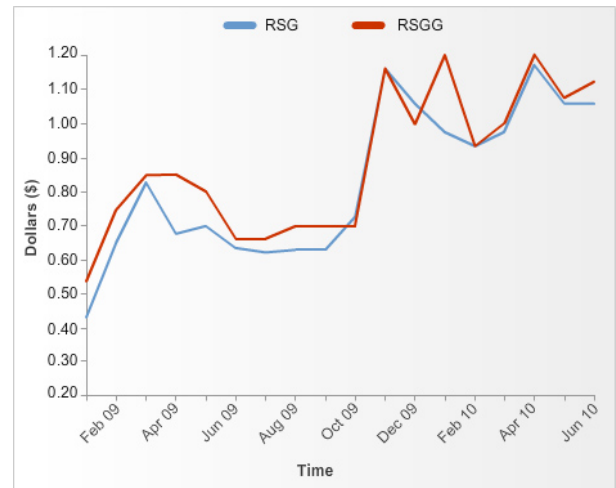
Additionally, the holder has the right to convert the note into ordinary shares in the company at specified times.



The market price of a convertible note tends to move in line with the ordinary share price, offering the holder a 'share-like' exposure.

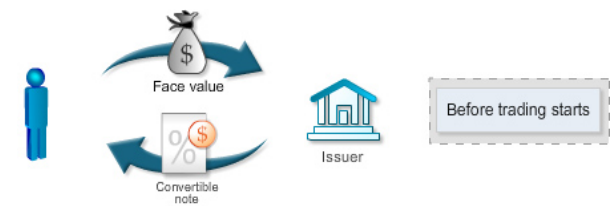
If the ordinary share price fluctuates significantly, then the price of the convertible notes is also likely to be volatile.

Consequently, convertible notes offer the possibility of significant capital gains - and losses - unlike some other interest rate securities that tend to fluctuate less in price.



Buying convertible notes

At the time of issue, you can subscribe for convertible notes directly from the company - just as you would apply for shares in a float. You will pay face value for your notes.



Once the issue period is finished, the notes start trading on ASX.

If you buy a note on market, you buy from another investor, not from the issuing company. You will pay the market price.

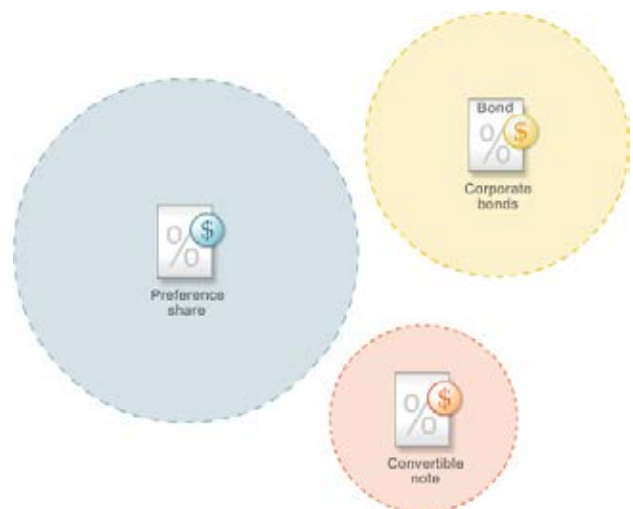


The convertible note market

Three main types of interest rate security are traded on ASX:

- corporate bonds/notes
- preference shares, and
- convertible notes.

Convertible notes are a relatively small sector of the interest rate security market, with a market capitalisation of \$1.3 billion, which is about 6% of the market (April 2010).



Convertible notes are a method of fund raising used primarily by smaller companies. Issues are typically under \$100 million in value.

Turnover can be low in some notes. This may not be important if you plan to hold your convertible notes to maturity, but you should take it into account if you think you may want to sell your notes on market.

For up-to-date statistics, please refer to ASX's [monthly report](#) on trading in the interest rate securities market.

What should I look for in a convertible note?

