FINANCIAL MANAGEMENT

- PART ONE

"Debentures" – Chapter Eleven

Debentures

"There is always demand for limited risk investment products which can offer attractive returns. In view of this many companies enter markets with debenture issues to raise capital from the market to fund long term business investments".

Learning Objectives

- Debentures as tax attractive source of long term debt
- Various terms associated with debentures.
- Interest, redemption options offered in Debenture Issues.
- Role of debenture indenture.

11.01 Introduction

A debenture is a fixed-income debt paper issued by a company. Here, the issuer agrees to pay a fixed interest on your investment. As the name suggests, these debentures cannot be converted into shares of the issuing company like convertible debentures where investors have the option of getting shares in the issuing company on conversion.

The issue can be both for secured as well as unsecured debentures. For secured debentures, which are backed by assets, in case the issuer is not able to fulfill its obligation, the assets are liquidated to repay the investors holding the debentures. But not in case of non-secured debentures.

11.01 Introduction

In view of the safety offered, secured NCDs (Non-convertible debentures) offer lower interest rates compared with unsecured ones.

If you want a regular income from NCDs, you can pick those that pay interest on a monthly (very rare), quarterly or annual basis. If you just want to grow your wealth, you can opt for cumulative option where the interest earned is reinvested and paid at maturity. In corporate finance, a debenture is a medium- to long-term debt instrument used by large companies to borrow money, at a fixed rate of interest.

11.01 Introduction

The legal term "debenture" originally referred to a document that either creates a debt or acknowledges it, but in some countries the term is now used interchangeably with bond, loan stock or note.

A debenture is thus like a certificate of loan evidencing the fact that the company is liable to pay a specified amount with interest to the holder of the instrument.

Although the money raised by the debentures becomes a part of the company's capital structure, and thus its net worth, it does not become share capital.

11.01 Introduction

- Fixed income
- Safety - backed by assets
- Certain maturity
- No voting rights
- Liquidity - transferable

11.01 Introduction

Debenture holders have no rights to vote in the company's annual general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights to the debentures.

Neither do the debenture holders have any prior claim if the company decides to issue fresh equity shares.

Debentures are generally freely transferable by the debenture holders. Debentures of large companies are traded on stock exchanges.

11.01 Introduction

The interest paid on debentures is an expense and hence a charge against profit in the company's financial statements.

Indian Companies Act, 1956 does not provide for any definition of a debenture.

Any debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not, as per the Act, are included in the term debenture.

11.02 Attributes

A debenture is a movable property issued by the company in the form of a certificate of indebtedness.

Most debentures are backed by the assets of the company issuing this long term finance instrument. Some debentures are backed by specific assets of the company while others have general claim on all assets not pledged otherwise. Unless claims of debenture holders are satisfied payments cannot be arranged to common stockholders.

11.02 Attributes

Debenture holders are creditors of the company. As such they do not have a right to vote and so they do not possess any controlling power over the company. Nor do they have a privilege to attend the annual general body meetings of the company.

Interest paid on debenture is a charge against income of the company or expense and hence paid from earnings before tax.
This attribute turns this source of finance attractive for the company.

11.02 Attributes

The debenture certificate needs to specify the date of redemption for repayment of the principal and specified dates on which interest on the capital of the instrument.

Failure of a company to repay a bond after its maturity date effectively means bankruptcy of the said company.

Bondholders who have not received their interest can throw an offending company into bankruptcy, or seize its assets if that is stipulated in the contract

11.02 Attributes


A secured debenture is one in which specific assets are pledged to bondholders in the event of default. Very rarely are these pledged assets sold and the proceeds distributed to debenture holders.

Instead, when default is likely, the concerned company arranges for reorganization of its capital structure and existing claims are satisfied by issue of new equity and or securities.

11.02 Attributes

- Most debentures are released on electronic forms and (if issued by larger companies) they are listed on the stock exchanges, thereby offering liquidity to the investors.

The trades in debentures take place in their demat format.

