LESSON: 3

SECURITIES : DEBT

3.0 Objective :

After reading this lesson, you should be able to:

- understand the different types of debt instruments;
- know the different kinds of bonds and other new debt instruments;
- appreciate merits and demerits of various debt instruments.

Structure

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3.1. INTRODUCTION

As a matter of fact, debt plays an important role in financing the business organizations. The debt is arranged in different ways by issuing the debentures, bonds raising term loans, advances, etc., which are for the purpose of raising the capital. This is a very important source for many companies, which are not capable of raising funds for a variety of reasons. Debt includes debentures, loans, Public Deposits, and other Trade Credit. Trade Credit and certain other provisions are used for short-term requirements. Among the various forms of capital, debt is considered to be a cheaper source of finance, because debt always carries a fixed rate of interest, which the company can claim as an allowable expenditure for computation of taxable income. In the following paragraphs the various debt capital instruments are analyzed in detail.

3.2. DEBENTURE:

Debenture includes debenture stock, bonds and any other securities of company, whether constituting a charge on the assets of the company or not. Debentures are generally issued by the private sector companies as a long-term promissory note for raising loan capital. Debenture is given in the form of certificate of indebtedness of the company by specifying the date of redemption and interest rate. Bond is an alternative form of debenture in India which is issued by the public sector organizations. The debenture holder becomes a general creditor of the firm in the event of liquidation of a company Therefore, for these debenture holders, the earning power of the firm is their primary security. Although, these are sometimes unsecured, debenture holders are afforded some protection by the restrictions imposed in the bond indenture. The Company has the legal binding to pay the interest and the company does the redemption of these debentures through the creation of sinking fund which eliminates the risk of facing financial difficulty at the time of redemption. As the debenture holders must look to the general credit worthiness of the borrower to meet principal and interest payments, typically only well established and credit worthy companies are able to issue debentures.

3.2.1 Features of Debentures

Form A debenture is given in the form of certificate of indebtedness by the company to the holder specifying the date of redemption and interest rate.

Interest The rate of interest is mentioned on the debenture certificate which is fixed and paid as percentage on the par value of the debenture and paid either annually, semi annually or quarterly. The company has the legal binding to pay the interest rate.

Redemption As stated earlier the redemption date would be specified in the issue itself. Redemption is done through the creation of sinking fund by the company, which eliminates the risk of facing financial difficulty at the time of redemption because redemption requires huge sum.

Indenture: Indenture is a legal agreement between the company issuing debentures and the debenture holders. In the indenture, the terms of the agreement, description of debentures, rights of the debenture holders, obligations and the responsibilities of the company are specified clearly.

3.2.2 Kinds of Debentures:

Debentures are classified based on their transferability, redemption, convertibility, secured ness, etc., in the following kinds

(i) Bearer Debentures:

These are debentures are similar to negotiable instruments and these are transferable by delivery. The interest on bearer debentures is paid by means of attached coupons. On maturity, the principal sum is paid to the bearers.

(ii) Registered debentures:

These debentures are payable to the registered holders i.e., persons whose names appear in the Register of Debenture holders. Such type of debentures is transferable in the same way as shares.

(iii) Redeemable Debentures:

These debentures are issued for a specified period of time. On the expiry of the specified period the company has the obligation to pay back the amount lend by the debenture holders and have its properties released from the mortgage or charge.

(iv) Irredeemable Debentures:

A debenture which contains no clause as to payment or which contains a clause that it shall not be paid back is called irredeemable or perpetual debenture. These debentures are redeemable only on the happening of a contingency or at the time of liquidation of the company.

(v) Secured Debentures:

A secured debenture is secured by a lien on the company's specific assets. In the case of default the trustee can take hold of the specific asset on behalf of the debenture holders. In the Indian market secured debentures have a charge on the present and future immovable assets of the company.

(vi) Un-secured Debentures:

When the debentures are not protected by any security they are known as unsecured or naked debentures. They are mere acknowledgement of a debt due from the company, creating no rights beyond those of unsecured creditors. These unsecured debentures find it difficult to attract investors because of the risk involved in them. . Generally debentures are rated by the credit rating agencies

(vii) Convertible Debentures:

This type of debenture is converted into equity shares of the company on the expiry of specific period. The conversion is carried out according to the guidelines issued by SEBI. These may be fully or partly convertible and in case of fully convertible debentures, the entire face value is converted into shares at the expiry of specified period. The fully convertible debenture carries lower interest rate than other types of debentures because of the attractive feature of convertibility into equity shares. Whereas, in case of partly convertible debentures only the convertible portion is converted into share capital at the end of the specified period and non-convertible portion is redeemed at the end of the specified period.