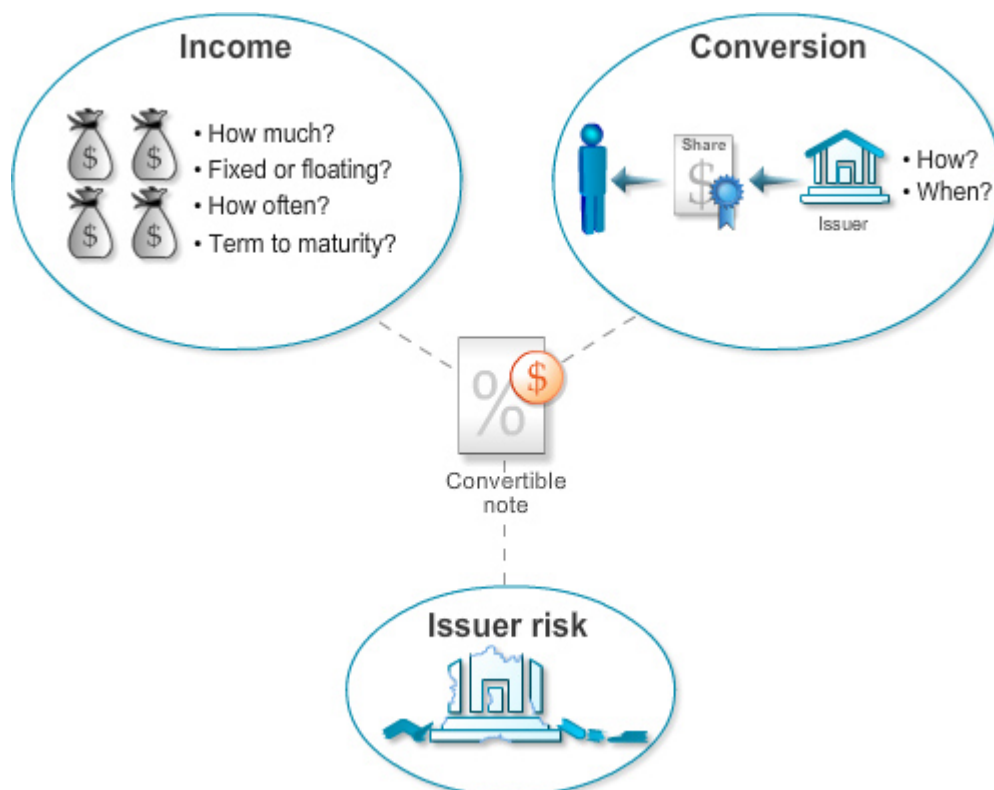
The most important information to know about a convertible note is:

- interest rate
- whether the rate is fixed or floating
- how often interest is paid
- term to maturity, and
- how and when you can convert the note into ordinary shares.

It is also essential to consider the risk associated with the company that issues the convertible notes.

The features and risks of convertible notes are covered in the next three topics of this module.

Features of convertible notes can vary significantly. You should read the prospectus carefully to ensure you are fully informed.



Topic 2: Income

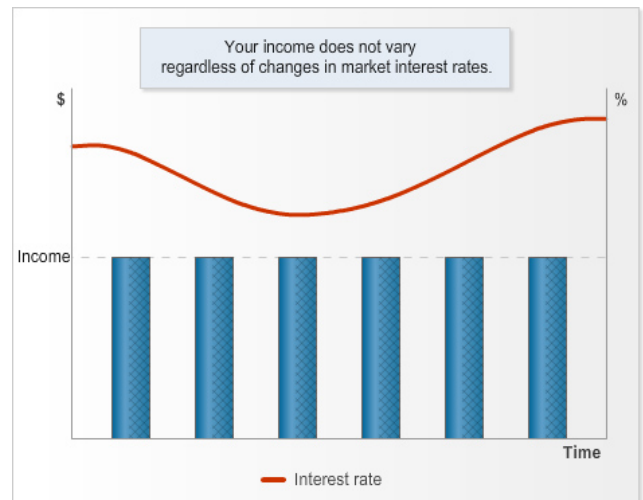
Fixed rate

The rate of interest paid on a convertible note may be fixed or floating.

