

Industrial Company Debentures

Standard Tests

41. The quality of a debenture cannot be determined wholly by quantitative evaluation—there are many subjective factors from views as to the future of the particular industry concerned to such matters as the weight to be placed on the lack of a parent company guarantee. The quantum of assets over which an effective charge is obtained may be greater than those used in determining borrowing limits—deductions may be made from book figures of total tangible assets in respect of investments in non-guaranteeing subsidiaries, but these investments are nevertheless part of the security and may have a very material value. Except in special cases, such quantitative evaluation as is possible can properly be based on the consolidated accounts of the borrowing company and all its subsidiaries.

42. The simplest test is that of **proprietorship ratio**, the relationship between net tangible assets and total tangible assets. Expressed as a percentage, this may not normally fall below 40% as it is the complement of the usual limitation that total liabilities and provisions may not exceed 60% of total tangible assets. The figure of 40% is a minimum, and to avoid the danger of breach of a trust deed (e.g., in the event of an unexpected loss) a safer working minimum is 50%. In some cases a higher working minimum is very desirable because of the relatively small size of the company or the nature of its activities. The calculation of the proprietorship ratio at intervals over a period gives an early indication of whether shareholders' funds are keeping pace with a company's growth in activity, and

* Owing to lack of space the sectional headings had to be omitted in the printing of Part II of this paper. They were—

Subsidiary Companies (pars 21-26)

Parent Companies (pars 27-30)

Gearing and Borrowing Limitations (pars 31-36)

Prior and Pari-Passu Charges (pars 37-40)

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The first and second parts of this paper appeared in the March and June issues of the Journal. This concluding part raises many practical aspects and leads to a discussion of the impediments to the development of a more active market in Australian industrial company debentures.

may indicate the need for a further issue of share capital.

43. An old-established test is the relationship between **current assets and current liabilities**. If the ratio is low attention is drawn to the possibility of the group being unable to pay its debts—not necessarily because of lack of profitability but because of lack of ready money. The issue of medium or long-term debentures to replace short-term borrowings may be immediately reflected in an improvement in the ratio. The calculation of the ratio at intervals over a period may give early warning of possible loss of liquidity, which may well be significant to a debenture holder or potential debenture holder. Furthermore, it could draw attention to a “hard core” of short-term debt in the form of bank overdraft, bills payable and delayed payment of creditors.

44. However the quantitative tests specifically associated with debentures are **asset cover** and **interest cover**. The former is simply the ratio of total tangible assets (after making the adjustment referred to in paragraph 18) to the sum of the issued debentures and any prior ranking or pari-passu charges. If such secured liabilities are limited to an amount not exceeding 40% of total tangible assets, the ratio or cover cannot without breach of the trust deed fall below \$250 for each \$100 of relevant liabilities. It is quite incorrect to reduce both secured liabilities and total tangible assets by the amount of prior charges—this is sometimes done but has the effect of overstating the degree of asset cover for the debentures alone. The calculation is nec-

essarily made as at a point of time and, if a new issue of debentures is contemplated, appropriate adjustments to the consolidated accounting figures must be made to allow for the effect of the issue. This will involve a knowledge of the intended division of the proceeds between repayments of existing secured and unsecured liabilities and the acquisition of additional assets.

45. In principle the calculation is a simple one, but it is desirable that details be set out so that the results can be properly interpreted. If correctly calculated it does give an indication of safety margin as an investment subject to a number of reservations—in particular that the assets of the group are worth their book value on enforced realisation. It must also be emphasised that the calculation relates to a point of time—it may or may not be rational for an investor to require not less than a certain asset cover at the time an investment is made, but in any case the figure will vary seasonably and secularly and may be reduced by subsequent borrowings. The real test lies in the minimum asset cover to be inferred from the terms of the trust deed itself.

