Industrial Company Debentures

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This is the first of three parts of a paper on an important subject, with many aspects relating to the principles of corporate financing on the one hand and the provision of security for lenders on the other. The remaining two parts of the paper will be published in subsequent issues of the Journal.

Introduction

1. There is increasing public interest in the debentures of industrial companies, and the development of a more active market than exists at present in these fixed-interest securities would certainly serve a useful purpose. Some investors prefer a fixed-interest return on at least part of their investments, but individual investors have been deterred by the difficulties of assessing the relative ratings of industrial company debentures and of selling such securities on reasonable terms. Even at best it may be many years before the market became an active one in the sense of the present Australian markets in listed ordinary shares and Commonwealth Government securities, but it would not take a great deal of development for a market in debentures to greatly exceed that of listed preference shares.

2. There are a number of specific impediments to the development of such a market as well as a number of problems relating to the nature of the debenture as a security. The purpose of this paper is to discuss these in some detail, and reference will be made in the later parts to such matters as the onerous burden of stamp duties on transfers, statutory provisions affecting debentures offered to the public, and problems arising out of the dispersion of assets over a number of subsidiaries. The main concern is with the creation of a marketable security in which the public can have confidence, and this confidence will be the greater if the debentures are acceptable to bankers as security for the accommodation they grant to borrowing companies. It will be felt that the paper has served a useful purpose if by promoting discussion it ultimately leads to improvements in techniques, to a more general acceptability and marketability of debentures, and to some standardisation of the provisions of the debenture trust deeds of industrial companies.

3. The term "industrial company" is used with the intention of excluding companies that deal in money as stock in trade, that is excluding banks, insurance companies, investment bankers, pastoral houses, short term money market dealers, discount companies, mortgage bankers, housing societies, hire purchase and finance companies, and similar organisations. Many of these from the very nature of their activities would not issue debentures in any circumstances, but a substantial volume of the debentures currently listed in Australia are those of hire purchase and finance companies and the issue of debentures would be consistent with the activities of some of the other members of the excluded finance group.

This paper will be continued in Part II which will deal with the theoretical and practical problems relating to subsidiaries, parent companies, gearing, borrowing limitations and the like, and Part III which will raise a number of practical aspects and inter alia discuss the standardisation of trust deeds and the statutory impediments to the development of an active market in industrial company debentures.

4. However, this paper is confined to the consideration of debentures issued by companies engaged in manufacturing or trading activities and whose employed funds, apart from extension of credit in the normal course of business, are mostly expended directly or indirectly on the acquisition of physical assets—land, buildings, plant, equipment, motor vehicles, furniture, office requisites, stocks, work-in-progress, etc. Despite this the term "debenture" is not used in relation to security over specific assets; an industrial company may borrow and give a specific charge from a loan on mortgage secured on land to a bill of sale over a piece of equipment, but "debenture" is used in the generally accepted sense of involving security by way of a floating charge over such assets as the borrowing company may hold from time to time. A company could issue "mortgage debentures" but as usually employed this is a technique for borrowing on the security of land and buildings from a number of lenders instead of from a single lender. The essence of the debenture is the existence of a floating charge and not a specific charge at the time of its issue, the charge only becoming specific in relation to then assets should a receiver subsequently act on behalf of debentureholders.

5. There has been some decline in the popularity of unsecured loans to companies. It is quite true that the unsecured notes of one company may be safer investments than the debentures of another but, on the whole, recent financial difficulties of some companies have led to a greater desire for security both on the part of the public and

on the part of institutional lenders. In a number of cases debentureholders have an expectation of being paid in full or at least receiving a substantial part of their capital back, whereas noteholders are left lamenting along with other unsecured creditors.