With a fixed rate your payments do not vary, so you know exactly how much income you will receive.

The interest rate (also called the 'coupon rate') is expressed as a percentage of the note's face value, and is set by the company at the time of issue.

For example, if a note has a fixed rate of 10% and a face value of \$1.00, you would receive payments ('coupons') totalling \$0.10 each year.



Floating rate

With a floating rate, your payments are linked to a market interest rate.

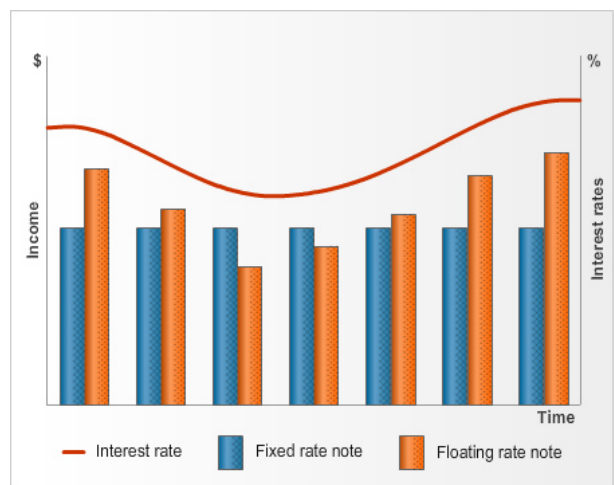
As the benchmark rate changes, so too do the payments you receive. At regular intervals, typically at the start of each quarter, the payment rate is adjusted to reflect changes in the benchmark rate.

As interest rates rise, your income increases. As rates fall, your income decreases.

At the time of issue the company specifies:

- the benchmark rate to be used e.g. the bank bill swap rate (BBSW), and
- a margin to be added to the benchmark e.g. 4.0%.

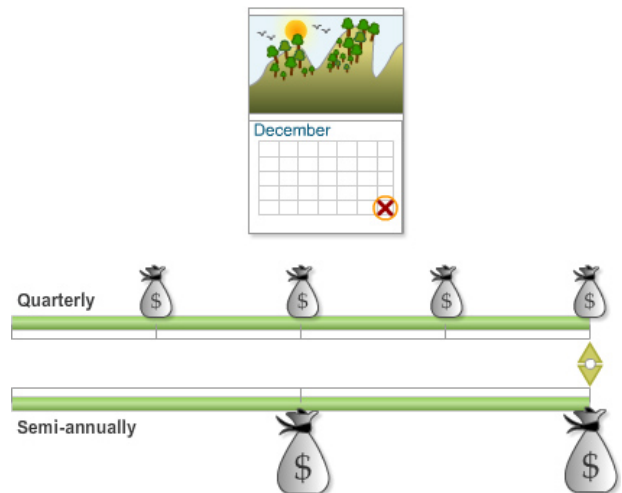
The benchmark plus the margin equals the floating rate for that payment period.



Frequency of payments

Interest is usually paid in arrears either quarterly or semi-annually (twice a year). 'In arrears' means you receive your payment at the end of the period over which the income is earned.

Generally, the more often you receive income the better. Receiving your income earlier means you can reinvest it sooner to produce more income.



Can an interest payment be changed or cancelled?

Interest payments on convertible notes:

- are set at the time of issue, unlike dividends on ordinary shares which may be varied at the company's discretion.
- must be paid before dividends are paid to shareholders.

Rank higher in order of payment	Share dividends
Set at time of issue	Convertible note interest
Variable at company's discretion	Share dividends
Rank lower in order of payment	Convertible note interest

However, it is important to check the prospectus for any rights the issuer may have in relation to interest payments.