- Payment of specified interest and return of capital on maturity is arranged by direct transfer to investor's bank account through Direct Credit / ECS / RTGS / NEFT mode like in case of dividends to preference and ordinary shareholders.

11.02 Attributes


A company wishing to issue debentures need to enjoy a good credit rating in the financial markets. Companies seeking to raise money through debentures have to get their issue rated by agencies such as CRISIL, ICRA, CARE and Fitch Ratings. Debentures with higher ratings are safer as this means the issuer has the ability to service its debt on time and carries lower default risk. Any Indian company can raise money through debentures if it has a tangible net worth of at least Rs 4 crore and has been sanctioned loans by banks or financial institutions which is classified as 'standard asset' and not as bad debt.

11.03 Terminology Associated with Long Term Debt

<u>Call Option</u>: a call provision that allows the company to retire the debenture before its date of maturity.

If this provision is included in the indenture of the debenture, the company usually offers a premium of five to ten percent over par value at the time of redemption.

This option is exercised after a lapse of a few years from the issue and when the ruling interest rates in the market allow the company to obtain funds at rate cheaper than the coupon rate.

11.03 Terminology Associated with Long Term Debt

Convertibility: companies adopt a subtle method of reducing outstanding debt by introducing convertibility clause into the indenture of the debenture. This clause allows them to convert outstanding debentures into common stock at rates specified in the indenture (e.g. one equity share for five units of debentures).

When company converts debentures into equity it does not have to pay cash to bond holders and thus its liquidity remains unchanged. Instead of interest from income before tax, now it pays dividends from after tax earnings as tax benefit is lost after this conversion.

11.03 Terminology Associated with Long Term Debt

Coupon rate: this reflects the actual rate of interest payable on the principal amount to the debenture holder.

The extent to which the rates of interest prevailing in the market fluctuate from this coupon rate is reflected in the market price of debentures.

Usually this rate is fixed throughout the life of the bond. Interest can be paid at different frequencies: generally semi-annual, i.e. every six months, or annual.

11.03 Terminology Associated with Long Term Debt

<u>Tenor</u>: The length of time until the maturity date is often referred to as the tenor of a bond. Thus a debenture that matures after ten years for repayment carries a ten year tenor.

<u>Indenture</u>: the bond agreement is supplemented by a much detailed document termed bond indenture.

It spells out collaterals pledged for the issue; methods of repayments, restrictions on the company to protect interests of debenture holders etc.

11.03 Terminology Associated with Long Term Debt

Trustee: Trustee is a financially independent person appointed to administer the provisions contained in the above indenture.

This trustee is most often a bank or some other financial institution.

If the company breaks the agreement set forth in the bond indenture, the trustee can sue the company on behalf of the bondholders.

11.04 Debenture Indenture

A bond indenture is a legal document or contract between the bond issuer and the bondholder that records the obligations of the bond issuer and benefits owed to the bondholder. It also includes the details of the rights of ownership as well as the rights of the bondholder to receive interest and principal payments in the future.

It is created during the bond issuing process when bond issuers are receiving approval from state and central governments to issue bonds to the public. After the size of bonds is authorized by the applicable government agency, the company issuing the bonds must construct a bond indenture.

11.04 Debenture Indenture

Bond indentures are *not* issued to individual bondholders. It would be pretty impractical for a company to try to enter into a contract with every single bondholder.

That is why the bond indenture is actually issued to a trustee or third party that represents the bondholders.

This trustee is most often a bank or some other financial institution. If the company breaks the agreement set forth in the bond indenture, the trustee can sue the company on behalf of the bondholders.

11.04 Debenture Indenture

The indenture specifies all the important features of a bond, such as its maturity date, timing of interest payments, method of interest calculation, callable/convertible features if applicable and so on.

The indenture also contains all the terms and conditions applicable to the bond issue. Other critical information included in the indenture includes the financial covenants that govern the issuer and the formulas for calculating whether the issuer is within the covenants.

11.04 Debenture Indenture

Should a conflict arise between the issuer and bondholders, the indenture is the reference document used for conflict resolution. As a result, the indenture contains all the minutiae of the bond issue. The bondholders can also voice complaints to the trustee in an effort to raise legal action against the issuing company.