46. Perhaps more weight should be given to the test of **interest cover**. In respect of a period of operations of a company, this is the ratio based on its consolidated accounts of net profit, before charging interest and income tax, to the sum of such interest and any additional interest outgo now being incurred. The ratio is expressed as a number of times interest cover. There are theoretical considerations affecting the extent of interest paid that

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should be brought into the calculation, but for practical purposes all interest paid (whether secured or unsecured) should be included—including interest on overdrafts and discounts on commercial bills. A published figure of interest paid on fixed term borrowings is not enough, and not only in relation to interest cover calculations but for security analysis generally it would be helpful if the total of all interest paid were required to be published by every company.

47. Even so, interest cover calculations can be misleading, and a figure must be interpreted in relation to the particular company or the normal method of calculation adjusted to suit its circumstances. Profits may be rising or falling, dependence upon borrowed funds may be rising or falling, and the aim must be to produce a rational and unbiased estimate of the ratio of current interest outgo (including any new burden being imposed on the borrowing company) to the profits available to meet the payment, i.e., net profit before charging interest and income tax. It is only too easy to make inaccurate or misleading estimates, and the underlying principles must be kept in mind. A soundly calculated figure will aid in assessing a debenture, and normally a high figure will indicate that a fall in profits would have to be very severe before a borrowing company experienced difficulty in maintaining interest payments. Nevertheless the number of times cover is only an aid, and 2 times cover may be more than adequate for one company and 4 times cover insufficient for another. It is only necessary to contrast the regularity of profit from some activities with the high volatility of others.

Continuing Interest Cover Requirements

48. It is clearly undesirable to attempt to make the maintenance of a specific interest cover a continuing requirement under a debenture trust deed, that is to make the secur-

ity enforceable should the interest cover fall below that figure in respect of any period of a year or six months. But a great deal of attention has been given to the question of new borrowing should a minimum interest cover not be reached. Many overseas open-ended debenture trust deeds provide that additional debentures may not be issued if the effect of their issue would be to impose an interest burden beyond the ratio laid down in the deed, and this can be a desirable protection for existing debenture holders should a company experience very severe difficulties. The restriction, of course, relates only to the issue of additional debentures, and does not prevent further unsecured borrowings or inhibit the company in its use of normal financial facilities in carrying on its business.

49. Much less satisfactory is an attempt under a debenture trust deed to restrict all forms of additional borrowing should a degree of interest cover not be maintained during all accounting periods. For practical purposes this amounts to a continuing requirement as even the drawing of a cheque against an unsecured bank overdraft could be regarded as an additional borrowing. A temporary down-turn in profits for reasons beyond the control of a company could place it in a most invidious position, and the exercise of powers under a debenture trust deed may not only be against the interests of the company but be against the interests of the debenture holders themselves. A restriction in adverse circumstances of additional debenture and prior-ranking borrowing (except with the consent of the Trustee) can add to the debenture holder's security, but an attempt to inhibit all borrowing is to be deprecated—indeed the latter may even be regarded as reducing the value of the debentures as an investment.

Leasing

50. Little attention has been paid to the situation where a company

that has issued debentures should lease real property, or plant and equipment, in preference to ownership. Its holding of tangible assets and therefore its debenture-issuing capacity is thereby relatively reduced but it is to be noted that—

(i) a desirable form of security—real property—may not be available to debenture holders either in whole or in respect of an equity on redemption,

(ii) in effect 100% loans have been obtained but are not brought into account in calculating borrowing restrictions, and

(iii) a rental burden is assumed, but whilst this is of the same nature as interest it is not brought into account in calculating interest cover.

To the extent that real property in particular and other assets generally are leased rather than owned by an industrial company, its debentures may be that much less attractive. In adverse circumstances the borrowing company may have particular difficulty in continuing its use of assets that are essential for the conduct of its business. There are often advantages in leasing rather than owning property, but a change in policy to leasing could be adopted as a means of deferring the right of a trustee for debenture holders to enforce the security by deferring a breach of liability limitations. Some provisions of a normal trust deed may limit these opportunities but they appear to exist, and in particular little or no information as to leased real property, plant or equipment can be ascertained from a company's accounts.