For example, the terms of issue may give the issuer the right to defer interest payments, meaning you will receive no payments during the deferral period. Or the issuer may have the right to issue shares to you in lieu of paying interest in cash.

Do changes in market interest rates affect my interest?

The effect of a change in interest rates depends on whether your convertible notes pay floating or fixed interest.

If your notes pay a floating rate, your interest payments move in line with market rates. If interest rates rise, the income you receive will also increase. However, if rates fall, your income will decrease.

If your notes pay a fixed rate, your income stays the same regardless of changes in market interest rates.

Interest rates	Floating rate payments	Fixed payments
↑	up	unchanged
↓	down	unchanged

Topic 3: Getting your money back

You can get your money back either in the form of ordinary shares or in cash.

As shares

If you exercise your conversion rights, you will receive ordinary shares in the company. The prospectus will set out when you are able to convert your notes.

Your last opportunity for conversion is usually the maturity date.

Cash payment at maturity

If you do not convert your notes by maturity, the issuer will pay you the note's face value in cash.

Sell on ASX before maturity

To get cash for your notes before maturity, you will need to sell on ASX.

Conversion

Convertible notes give you the right to convert your notes into ordinary shares at maturity.

You will also be able to convert your notes before maturity. You may have the right to convert at any time before maturity, or you may have the right to convert on specified dates such as interest payment dates.

The prospectus will specify when you are able to exercise your right to convert.

How many ordinary shares will I receive on conversion?

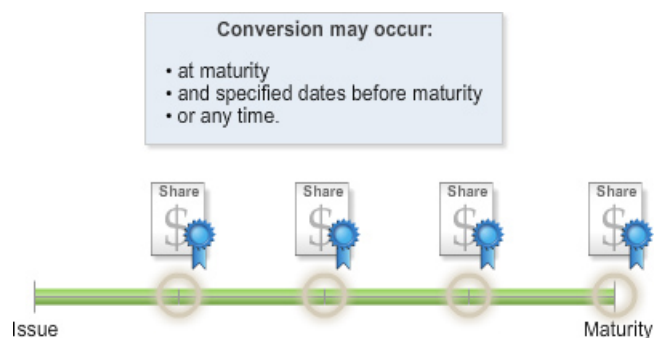
A convertible note converts into a fixed number of ordinary shares.

The number of shares you receive depends on the conversion mechanism specified in the prospectus.

One convertible note may convert into one ordinary share, or a conversion ratio different from 1:1 may apply.

To work out how many shares you will receive, multiply the number of notes you hold by the conversion rate.

Action	Receive
Sell note on ASX	Market price in cash
Convert note	Ordinary shares
Hold note till maturity, do not convert	Face value in cash



No. of convertible notes held	Conversion rate	No. shares received
100	3:1	300
200	2:1	400
1000	1:1	1000

Cash payment of face value

If by maturity you have not converted your notes into ordinary shares, the issuer will pay you the face value of your notes in cash.

It is important to compare this cash payment with the value of shares you would receive if you converted - it is possible that the share value could be greater than the cash payment.

If this is the case, you will receive more value by exercising your right to convert your notes than by taking no action and receiving a cash payment of face value.

Face value	Ordinary share price	Most value received if you:
\$0.50	\$0.95	Exercise right to convert
\$0.50	\$0.45	Take no action; issuer redeems note
\$1.00	\$1.20	Exercise right to convert

Sell on ASX

If you want to exit your investment before maturity and do not want to convert your notes into ordinary shares, you will have to sell on ASX.

There is no guarantee you will receive face value for your convertible notes when you sell on market, and some convertible notes are easier to sell than others. The market price at the time you want to sell may be above or below face value.



Can the company end the term early?

Even when a convertible note has a fixed term, the issuer may have the right to redeem or convert the note ahead of maturity. This would be likely to occur only if the ordinary share price has risen well above the issue price of the note.

It is important to check in the prospectus whether the issuer has such rights.

Early redemption

The issuer may have the right to redeem your notes early by paying you the face value in cash.