11.05 Debenture Classification

Debentures are issued by companies in many forms of bonds with varying features as regards

- to interest rates or payments,
- redemption values or methods and
- tax burden on interest income.

All of them are not common in India. This has resulted into seven categories of debentures as described next.

11.05 Debenture Classification

❶ **Zero-Coupon Bonds:** This is a type of bond that makes no coupon payments but instead is issued at a considerable discount to par value.

For example, a zero-coupon bond with a ` 10,000/- par value and ten years to maturity is trading at ` 6000/- ; if you buy this bond you pay ` 6000/- today for a bond that will be worth ` 10,000/- in 10 years.

The issue price of Zero Coupon Bonds is inversely related to their maturity period, i.e. longer the maturity period lesser would be the issue price and vice-versa.

11.05 Debenture Classification

❷ **Deep Discount Bonds**: they are similar to zero-coupon bonds.

But for these debentures discounts offered at the time of issue on the par value are larger and correspondingly maturity period longer.

IDBI set a record by offering bonds with a face value of ` 0.1 million for just ` 2,700/-

The maturity period for these bonds was twenty five years.

11.05 Debenture Classification

❸ **Floating Rate Bonds**: floating rate bond holders receive interest at the interest rate that varies with the interest rate prevailing in the money market.

The interest rate paid to the bondholder at regular intervals comprises of the interest rate prevailing in the market and ‘spread’, which is a rate that is fixed when the prices of the bond are being determined.

This spread remains constant till the maturity period of the bond. The upper and lower limit on the interest rate on such instruments is termed collar.

11.05 Debenture Classification

Debenture Classification

Based on Interest Payment

Rate

- Fixed Rate
- Floating Rate
- Zero Coupon

Frequency

- Cumulative
- Non-Cumulative

Based on Redemption

- Convertible
- Non- Convertible
- Partially Convertible

11.05 Debenture Classification

❹ **Government Bonds:** These are the bonds issued by government of a country in its own currency. They are usually referred to as risk-free bonds. Bonds issued by national governments in foreign currencies are referred to as sovereign bonds.

Many public undertakings have issued bonds in the market to raise finance. A major part of bonds is placed with financial institutions. They are also offered to the public. Interest is taxable but often tax free government bonds are issued to attract more funds.

Tax free offer is a major attraction for investors in high tax bracket

11.05 Debenture Classification

❺ **Cumulative or Non-cumulative Bonds**: cumulative bond holders are not paid interest at regular intervals; instead it gets accumulated over a period of maturity.

The accumulated interest on maturity is merged along with the principal and lump sum payment is arranged.

In case of non-cumulative debentures (which are more common) interest is paid at regular intervals during the year until maturity of the bond. At the maturity, principal is returned to investors.

11.05 Debenture Classification

❻ **Convertible Debentures**: bonds that can be converted into equity shares of the issuing company after a predetermined period of time.

"Convertibility" is a feature that companies may add to the bonds they issue to make them more attractive to buyers. In other words, it is a special feature that a corporate bond may carry.

As a result of the advantage an investor enjoys from the ability to convert, convertible bonds typically offer lower interest rates than non-convertible bonds.

11.05 Debenture Classification

❻ **Convertible Debentures**: This provides the advantage to companies to source long term funds at lesser costs, defer sale of equity stock and prevent dilution of earnings available to current stock holders. It is not necessary to create reserves for redemption of debentures.

Investors in convertible debentures enjoy threefold benefit in the form of

(1) certainty of income,
(2) priority in claim on company's income and
(3) chance to share in company's earnings on conversion.

11.05 Debenture Classification

❻ **Convertible Debentures**: This conversion option can be for the full amount of the debenture or only for a part of it (say fifty percent).

Partly convertible debenture holders receive equity stock for a part of face value and the remaining portion is redeemed on maturity.

The remaining part of debenture after it has lost attraction of conversion is often referred in money markets as 'Khoka' – an empty box.