(viii)Non-Convertible Debentures:

Non-convertible debentures do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of specified period. These non-convertible debentures carry higher interest rate than other types of debentures because of the non-attractive feature of non-convertibility into other form of stock.

(ix) Subordinated Debentures:

It is an unsecured debt, which is junior to all other debts. This type of debt will have a higher interest rate than senior debt and will frequently have rights of conversion into ordinary shares. Subordinated debt is often called Mezzanine finance because it ranks between equity and debt.

(x) Guaranteed Debentures:

Some businesses are able to raise long-term money because their debts are guaranteed, usually by their parent companies. In some instances, the governments guarantee the bonds issued by their undertakings and corporations like Electricity Supply Board, Irrigation Corporation, etc.

3.2.3 Advantages of Debentures

Rising of finance through issue of debentures and bonds is one of the major sources of finance for a company. The ***advantages*** of this form of capital are as follows:

• Trading on equity i.e., fixed cost of capital, helps increase in profits available for equity shareholders is one of the major objectives of raising finance by issue of debentures. In other words, if the company is earning more than cost of debt, the excess generated over and above the cost of debt would ultimately goes to equity shareholders only.

• The company can adjust its gearing i.e., debt-equity ratio according to its financial plans just by redemption of debentures or raising of finance, which is not possible with the equity capital.

• The interest payable to the debenture holders is a charge on profit and hence tax liability on the levered companies is reduced.

• At the time of winding-up, the debenture holders are placed before the equity shareholder for payments.

• Debentures are generally, secured on the assets of the company and hence carry lesser risk.

3.2.4 Limitations of Debentures:

The following are the ***limitations*** in raising funds by the issue of debentures:

• It is a legal obligation on the part of the company to pay interest and repayment of principal on

scheduled dates. Any failure to meet these obligations may paralyze the company's operations.

• Financing through debentures is associated with financial risk of the firm, which increases the cost of equity capital,

• Debentures usually have a fixed maturity date. Because of this redemption Fund must be made for their repayment.

• There is a limit to the extent to which Funds can be raised through debentures.

3.3. PUBLIC DEPOSITS:

Public deposits are also known as fixed deposits which are very attractive for companies as well as investors. For companies, public deposits are very easy and convenient source of mobilizing funds, as they do not need to mortgage any property of the company. These public deposits provide a simple avenue for investment in good and reputed companies at a better rate of interest. One of the weaknesses of public deposits is the uncertainty about the payment of interest and the repayment of principle, as these are unsecured. Therefore, it is very important to see the credit rating of these companies before investing in them.

3.4. LOANS:

There are various types of loans, which can be divided into long-term and short-term. These are discussed in the following paragraphs.

3.4.1 Long-term

All the Developmental Financial Institutions and many Commercial Banks play a significant role in providing long term loans to corporate customers. These long term loans are classified into term loans, mortgage loans and financial guarantees.

(a) Term loans:

In India, many industrial financing institutions have been create by the Government both at the national and regional levels to supply long-term and medium term loans to corporate customers. These financial institutions meet the growing and varied long-term requirements of industrial concerns by supplying the term loans. These loans are raised for purchasing of fixed assets, like land and buildings, machinery, etc., which are sanctioned under various schemes and these loans are payable over a long period like 10 years or so.

(b) Mortgage loans:

The mortgages loan is a loan against the security of the immovable property of the loanee. These mortgages are different types, which are based on the chargeability, transferability, marketability, etc.

(c) Financial Guarantees:

Financial Guarantee is a contract to discharge the liability of a third party in case of the borrower fails to repay the loan, the responsibility lies on the shoulders of the guarantor. Hence, the guarantor must be known to both the borrower and the lender and he must have the means of discharge his responsibility.

3.4.2 Short-term

These loans are given to the companies for meeting their working capital requirements, which are arranged mostly by the commercial banks in the form of overdraft. The overdraft facility is mainly sanctioned to the business units, whereas cash credit is given to industrialists. Short-term loans include trade credit and hand loans.

(a) Bank Overdraft:

The banks meet most of the working capital requirements of the corporate. For this purpose banks may accept inventories as security against these loans.