Redemption

51. Sometimes little thought is given to the ultimate redemption of debentures. It may well be possible to replace maturing debentures by a new issue in terms of an open-ended deed, but it is possible that maturity will take place just at a time when the company is experiencing a down-turn in profits or the community is experiencing a heavy

demand on available financial resources. It is possible to arrange for a particular issue of debentures to be repayable by annual instalments so that redemption imposes little burden if it is met out of cash flow; such debentures, however, are not generally attractive to either the institutions or the public in Australia. A similar result could be achieved by the issue of debentures for fixed terms and the separate building up of a redemption fund; the rate of interest credited on the redemption fund (whether arranged as a portfolio of investments in the hands of a trustee or the effecting of a sinking fund policy with a life insurance company) is, however, likely to be much less than that being paid on the gross outstanding debentures.

52. In practice, therefore, debentures in Australia are normally issued for fixed terms without special redemption arrangements. This can still be entirely satisfactory if a number of terms are offered to investors, and particularly if successive issues provide for different maturity dates again. The ultimate effect may be that modest quantities of debentures mature in successive years—whilst the flow may not be quite even, the quantum maturing in any short period may well be manageable from cash flow. In considering the desirableness of investment in the debentures of a particular industrial company, the amounts maturing in various years should be considered in relation to the size of the company—and special thought given to any situation where an uncomfortably large volume is to fall due for repayment at one time.

53. In the case of a sound well-regarded company there is no particular merit in preferring an early maturity date over a later one, as in the event of breach of a trust deed all debentures would become immediately repayable irrespective of their remaining terms. The point only has significance in the case of

a declining company where there is thought to be a danger that early maturing debentures may be paid off in full before a breach occurred; the statistical probability of later decline of a currently sound company, even if slight, may however justify a higher rate of return on the longer maturities. The rates of interest actually offered for the various maturities of a new issue could be affected by future expectations as to movement in the general level of interest rates—if a fall were thought likely it may well be rational to offer the one rate on both medium and long-term issues, whereas in other circumstances there could be a tendency for the rate to increase with period to maturity.

Statutory Considerations

54. Statutory requirements under companies legislation are more important in relation to hire purchase and finance companies that deal in money as stock in trade, than to the industrial companies that form the subject of this paper. Although the legislation was instigated by abuses in the finance area—including those of companies engaged in industrial activities but which had finance companies in their groups—it covers all companies that become “borrowing corporations”. Many industrial company issues are arranged by private placement with institutions or through offers to shareholders and holders of existing debt securities, and the legislative provisions are thereby avoided unless and until a public issue is actually made. However, modern trust deeds contain what is needed for the protection of investors, and there are only three points worth special mention.

55. The first is the lodging of a prospectus and the second the possibility that half-yearly audited accounts may be required to be prepared and lodged. The preparation of a formal prospectus can be a useful discipline, but the knowledge of a company gained by a reputable Issuing House and its recommenda-

tion of an issue can be even more valuable to sophisticated investors. It is usual in trust deeds to give the Trustee a reserve power to call for audited accounts at any time—a power that should not be exercised except for proper reason—and with most industrial companies this should be an adequate and sufficient supplement to the normal provision of annual audited accounts.

56. The third point concerns the responsibilities of the Trustee. The normal trust deed so minimises these responsibilities that the Trustee may be little more than a figurehead or central point of reference, and there is some complaint that it does little to warrant the fees charged. This criticism is not justified in respect of many reputable corporate trustees which, whatever the trust deed may say, accept and carry out a trust with a deep sense of responsibility to investors. So far as “borrowing corporations” are concerned the office of Trustee is not only now restricted to a limited class of corporate trustees, but certain responsibilities (which may be briefly but inadequately summed up in a need to exercise diligence) are imposed on them by legislation. This overriding by legislation does not apply to a deed unless and until a public issue is made, but there has been some tendency in new deeds for the former avoidance of responsibility to be modified. However, the real test is the reputation and experience of the Trustee, and the selection of a well-regarded corporate trustee (particularly one with a knowledge of the practical problems involved in running an industrial enterprise) is more important than any trust deed or legislative attempts to impose a duty of diligence.