6. There is also a widespread feeling that the man-in-the-street desiring a fixed-interest investment for a term of years should be protected. On the one hand he is not purporting to risk his savings in the form of equity in the enterprise entitling him to a substantial return should the venture be successful; his return is fixed. On the other hand he has not the ability to assess the credit-worthiness of the company; the view may be paternalistic but is nevertheless strong that his investment should be secured. As a result there has been an increase of interest in the debentures of industrial companies that provide some degree of security in the form of physical assets standing directly behind the transaction, in contradistinction to the debentures of finance companies (where security over physical assets is further removed) or the unsecured notes of industrial companies.

Physical Assets

7. The assets of an industrial company are normally a hodge-podge of the various items mentioned earlier, the relative proportions varying according to the nature of its business. There may also be some seasonal variation, and as a company grows there is likely to be some change in relative proportions related to the advantages of large scale production or widening of range of activities. The "debenture" serves a purpose because of this hodge-podge nature of the company's assets—on the one hand the lender desires at least some security over physical assets, and on the other the borrower's assets in the normally acceptable forms may not be of sufficient extent or be intended to be held for sufficiently long to provide suitable security for borrowing on specific assets.

8. It is important to appreciate that although expressed as a floating charge the security for the debentureholder really consists, apart from book debts, of the company's agglomeration of physical assets. It is for this reason that a company that issues debentures must be subject to some restraints in regard to the granting of specific charges which of their nature would rank in priority to the floating charge of the debentureholders. If too much freedom is given the debentureholders may end up as no more than second mortgagees. In particular real property is generally regarded highly as security and the debentures of a company which has little or no real property, or whose real property is specifically charged in favour of other lenders, will not normally be regarded as being of the same standing as those of a company whose assets have an effective realty content.

9. Ideally there should be no prior charges, but this is normally too restrictive and could inhibit the carrying on of the company's business, its development through taking over of other businesses, and in particular its acquisition of real estate or extension of the real property occupied. A trust deed providing a floating charge in favour of debentureholders has to allow some flexibility, and the normal provisions are discussed later in this paper. What is being emphasised at this point is that a debentureholder is a secured lender, and that the security has to be more than a paper one and amount to something better than a mere charge over book debts.

10. There is an old adage that the real security for debentures is earning power — and this is of course true for debentures as it is for any other form of lending from unsecured notes to loans on mortgage of real property. No matter how good the security may be in terms of physical assets standing behind the transaction, a lender does not wish to be forced to realise assets with attendant delay and expense. Confidence in earning power is a condition precedent except perhaps for loans from fringe institutions on most onerous terms.

11. Given such confidence, however, the nature of the assets is fundamental in relation to the detailed terms and conditions of a secured loan. This is particularly true for debentures as against loans on mortgage of real property—in the latter case there is specific security over a class of asset for which there is normally a wide demand, which normally tends to hold its value over a long period, and which is normally capable of fairly ready realisation. Debentures are in effect secured by assets of a heterogeneous nature, and the path of a receiver appointed by a trustee acting for debentureholders is not an easy one—for example in the early choice between carrying on the business or realising the individual assets as quickly as possible.

Flexibility

12. A loan on the security of specific assets is limited by the value of those assets, and is usually for a fixed amount and a fixed term. As a precaution against anticipated or possible decline in value of the security, provision may be made for regular reductions in the amount of the loan. Debentures may be secured by an **open-ended** trust deed that provides for original and subsequent issues of debentures; subject to the borrowing limitations incorporated in the deed, issues of debentures may be made from time to time and the ability to borrow will grow as the company grows. The most important attribute, to an industrial company, of borrowing through the issue of debentures is this flexibility—the company's assets will be varying in nature and amount and its needs for loan capital will be varying with time, but the open-ended debenture trust deed provides a

suitable medium through which these circumstances can be met.

13. Under the one security, a floating charge in favour of the trustee for debentureholders, debentures may be issued for a variety of purposes and for a variety of terms to maturity. The rate of interest payable will depend upon the state of the capital market at the time of issue of a debenture, so that although all rank pari passu as to security the rates of interest payable may vary according to date of issue and original term to maturity. Debentures may be issued primarily as security for other transactions, the most important use of this nature being the issue of debentures (payable on demand or at the end of a short fixed period) to bankers as security for bank overdraft accommodation.