11.05 Debenture Classification

❻ **Convertible Debentures:** Zero coupon versions of convertible debentures are also in use by some companies (Mahindra & Mahindra) in India.

❼ **Non-convertible debentures:** These debentures on the other hand, carry higher interest rates as investors do not have option of conversion into company's equity.

11.06 Benefits and Drawbacks

Issue of debentures for financing long term needs provides certain benefits as well as drawbacks to the company. These are enumerated below.

BENEFITS

- Interest payable on debentures is a tax deductible expense unlike equity and preference dividends which are paid out of profit after tax. This is an important benefit while considering alternate modes for long term financing.

11.06 Benefits and Drawbacks

BENEFITS

- Debenture holders do not acquire any control over company as they do not possess any voting rights. Thus debenture financing does not result in dilution of control Liability of company to debenture holders is limited to contractual payment of principal and interest. Value created by the company stays with its equity owners.

- Maturity period of debentures can be tailored to match with company's funds requirements. This flexibility again makes this instrument attractive to companies selecting most beneficial source of long term finance.

11.06 Benefits and Drawbacks

BENEFITS

- Debentures provide protection to the company against inflation as the interest burden stays constant through the maturity period of the instrument.

- Debentures are beneficial to investors also as they provide an opportunity to earn 2-3 percentage points higher return than other fixed-income instruments such as bank fixed deposits. Investors can use them wisely to diversify their debt portfolio.

11.06 Benefits and Drawbacks

DRAWBACKS

- For the issuer company debentures create a permanent interest and principal repayment obligation. Failure to meet these commitments in adverse circumstances can result in a major financial embarrassment and in some cases firm's bankruptcy.

- Issue of debentures to meet long term need for the finance increases Issuer Company's debt equity ratio. As result the debenture issue raises cost of equity to the firm. Company's credit rating stands corrected in the money markets.