However, the company typically announces this to the market, and notifies note holders in advance of its intention to redeem, so that note holders who do not want to be paid cash have the chance to convert their notes into shares.

Early conversion by issuer

The terms of the issue may set out circumstances in which the company has the right to enforce conversion ahead of maturity.

For example, the company may be able to require conversion if the ordinary share price is trading at a specified premium to the face value of the notes.

The main consequences of early conversion are that:

- the income you receive in dividends from the ordinary shares may be less than the interest you were receiving on your notes, and
- you are no longer able to receive face value as cash for your notes at maturity.



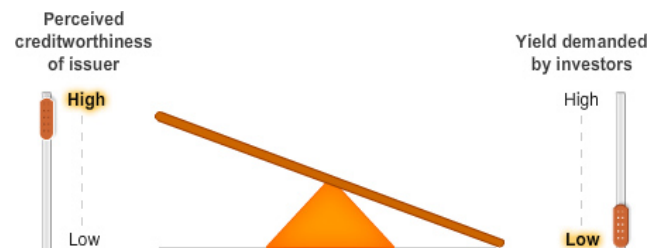
Topic 4: Return and risk

Higher return - higher risk

When looking at the potential returns from a convertible note, it is essential also to consider the risk involved.

If investors think a company is high risk, they will demand a high return. If you see notes offering unusually high returns, it may be because the market thinks there is a risk the company will default on its payment obligations.

Conversely, if a company is seen as low risk, it may not have to offer such high returns on its notes in order to attract investors.



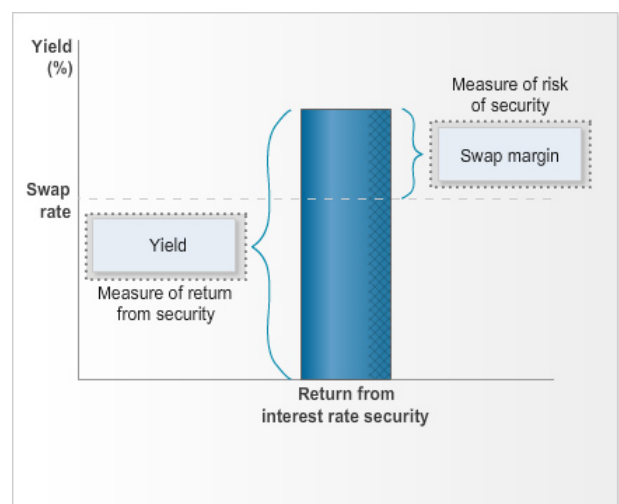
Calculating returns

The key measure of the return from an interest rate security is 'yield to maturity', or simply 'yield'. A security's yield captures both income payments and the capital gain or loss you will make if you hold the security until maturity.

Yield is important for two reasons.

Firstly, it tells you how much you can expect to make if you hold the security until maturity.

Secondly, the difference between the security's yield and a low-risk market rate such as the swap rate is a measure of the risk of the security, and of the issuer, as assessed by the market. This difference is known as the 'swap margin'.

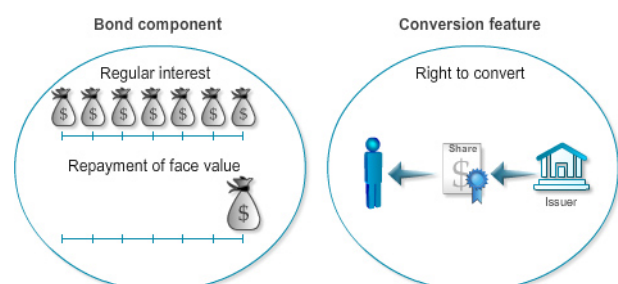


For example, if a convertible note with three years to maturity has a yield of 9% and the 3-year swap rate is 5%, the swap margin is 4%.

In Topic 1 we said you can think of a convertible note as a bond with a conversion feature.