Impediments to the Development of a Market

57. The idea of an active market in which industrial company debentures can be readily bought and sold is an attractive one. The volume of these debt securities is growing rapidly, and apart from the direct value

of a market to investors and dis-investors, the existence of such a market-place would enable market judgment to be given upon comparable securities of different companies. Redemption yields would provide a standard against which to gauge the terms of new issues. The impediments mentioned at various points in this paper are, however, very material. Active trading is necessarily inhibited by stamp duties and brokerage—particularly in respect of debentures with a short period to maturity where the effect on overall redemption yield is pronounced. The lack of standardisation of trust deeds makes it difficult for the general public to understand fine points affecting the nature of the security for debentures, and should a particular company experience difficulties this lack of understanding could lead to a speculative, rather than an orderly, market in its debentures.

58. There are difficulties in regard to the listing of industrial company debentures on stock exchanges. Most companies have only one form of listed ordinary share—for periods there may be classes of ordinary shares that have different dividend ranking and there are also cases of separately listed ordinary shares of special nature, but normally there is one listing for each company. Debt securities on the other hand have diversity according to type, and more importantly have various maturity dates. The minimising of the number of maturities would facilitate trading, but as indicated earlier this may not be desirable for either the company or the investing public. The situation could arise, therefore, where an industrial company had only one class of listed ordinary share but in respect of debentures alone had up to ten or even more listed debenture issues—all ranking *pari passu* but having different maturity dates.

59. Stock exchange listing requirements are themselves reasonable. For practical purposes it is

only possible to list issues that exceed a minimum size and have fixed maturity dates, but this fits in with the underlying concepts of industrial company debentures and the creation of markets in them. Hire purchase and finance companies currently issue short-term securities that mature at fixed periods from a diversity of dates of issue—a market in such borrowing is impracticable and it would be better if they were replaced by commercial bills when and if existing State bill stamp duties are eliminated or reduced to a small flat charge as is the case with cheques. It is considered that industrial companies should not issue such short-term debt securities or accept deposits of corresponding nature, that they should rather issue medium and long-term debentures for loan capital needs and make greater use of commercial bills for short-term purposes.

60. High rates of brokerage could have a more marked adverse effect on the development of a market in debentures than on ordinary shares—the relatively high volatility in market prices of the latter tends to disguise the incidence of brokerage. Brokerage on transfer of debentures is more obvious in its effect of reducing the purchaser's yield to redemption. Actually as a whole the current rates of brokerage on transfers of listed debentures are not unreasonable, but they become burdensome when the debentures become relatively short-term through effluxion of time—and this is when they are most likely to be traded actively.

61. Reference has already been made, in paragraphs 15 to 18, to the issue of debentures to bankers. It is important that bankers have adequate security in relation to the accommodation provided, but if an active market in industrial company debentures is to be developed it is equally important that institutional investors and members of the public have an adequate degree of secur-

ity. Unfortunately bankers have often acquired charges over the whole of an industrial undertaking's assets far beyond what is justified by the amount of accommodation provided by way of overdraft facilities and the assumption of contingent liabilities under guarantees, bills discounted, etc. Sound companies can therefore be precluded from raising fixed-interest funds from other sources by their inability to provide satisfactory security, or be forced to borrow moneys on terms and conditions that are undesirable for the community as a whole and perhaps onerous to themselves.