11.06 Benefits and Drawbacks

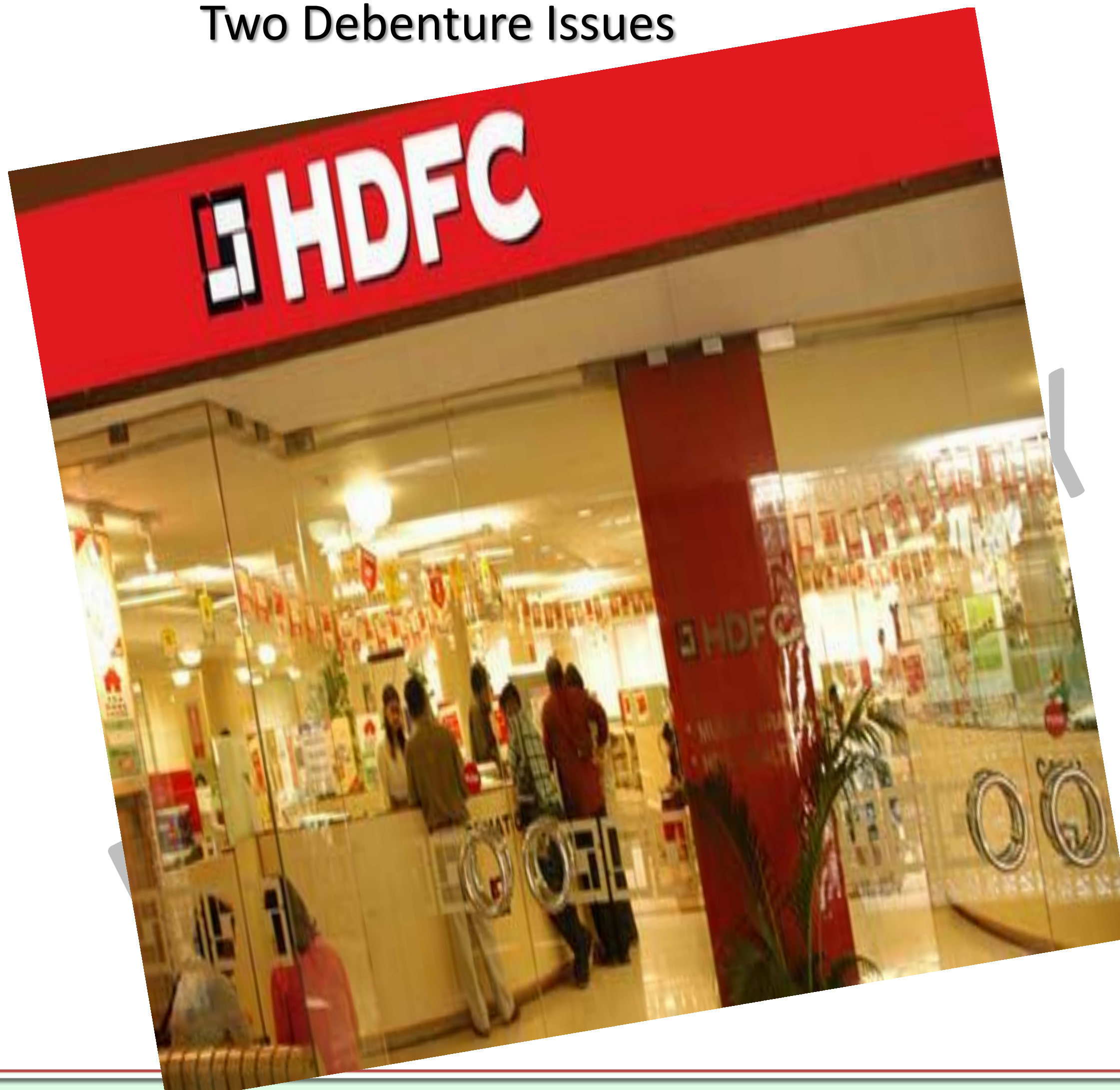
DRAWBACKS

- In unlikely possibility of low inflation the issuer company is forced to pay interest on debentures that is higher than the one prevalent in depressed markets.

All throughout the maturity period debentures carry a fixed rate of interest as stated in its indenture. So there is no option to reduce the interest rate to match the market.

11.07 Two Debenture Issues

HDFC



11.07 Two Debenture Issues

New Delhi: Country's largest mortgage lender HDFC Ltd said the bid to raise up to Rs 5,000 crore via Non-Convertible Debentures and warrants opens today.

" Committee (of Directors) be and is hereby accorded to open the issue in accordance with Sebi regulations. "In respect of the issue, the bid opening date for the issue shall be September 30, 2015," it said in a filing on the BSE. HDFC Ltd in its annual general meeting held in end of July had said that it will issue non-convertible debentures (NCDs) and warrants to qualified institutional buyers QIBs up to Rs 5,000 crore.

11.07 Two Debenture Issues

HDFC

"We will issue, offer and allot warrants exchangeable for equity shares simultaneously with secured redeemable non-convertible debentures of face value of Rs 1 crore each to eligible qualified institutional buyers (QIBs) by way of qualified institutional placement (QIP)," it said in the filing.

In case warrants are exchanged with equity shares of the company, it would result in a maximum issue of 3.65 crore equity shares of face value of Rs 2 each of the Corporation. The floor price of the warrants shall be Rs 1,189.66 per warrant, it added.

11.07 Two Debenture Issues

The company said the NCDs will mature in March 2017, while the exercise period of the warrants will be 36 months from the date of allotment of warrants. Also, it said the bidder will be entitled and eligible to apply for at least 7,300 warrants for each NCD applied for in the issue.

The Housing Development Finance Corporation (HDFC) Ltd will use the proceeds from the issue to boost lending operations and meet its future capital needs.”

11.07 Two Debenture Issues

11.07 Two Debenture Issues

AXIS BANK

Axis bank announced resolution passed by Circulation on October 30, 2015 allotted 30000 Senior Unsecured Redeemable Non-Convertible Debentures (Series - 2) of the face value of Rs. 10 lakh each for cash at par aggregating to Rs. 3000 crores, on a private placement basis.

The said Debentures will be listed on the Wholesale Debt Market segment of the BSE Limited and National Stock Exchange of India Limited. The said Debentures are rated "AAA" by CRISIL, CARE and ICRA.