(b) Trade Credit

This is the most common source of short - term financing. Trade credit is the credit extended by sellers to buyers (the corporate) while making purchases for production. When a company buys goods required on credit and clears those dues after the sale role of the finished product, this becomes a resource of finance. This is because the company does not need money to pay for the purchases immediately

3.5. BONDS:

Bond is a long term debt instrument that promises to pay a fixed annual sum as interest for specified period of time. The basic features of the bonds are given under:

i) Bonds have face value, which may be issued at par or at discount.
ii) The interest rate is fixed or variable, which may be paid annually or semi-annually.

iii) The maturity date is usually specified at the time of issue except in case of perpetual bonds.
iv) The redemption value of the bond may be at par value or at premium.

v) Bonds are traded in the stock market.

Bonds are classified into different kinds based on their features, which are explained as under:

(i)Secured bonds and unsecured bonds:

The secured bond is secured by the real assets of the issuer. In the case of the unsecured bond the name and fame of issuer may be the only security.

(ii) Perpetual bonds and redeemable bonds:

Bonds that do not mature or never mature are called perpetual bonds and the interest alone would be paid. In the redeemable bond, the bond is redeemed after a specific period of time.

(iii) Fixed interest rate bonds and floating interest rate bonds:

In the fixed interest rate bonds, the interest rate is fixed at the time of the issue, whereas in the floating interest rate bonds, the interest is varied from time to time based on the capital market conditions.

(iv) Zero coupon bonds:

These are sold at discount from their eventual maturity value and have zero interest. The difference between the face value and the purchase cost of the bond is the gain to the investors. The investors are not entitled to any interest and only repayment of principal sum on the maturity date. The individual investors prefer these bonds because the they do not carry any interest, which is otherwise taxable. Companies also find ZIB quite attractive because there is no immediate interest commitment. On maturity, the bonds can be converted into equity shares or non-convertible debentures depending on the capital requirements of a company.

(v) Deep Discount bonds:

Deep discount bond is another form of zero-coupon bond, which is sold at large discount on their nominal value with a maturity period range from 3 years to 25 years or more. This bond appreciates to its face value over the maturity period. The unique advantage of deep discount bond is the elimination of investment risk. It allows an investor to lock-in the yield to maturity or keep on withdrawing from the scheme periodically after five years by returning the certificate. The main advantage of this bond is that the difference between the sale price and original cost of acquisition will be treated as capital gain. The deep discount bond is safe, solid and liquid instrument.

(vi) Callable Bonds:

It is a bond issued with a right to call in and pay off at a price stipulated in the bond contract. The main advantage in callable bond is that the issuers have an incentive to call their existing bonds if the current interest rate in the market is sufficiently lower than the bond's coupon rate. Usually the issuer cannot call the bond for a certain period after issue.

(vii) Option Bonds:

Option bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In case of cumulative bonds, interest is accumulated and is payable on maturity only. In case of non-cumulative bonds, the interest is paid periodically. The option is to be exercised by the investor at the time of investment .

(viii) Floating Rate Bonds:

The interest paid to the floating rate bondholders changes according to the prefixed norms depending on the market rate of interest payable on the gilt-edged securities. These bonds are also called adjustable interest bonds.

(ix) Junk Bonds:

Junk bonds are high yield security, which are used as a source of finance in takeovers and leveraged buyouts. Firms with low credit ratings are willing to pay 3 to 5 per cent more than the high-grade corporate debt to compensate for the greater risk.

(x) Capital Indexed Bonds:

The payment of interest and principal amount in fixed terms is uneconomic in times of rapid inflation. In the capital indexed bond, the principal amount of the bond is adjusted for inflation for every year, so that it gives the investor an increase in return by taking inflation into account. To avail the benefit of inflated principal, the investor needs to hold the instrument for at least 5 years. If the investor wants to exit early, he can do it through the secondary market In the Indian capital market, indexed bonds offer more scope since the economy is highly sensitive to the inflation.

(xi) Inflation Adjusted Bonds:

Inflation Adjusted Bonds (IABs) are promise to repay both the principal and the interest, by floating both these amounts upwards or downwards in line with the movements in the value of the specified index of commodity prices.

3.6. NEW DEBT INSTRUMENTS

Recently, new instruments to meet the varied needs of the investors in terms of security, rate of return, marketability and appreciation in value are being issued by the companies. In the fast changing financial scenario, it has become imperative for these companies to device new instruments for raising funds from the debt market. Some of the important new debt instruments and their characteristics are explained below.