14. Another area of flexibility is that a number of methods of issue may be adopted, either at one time or from time to time. Apart from any that may be issued to bankers as security for bank overdraft, debentures may be issued by way of private placement with institutions, through offer to shareholders and/or holders of existing fixed interest securities, or by offer to the public. These methods of issue have their advantages and disadvantages, and varying degrees of relevance to the circumstances of a particular company. An offer to the public may have relative disadvantages arising from provisions of companies' legislation and this tends to inhibit the issue of listed debentures; certain companies with large numbers of shareholders, however, have obtained the best of both worlds by offering listed debentures to their shareholders without becoming borrowing corporations for the purpose of the legislation. An open-ended debenture trust deed that is generally acceptable to investors need not contain certain statutory provisions, but if in fact debentures are issued to the public such statutory provisions as may apply from time to time would of course override the actual provisions of the deed. Subject to acceptability to investors, onerous current statutory provisions should not be repeated in a deed as the law may change.

Debentures Issued to Bankers

15. A company's bankers play an important role. On the one hand their co-operation is almost invariably a condition precedent to the issue of debentures by an industrial company because of the need to arrange for the release of their existing securities. On the other hand their acceptance of debentures, issued in terms of the debenture trust deed, as security for bank overdraft accommodation implies a degree of confidence in the borrowing company and in the form of security being offered to investors. The acceptance by bankers of pari passu debentures is perhaps the best form of recommendation possible to the man-in-the-street.

16. This co-operation of bankers cannot be taken for granted and difficulties arise in particular cases. There need be no concern for weak or small industrial companies—the issue of debentures is not an appropriate form of finance for them. But in relation to companies that are sufficiently strong and whose future is sufficiently well-regarded, varying attitudes on the part of bankers can be disturbing and may even inhibit the issue of debentures by sound industrial companies. A banker may be reluctant to accept a security that does not have ready marketability and which at the same time, through the introduction of a trustee for debentureholders as an intermediary, reduces his ability to take quick action when he feels it to be desirable.

17. In practice, therefore, cases arise where bankers seek a preferred position as against medium and long-term lenders through the requirement of an excessive amount of debentures as security, the right to prove for more than the actual amount owing to them, and even the right to sell on any terms an amount of debentures held in excess of the amount owing. These cases are unfortunate in principle, but the point of view of the banker has to be appreciated. Some are influenced by the memory of past losses but improvements in the drafting of trust deeds, particularly in relation to the assets of subsidiaries and more stringent borrowing limitations, should help to minimise these in the future. It would be undesirable under a private enterprise system for attitudes to be entirely similar, but perhaps a more uniformly co-operative approach could develop with improved marketability of debentures and with progress towards standardisation of the provisions of debenture trust deeds—a subject discussed later in this paper.

18. In the meantime the open-ended debenture trust deed does provide in most cases a form of security eminently suitable for bank overdraft accommodation, acceptable to bankers and convenient to their client industrial companies. The use of debentures in this way can readily be extended to cover bank guarantees and lines of credit in those cases where security is required and the issue of debentures is possible within the limitations imposed by the trust deed itself. As all issued debentures rank pari passu it is normal to include the whole quantum of debentures issued as security as part of the secured liabilities of a company for the purpose of calculating borrowing margins; in equity it is equally normal to provide for the addition to total tangible assets, as otherwise defined in the trust deed, of an amount equal to the excess of debentures issued over the actual amount of bank accommodation in use as at the calculation date.

Balance Sheets and Bank Overdrafts

19. A weakness in present company accounting is that it is possible for cheques to be drawn just before a balancing date in such a way as to unduly reduce creditors and increase bank overdraft in a

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price, average operating costs and recoverable average ground values during the life of the mine.