11.08 Bonus Debentures – A New Concept

Usually, for equity investors, bonuses come in free bonus shares – x number of bonus shares on y number existing shares held.

But earlier NTPC declared the issue of bonus debentures to its shareholders. A bonus debenture is a free debt instrument issued to a company's shareholders as a reward. When the company declares a bonus debenture, you will receive bonds from the company for a specific face value.

Interest will be paid on these debentures every year. They will be redeemed after a specific period of maturity, when you will receive a lump-sum payment.

11.08 Bonus Debentures – A New Concept

Suppose you hold 100 shares of the NTPC, you will receive 100 debentures with a face value of ₹12.5 each, valued at ₹1,250. The interest paid on this debenture is at a floating rate.

The interest rate is pegged 50 basis points higher than the prevailing yield of 10-year government bonds.

The debentures are valid for 10 years and will be redeemed in three installments at the end of which you would have received ₹1,250.

A few companies have issued bonus debentures in the past — Hindustan Unilever, Britannia, Blue Dart Express and Dr Reddy's Labs.

11.08 Bonus Debentures – A New Concept

Bonus debentures serve many purposes.

One, as the debentures are redeemed after many years, the company will not see its reserves deplete drastically at one go as is the case with bonus shares. The company will be able to hold on to them for expansion projects.

Two, it manages to ‘borrow’ from shareholders at lower rates.

Three, the interest paid is claimed as an expense and bonus debentures reduce tax incidence. Shareholders get free interest-earning bonds.

11.08 Bonus Debentures – A New Concept

Shareholders get free interest-earning bonds. The debentures are fully secured.

Companies can also list the debentures on the exchanges and investor can sell them in the markets when they need cash.

Unlike bonus shares, a bonus debenture issue does not increase the equity share base, which dents the earnings per share. They do not squeeze return on equity, or bump up valuations.

11.08 Bonus Debentures – A New Concept

Drawbacks

Bonus debentures do sound like an all-round winner, but they are not. Here is the flip side. When your company declares a bonus share issue, the entire lot of shares is credited to you at zero cost. If you sell them, you can stand to make gains. These gains are tax-free if you hold them for more than a year, as they are equity instruments.

But for bonus debentures, the redemption amount will come in only at the end of the period, which can be long.

11.08 Bonus Debentures – A New Concept

In NTPC's case, given that the interest is linked to G-Sec yields, the amount you receive will fluctuate and is uncertain. Bonus debentures also do not enjoy similar tax breaks to bonus shares.

First, under Income Tax rules, the amount of the bonus issue is considered to be 'deemed dividend' and will attract dividend distribution tax.

Two, the interest will be taxable in your hands at your slab rate just like your fixed deposit interest.

11.08 Bonus Debentures – A New Concept

Next, even if you can exit debentures on the exchanges, it is hard to do so in reality due to lack of trading volumes.

Assuming that you do manage to exit at a profit, short-term or long-term capital gains tax will apply.

But in order to calculate the gains, it is unclear what exactly will tax authorities determine as an acquisition cost.

11.09 Popularity of Debentures

PVR gets shareholders' nod to raise Rs 500 crore via non-convertible debentures

September 29, 2015 | PTI

NEW DELHI: Multiplex operator PVR today said its shareholders have approved raising Rs 500 crore through issuance of non-convertible debentures (NCDs) on private placement basis. Shareholders have approved "subscription of non-convertible debentures for an amount not exceeding Rs 500 crore on private placement," PVR said in a BSE filing.