(i) Equity Warrants with NCDs:

Equity Warrant is a piece of paper attached to a non-convertible debenture, which gives the buyer or holder right to apply for and acquire an equity share at a future date.

a) The benefits for the ***corporate sector*** in case of equity warrants include the following:

- The equity warrant increases the marketability of debentures and reduces the **n**eed for the efforts of brokers by way of private placement.
- The opportunity of receiving equity shares at a future date is a great attraction for investors.

• Lesser dependence on financial institutions and mutual funds for subscribing to the equity capital.

• Provides an effective tool for long-term planning of capital structure to minimize the cost of capital.

b) Benefits for *investors'.*

• Assured rate of interest over life on non-convertible debentures.
• There is no extra cost of equity warrant but it has high price, depending on the financial performance of the company.
• When the market is dampening the response to the new issues, equity warrants can be added attraction for investors to apply for the issues, offering equity warrants with their securities,

(ii) Secured Premium Notes:

The Secured Premium Notes (SPNs) are tradable instruments with detachable warrant against which the holder gets equity shares after a fixed period of time. The secured premium notes are issued at a nominal value and do not carry any interest. The instrument is secured by a mortgage of all immovable properties of the company. There is a lock in period for secured premium notes during which no interest will be paid for the invested amount. The SPNs have features of medium to long-term notes. With each SPN, a warrant may be attached to it, which will give the holder the right to apply for and get allotment of equity shares.

(iii) Zero Coupon Convertible Notes:

It is an instrument, which can be converted into common stock of the issuer. If the investor chooses to convert, they will be required to forego all accrued and unpaid interest. This allows the issuer to obtain the advantages of Convertible debt without too much dilution of common stock. Like any other zero coupon bond, the issuer gets a tax deduction for imputed interest, even though no cash is paid until maturity. The prices of zero coupon bonds are much more sensitive to changing interest rates than coupon bonds. If the proposal docs not seem to be advantageous to convert, the investor will be left with a relatively low yield to maturity.

(iv) Debt for Equity Swaps:

This instrument is an offer from an issuer of debt to its debt holders to exchange the debt for the common stock. The issuer who offers debt for equity swaps does so with a view to increasing equity capital for the purposes of improving its debt-equity ratio and also enhances its debt raising capacity. It also helps issuers to reduce their interest expenses and enables them to replace it with dividends on stock that are payable at their discretion.

(v) Coupon Stripping:

The major mechanism in coupon stripping is that it requires separation of the principal part and interest part of an ordinary bond, and selling them separately to the investors. In

the initial stages, the issuance of a bond will be similar to that of any other bond issued either by the government or corporation. Later, depending on the requirements of the primary investor, he can strip the bond into principal and interest parts and sell them in the market again.

3.7. SUMMARY

These are many other sources of long-terms debt like global depository receipts, euro bonds, foreign direct investment, etc. Bill discounting, commercial papers, and factoring are some of the sources of short-term finance. Firms use a mix of different forms of capital and different kinds of instruments under each source of capital. Firms choose their capital structure by taking into account several factors that have a bearing on the choice of capital mix. Some of these issues are tax management of the firm, situation in the capital market, attitude and policies of the financial institutions, Government Policies, etc.. Each and every company has to develop its capital structure depending upon their specific needs and conditions. There is no readymade or set capital structure which is suitable for all the companies.

3.8. KEY WORDS

Bond : a long term debt instrument issued by a corporation or government

Credit Rating: It is a rating process of deciding whether a public deposits scheme offered by a company is safe and able to pay interest and principal wherever they are due.

Coupon rate : the stated rate of interest on a Bond / debenture

Debenture : a long term, unsecured debt instrument

Face value : The stated value of an asset.

Market value : The market price at which an asset trades.

Secured Loans : a form of debt for money borrowed in which specific assets have been pledged to guarantee payment.

3.9. Self Assessment Questions

1. What is a Debenture? Discuss the various features of debenture capital.

2. What do you understand by Bond? Expalin the various kinds of bonds.

3. Explain the various new instruments introduced recently in the debt market.

3.10. FURTHER READINGS:

1) Bhalla, V.K., . *Working Capital Management: Text and Case,* Anmol Publications Pvt. Ltd., Delhi.

2) Machiraju, H.R., . *Introduction to Project Finance: An Analytical Perspectives,* Vikas Publishing House Pvt. Ltd., New Delhi.

3) Pandey, I.M; . *Financial Management,* Vikas Publishing House Pvt. Ltd., New Delhi.

4) Srinivasan, S., *Cash and Working Capital,* Vikas Publishing House Pvt Ltd., New Delhi.

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