The calculation of present value provides management with a basis on which to assess the worth of an investment, and is of use when it is necessary to make decisions on mining policy and development. It is also determined for many other reasons, such as the transfer of land from one mining company to another, the sale of tin-bearing agricultural land to a mining company, and for assessment of death duties. Apart from these reasons, it is sometimes difficult for a miner or a mining company to assess the value of mining land unless the present value is calculated. For example, it is not immediately obvious which of the following propositions is the best investment:

(a) Land yielding $100,000 per year for 20 years, total yield $2,000,000.
(b) Land yielding $150,000 per year for 10 years, total yield $1,500,000.

The present values, allowing 15% risk rate and 3% on the sinking fund, are:

(a) $534,100.
(b) $632,250.

Approximately the same difference in favour of (b) results if simple interest of 15% per year only is allowed and the sinking fund is neglected.

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company's published accounts. Some volume of unpresented cheques is only to be expected, but concern could be expressed at a situation where the volume is abnormally increased at the time of preparing a balance sheet and particularly where some are not even despatched to creditors at that time. Whilst the total of current liabilities is not affected, the apparent bank overdraft facilities of the company are increased beyond the true position and perhaps far beyond the actual overdraft limit of the company. A large amount of overdraft accommodation in use may appear to show a confidence in the company on the part of its bankers, and along with an understatement of amounts owing to creditors could create a wrong impression of the situation of the company.

20. There is no untoward effect so far as a debenture trust deed is concerned. Provision is normally made for the figures disclosed in the audited published balance sheet to be used as a basis for calculating borrowing limitations, and the effect may be to overstate secured borrowings and reduce the margin available under an open-ended deed for the issue of further debentures. However, a purchaser of debentures could be misled as to the strength of the industrial company concerned, and a case can be made for the publication in annual accounts of (i) the arranged bank overdraft limit or (ii) a reconciliation between book and actual bank overdraft. It is believed that a statutory provision along these lines would be supported by many bankers who have been embarrassed through the linking of their names with company overdraft facilities of a degree that they would not entertain.

(To be continued.)

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between the first period, 1954 to 1959, and the second period, 1959 to 1963, might have led to abnormal results, and that if the economic circumstances had remained unaltered the survey would have shown that growth does breed growth. It is my impression that those who believe that "growth breeds growth" believe that their selected growth stocks will perform better than average, no matter what the average does. If so, they cannot claim that the change in economic circumstances invalidates the results set out above. On the other hand, if it is claimed that past growth is a guide to future growth only so long as economic conditions remain static, then this guide is of little practical value whether it is correct or not.

These results support Mr. Little's belief that past growth of earnings is not a useful guide to likely future growth of earnings.

TABLE III

Annual Percentage Growth Rates of Earnings per Share Averaged for the Companies in each Group

	From 1954 To 1959	From 1959 To 1960	From 1959 To 1963
Group 1	-6.6*	7.1	4.7
2	1.7	12.4	5.5
3	6.0	8.3	3.0
4	10.5	6.1	3.3
5	23.4	9.3	1.3

(* From 1954 to 1959 the earnings per share of all the companies in Group 1 *declined*. The average rate of decline was 6.6% p.a.)

At first glance it may seem strange that 23.4% p.a. is equivalent to a growth of 186.8% in five years (these are the figures for Group 5 from 1954 to 1959). These figures are reconciled in the table below.

TABLE IV

Earnings	1954	100.0	23.4%	Growth of earnings	54/55	23.4
	1955	123.4	23.4%	,, ,, ,,	55/56	28.9
	1956	152.3	23.4%	,, ,, ,,	56/57	35.7
	1957	188.1	23.4%	,, ,, ,,	57/58	44.2
	1958	232.3	23.4%	,, ,, ,,	58/59	54.5
	1959	286.8				

Thus at a growth rate of 23.4% p.a. over five years, a growth from 100 to 286.8 results, an increase of 186.8% in five years.