11.09 Popularity of Debentures

LIC Housing Finance to raise up to Rs 47,000 crore

September 7, 2015 | PTI

NEW DELHI: LIC Housing Finance Ltd today said it will raise up to Rs 43,000 crore via non-convertible debentures

11.09 Popularity of Debentures

Syndicate Bank bonds worth Rs 1,000 crore fully subscribed

September 29, 2015 | PTI

NEW DELHI: Public sector Syndicate Bank today said the issue of Rs 1,000 crore tier-II Basel compliant non-convertible bonds has been fully subscribed. "The bank has finalized the issue of unsecured redeemable non-convertible Basel III compliant tier-II bonds in the nature of debentures aggregating to Rs 1,000 crore. The issue is fully subscribed," it said in a BSE filing

11.10 Summary

The legal term "debenture" originally referred to a document that either creates a debt or acknowledges it, but in some countries the term is now used interchangeably with bond, loan stock or note.
A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest.
Although the money raised by the debentures becomes a part of the company's capital structure, and thus its net worth, it does not become share capital. Debenture holders have no rights to vote in the company's AGM.

11.10 Summary

A debenture is a movable property issued by the company in the form of a certificate of indebtedness.

Debenture holders are creditors of the company. Interest paid on debenture is a charge against income of the company or expense and hence paid from earnings before tax. Failure to pay a bond effectively means bankruptcy.

A secured debenture is one in which specific assets are pledged to bondholders in the event of default. A company wishing to issue debentures need to enjoy a good credit rating in the financial markets.

11.10 Summary

Call Option is a provision that allows the company to retire the debenture before its date of maturity.

Convertibility clause allows the company to convert outstanding debentures into common stock at rates specified in the indenture.

Coupon rate is the rate of interest payable on the principal amount to the debenture holder.

Maturity denotes the period after which the issuer has to repay the principal amount to the bond holder.

11.10 Summary

Nominal, principal, par or face value is the initial value of the bond.

Put Option allows the holder to redeem the debenture at specified time before its date of maturity. The length of time until the maturity date is often referred to as the tenor of a bond.

A bond indenture is a legal contract between the bond issuer and the bondholder that records the obligations of the bond issuer and benefits owed to the bondholder. It also includes the details of the rights of ownership as well as the rights of the bondholder to receive interest payments and principal payments in the future

11.10 Summary

Debentures are issued by companies in many forms of bonds with varying features as regards to interest rates or payments, redemption values or methods and tax burden on interest income.

Zero-Coupon Bonds carry no interest obligation hence they are issued at discount. Floating Rate Bonds provide variable rates of interest generally based on market rates plus a fixed 'spread.'

Cumulative bond holders do not get interest at regular intervals; it is accumulated up to maturity and both principal / interest are merged, paid together at the time of redemption. Interest is paid on non-cumulative bonds.

11.10 Summary

Convertible Debentures are bonds that can be converted into equity shares of the issuing company after a predetermined period of time in the ratios specified at the time of issue.

Convertibility clause turns bonds of profitable companies more attractive to investors and can be issued at lesser rate of interest.

Non-convertible debentures, on the other hand, carry higher interest rates as investors do not have option of conversion into company's equity.

11.10 Summary

Debentures as a long term debt instrument have many benefits. A) Interest payable on debentures is a tax deductible expense unlike equity and preference dividends are paid out of profit after tax. B) Debenture financing does not result in dilution of control. Liability of company to debenture holders is limited to contractual payment of principal and interest. C) Maturity period of debentures can be tailored to match with company's funds requirements. D) Debentures provide protection to the company against inflation as the interest burden stays constant through the maturity period of the instrument.

11.10 Summary

A major drawback of debentures for the issuer company is they create a permanent interest and principal repayment obligation.

Failure to meet these commitments in adverse circumstances can result in a major financial embarrassment and in some cases firm's bankruptcy.

They increase Issuer Company's debt equity ratio and thereby decrease its credit rating.

11.10 Summary

Usually, for equity investors, bonuses come in free bonus shares – x number of bonus shares on y number existing shares held.

Sometime back NTPC cleared the issue of bonus debentures to its shareholders.

A bonus debenture is a free debt instrument issued to a company’s shareholders as a reward. Unlike bonus shares, a bonus debenture issue does not increase the equity share base, which dents the earnings per share. They do not squeeze return on equity, or bump up valuations.

With this
we come to the end
of this chapter Eleven
Next

"Capital Structure Equity vs. Debts"
– Chapter Twelve

GOOD LUCK !