62. The burden of stamp duties is a serious one in Australia. The debenture trust deed itself creates a charge which may have to be registered in many States and Territories in respect of the borrowing company and relevant guaranteeing subsidiaries. Stamp duties vary greatly between jurisdictions and in some States are so onerous that every effort has to be made to reduce their incidence—with some effect on the detail of the wording of a deed and making more difficult the adoption of a standard form. Like other securities debentures attract State stamp duties on assignment, imposed on an *ad valorem* basis without regard to remaining term and therefore particularly inhibiting transactions in debt securities approaching maturity. Unsecured deposits can be made with companies and these can be repaid and replaced by other deposits, all without attracting any stamp duty except that on receipts, but the giving of security for the protection of investors immediately involves a range of severe duties with effects greatly contrary to the public interest. Particular attention is again drawn to the aspect discussed in paragraph 23—the barrier created by stamp duties against the concentration of chargeable assets in the hands of borrowing companies, so contrary to United Kingdom practice and so undesirable an influ-

ence in maintaining a proliferation of subsidiaries and making more difficult the provision of sound security to holders of debentures.

Standardisation of Trust Deeds

63. The debenture trust deed is a lengthy document which has tended to grow further in size in recent years as various additional provisions have been introduced. Although a substantial body of material is of a routine nature, there is considerable variety in format and order of relevant clauses. It has been suggested from many quarters that a standard deed could be prepared, such adaptation as is necessary to meet the circumstances of the particular case being made through special clauses. Many of the actual differences between deeds are due to the preferences of individual draftsmen, but at the same time it must be admitted that the circumstances of individual companies necessarily lead to considerable variations in detail. It would be a very difficult task to prepare a standard form of deed that required a minimum of adaptation to individual circumstances, particularly because of stamp duty complications if intended to be used throughout Australia, but so strong a case can be made in favour of the production of a standard deed that the effort would be well worthwhile.

64. Some progress has been made towards standardising the objectives of a deed, and there is a tendency for institutional investors to adopt a more uniform approach towards the exact nature of the security desired. If this movement can be expedited and general agreement reached, **provided that this is on a rational and practical basis**, there seems no reason why a great deal of progress should not be made towards the standardisation of the format of the deeds themselves. The objection that every case must be considered on its merits can be over-stated, in that questions can be asked as to the real need for such

variety. In practice many variations agreed upon are not essential, and the general adaptation of a standard format may result in less insistence upon specific variations in individual cases. At present, too, many deeds simply omit reference to points that are not relevant at the time of execution; circumstances can change, and the adoption of a standard form of deed may save a great deal of difficulty later. All too often a deed designed to suit a particular case is found wanting in that insufficient thought has been given to the effects of possible—or probable—future changes; put another way there may be too much insistence on the part of the investor in getting a charge over the assets that he can see there now, and too little thought given to the long-term needs of the company and debenture holders in a dynamic and changing economy.

Conclusion

65. If an active market in industrial company debentures could be developed a number of benefits would flow to the financial community. More debenture issues would be listed than is currently the case, and there would be a tendency for companies of appropriate nature and sufficient size to issue debentures more freely as compared with their taking of deposits or issue of unsecured notes. New issues would have to meet a more effective test of market acceptability, and greater emphasis would be placed on their sponsorship by reputable Issuing Houses. Companies would be encouraged to adopt better standards of reporting in that they would be forced to consider the interests of debenture holders as well as of shareholders; even if no statutory action were taken more information may be published in regard to such matters as volume of outstanding cheques, total interest paid and even particulars of leased property. There would be more public interest in the gearing of companies, and in particular a more ready awareness of over-borrowing and/or

potential loss of liquidity. It is therefore most unfortunate that the most serious of the impediments to the development of an active market in industrial company debentures have been created by law—the imposition of stamp duties not only on debenture trust deeds but on the transfer of such debt securities and on the transfer of chargeable assets from subsidiary to parent companies. Companies Act provisions designed to protect the investor—and mainly arising out of failures of finance companies or finance subsidiaries of other companies—have tended to inhibit the issue of debentures by industrial companies except where the relevant provisions can be avoided by private placement or issues to shareholders and existing holders of debt securities. A simple idea in principle—public issues of debentures by sound industrial companies—has been largely inhibited, and it is submitted that this is contrary to the public interest.

— MEMBERS —

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