One part of the return from a convertible note is the yield from the bond component:

- regular interest payments, and
- capital gain or loss - the difference between what you pay for the note and



the note's face value, which you receive at maturity if the note is not converted.

The other part of the return from a convertible note is due to the value attached to the conversion feature. The higher the share price, the more valuable the right to convert your notes into shares.

Option-adjusted swap margin

A convertible note's margin over the swap rate incorporates both the value of the bond component and the value of the conversion feature.

However, the value of the note's conversion feature is a reflection of the company's share price, rather than of its risk.

If we want the comparison of the convertible note's yield with the low-risk benchmark rate to be useful as a measure of the note's risk, it is necessary to strip out the value of the conversion feature.

The 'option-adjusted swap margin' removes the value of the conversion feature and isolates the bond-like returns. The option-adjusted margin is regarded as a more accurate reflection of the returns from the 'bond component' of the note.

You should consider whether the option-adjusted swap margin is a fair reflection of the risk of the convertible note.

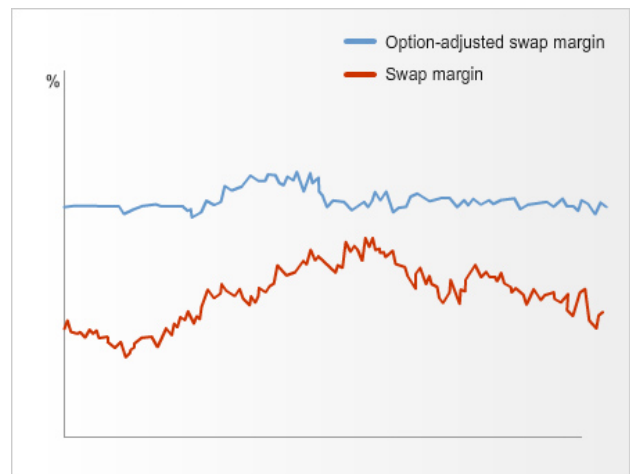
This is an important but complex concept that you may want to discuss with your adviser.

Performance of the company's shares

The market price of a convertible note typically moves in line with the ordinary share price. You are therefore exposed to the performance of the company's ordinary shares.

If the ordinary shares fall in value, your convertible notes will also lose value.

This is an important point of difference from some other interest rate securities that have a market price which moves independently of the ordinary share price.



If the share price is below face value at maturity, you can choose not to convert your notes into ordinary shares, and the issuer will pay you face value in cash.

Risk of capital loss

The price of a convertible note can fluctuate significantly.

You will make a capital loss on selling if:

- you sell your notes prior to maturity, and
- the price you receive is less than what you paid for the notes.

You will make a capital loss on conversion if:

- you convert your notes, and
- the value of the shares you receive on conversion is less than what you paid for the notes.

You will make a capital loss on redemption if:

- you pay more than face value for your notes
- do not convert your notes, and
- your notes are redeemed for face value.

Buy	Exit method	Value of shares on conversion	Result
At issue	On ASX < face value		Capital loss
At issue	Converted	> face value	Capital gain
On ASX < face value	Converted	> face value	Capital gain
On ASX > face value	Redeemed at maturity		Capital loss

What happens if the issuer gets into financial difficulty?

If the company goes into liquidation, there is a risk there may be no funds left for convertible note holders after other creditors are repaid.

A convertible note is subordinated debt, so it ranks after senior debt such as bank loans.

Notes are usually unsecured i.e. not secured by any company assets. Proceeds from the sale of company assets will first of all be used to satisfy the claims of secured creditors.

However, holders of convertible notes rank before shareholders, so must be repaid face value of their notes before shareholders receive any distribution.



Topic 5: Case study - Resolute Mining

The previous topics have looked at the features, benefits and risks of convertible notes. Now let's take a look at a convertible note quoted on ASX to illustrate what has been discussed so far.

In 2008, Resolute Mining Limited (RSG) raised \$60 million through the issue of convertible notes.

Income

RSG convertible notes pay a fixed rate of interest, set at 12% per annum.

Interest is paid every six months in arrears.

The company has the right to:

- defer interest payments until three years after the date of issue
- issue shares to note holders in lieu of paying interest in cash.

Interest	12% per annum payable 6 monthly in arrears	Sections 6.1(d), 6.1(e), 6.1(g), 6.1(h), 6.5(e) and 6.5(f)
Deferral of Interest	The Company may elect to defer interest payments until the third anniversary of the issue of Convertible Notes	Section 6.1(e)
Issue of Shares in lieu of interest	The Company may elect to issue Shares in lieu of paying interest in cash	Sections 6.1(f) & 6.5(e)

Conversion/repayment

Each convertible note can be converted into one ordinary share in RSG.

A note holder can exercise their right to convert their notes at any time after the date of issue and before the maturity date.

If at maturity a note has not been converted, it will be redeemed. The holder will be paid face value (\$0.50) in cash.

The RSG notes have a term of 4 years.

Early redemption by company

The company has the right to redeem the notes at any time after the third anniversary of the issue date.

However, the company must give holders 20 days' notice in writing of its intention to redeem. During this period, note holders can elect to convert their notes into ordinary shares.

Conversion	Each Convertible Note maybe converted into 1 Share	Sections 6.1(b), 6.1(g), 6.1(i) and 6.1(m), 6.1(x) and 6.5(e)
Redemption	Redeemed Convertible Notes will be redeemed for the face value	Sections 6.1(b), 6.1(i), 6.1(j), 6.1(k), 6.5(a), 6.5(c) and 6.5(e)

Early Redemption	The Company may elect to redeem all (but not some) of the Convertible Notes after the third anniversary of the issue of the first Convertible Notes	Sections 6.1(k), 6.5(a) and 6.5(c)
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Note holders are not entitled to require redemption ahead of maturity.

Ranking and security

RSG convertible notes are unsecured and subordinated.

They rank after the company's secured creditors, but equally with other unsecured obligations of the company.

Note holders rank ahead of the company's ordinary shareholders.

Unsecured liability	The Convertible Notes are unsecured and subject to the Subordination Deed, rank equally with the other unsecured liabilities of the Company	Sections 6.1(c), 6.5(d) and 6.5(e)
Subordinated liability	The principal amount of the Convertible Notes and all related rights, claims and payments are subordinated and postponed to and rank in priority after the Company's secured facility agreements	Sections 6.1(c), 6.5(a) and 6.5(b)

Other features

For every three notes, an applicant receives one free option.

This option gives the right to buy one ordinary share for \$0.60. The options expire three years from the issue date, and can be exercised at any time on or before the expiry date.

Please note that this table contains summary information of the convertible note offer. You should always read the full length prospectus for detailed information about any convertible notes you are interested in.

	Terms and Conditions	Sections of Original Prospectus
Face Value	\$0.50	Section 6.1(b)
Maximum Number of Convertible Notes	120,000,000	
Options	Applicants will receive 1 free Option for every 3 Convertible Notes subscribed for	
Maximum amount raised	\$60,000,000	

RSG convertible notes are trading on ASX (ASX code RSGG). You can check the issuer's website or www.asx.com.au for updated information about this issue.

Summary

A convertible note represents a loan by the investor to the issuing company. In return, the company pays you interest.

The interest rate may be fixed, or may vary in line with market interest rates. Interest is paid either twice or four times a year.

You have the right to convert the note into ordinary shares in the company at maturity, and also at specified times before maturity.

If at maturity the note has not been converted, the issuer pays you the note's face value in cash.

A convertible note converts into a fixed number of ordinary shares. The number of shares you receive depends on the conversion mechanism specified in the prospectus.

The market price of a convertible note tends to move in line with the ordinary share price, offering the holder a 'share-like' exposure. You are exposed to the performance of the company's ordinary shares.

If you want to exit your investment before maturity, and do not want to convert your notes into ordinary shares, you will have to sell on ASX for market value.