

2.5

A Glossary of Debt

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Asset Cover is the ratio of net assets to total debt – ie total assets minus current liabilities/debt. It is used by banks to judge the security of their lending. The level of asset cover that a bank will feel comfortable with will depend on the nature of the assets: cash might be counted at 100 per cent, property at 80 per cent, stock and debtors at 50 per cent.

Bills of Exchange are instruments used in trade finance, typically used to provide finance between the time goods are delivered and payment is made. They are in the form of a promise to pay a fixed amount on a specified date (typically three months after issue). Most importantly they are tradable, enabling the vendor to realise the debt in cash by selling it on (usually to an accepting house). The price agreed will be discounted to reflect the prevailing interest rate.

Bonds are interest bearing securities which can be traded in the money markets. They are usually the cheapest source of debt for large companies. They consist of a coupon and a principal. The coupon represents the annual interest rate payable on the principal. The principal represents the face value of the bond which can be redeemed at maturity. They trade in the financial markets at a price which reflects the prevailing interest rate and expectations of the future interest rate. This process is described under **yield**, below. They are usually unsecured, but the borrower is required to have a **credit rating**. BBB- or Baa3 are considered the lowest investment grade rating. Money can

still be raised in the high yield bond (or junk bond) market on lower ratings, but a higher interest rate is required. There will usually be covenants to ensure that the company does not subsequently take out higher ranking loans. The minimum amount that a company can raise in a bond is probably £50m. This is because the market prefers liquid (ie large) bond issues.

The bond market is a public market – ownership of bonds has to be registered and they are taxed at source. This has led to the growth in the Eurobond market. Eurobonds are bonds issued outside the domestic jurisdiction of the residency of the issuer. They are payable free of withholding tax and they can be bought and sold anonymously. These tax advantages have made them a very popular means of raising debt among large corporations.

There are a number of different types of bond and Eurobond:

- *Commercial Paper*: bonds with a maturity of under one year. They offer no coupon. Instead they are usually sold at a discount to the redemption value which corresponds to the prevailing interest rate. They are used primarily by the largest, most credit-worthy institutions.
- *Medium Term Notes*: bonds with a maturity of between one and five years.
- *Floating Rate Notes*: bonds that pay interest pegged at a certain number of basis points (hundredths of a percentage point) above LIBOR.
- *Paid in kind*: bonds that issue more bonds instead of paying cash interest.
- *With Warrants*: bonds that give the right to acquire ordinary shares in the issuer after a certain period.
- *Zero-coupon bonds*: bonds that pay no interest. They are issued at a discount to their face value relating to the expected interest rate to maturity.

Charges represent security that a bank has in making a loan. They can be fixed or floating. A fixed charge is one that refers to a specific asset, e.g. a building or plant. In the event of default the lender can take control of the asset and sell it to cover the value of the loan. A floating charge refers to all the assets of a business over which there is no fixed charge. It therefore ranks below a fixed charge in a liquidation (see **Ranking** below).

Committed facilities are agreements between banks and borrowers to provide funds up to a specific amount, at a specific interest rate (usually a fixed amount above LIBOR) for a specific period of time. Term debt (see Chapter 2.1) is generally in the form of a committed facility. Unlike uncommitted facilities such as overdrafts, they cannot be removed on demand by the lender. They do however usually entail covenants which, if broken, can mean that the debt has to be repaid on demand.

Convertibles are debt instruments that can be converted into equity in certain circumstances. They include convertible bonds, which give the bearer the right to convert the bonds into shares at a pre-defined ratio after a specified date. Another example is convertible loan stock, which is often used by venture capitalists to dilute the management equity should they fail to perform (see ratchets, Chapter 3.3).

Covenants are conditions imposed on loans and bonds to protect lenders against default. They stipulate things such as:

- a minimum level of asset cover;
- a maximum level of gearing;
- a minimum level of interest cover;
- that no prior ranking debt is subsequently arranged;
- that specified assets cannot be sold without the consent of the lender;
- that the lender has the right to review the loan in the event of the business being taken over or control otherwise changing hands;
- that the lender has the right to call in the loan in the event of the borrower defaulting on other loans.

Whether or not a company accepts the covenants proposed to it by its bank will depend on the strength of its negotiating position. The very largest publicly quoted companies can usually avoid most covenants, but smaller unquoted companies may find themselves having to agree to very restrictive covenants simply because there is less competition for their business.

Credit Rating is the means by which the public debt markets assess the credit worthiness of an issuer of debt. There are two main rating agencies, Moody's and Standard & Poors. The rating systems they use are slightly different:

Investment Grade

Moody's	Standard & Poors	Interpretation
Aaa	AAA	Highest quality
Aa1, Aa2, Aa3	AA+, AA, AA-	High quality
A1, A2, A3	A+, A, A-	Strong payment capacity
Baa1, Baa2, Baa3	BBB+, BBB, BBB-	Adequate payment capacity

Speculative-Grade Ratings

Moody's	Standard & Poors	Interpretation
Ba1, Ba2, Ba3	BB+, BB, BB-	Likely to fulfil obligations, on-going uncertainty
B1, B2, B3	B+, B, B-	High-risk obligations
Caa	CCC+, CCC, CCC-	Current vulnerability to default, or in default
Ca, D	C, D	In bankruptcy or default, or other shortcoming.

The lower the credit rating the greater the **yield** required to entice investors to buy the bonds. Speculative grade-rated bonds are often referred to as high yield or junk bonds. Such issuers usually require **credit wrapping** to get their bonds away. The market's attitude to different credit ratings is dependent on the prevailing attitude to risk. A high yield bond might trade at 300 basis points above LIBOR in a stable market, but in a highly risk averse market this spread might increase to 800 basis points. Sometimes it becomes effectively impossible to raise finance at all in the bond market without a triple or double A credit rating. The process of achieving a rating takes at least three months.

Credit Wrapping is a technique by which a bond issued by a company with a poor credit rating can be shored up with the assistance of an institution with a strong credit rating. It involves the institution (usually a large insurer with a triple A credit rating) agreeing to underwrite a proportion of the amount payable in the event of default in exchange for a premium. In many cases it is the only way in which poorly rated companies can issue bonds.

Debt to Equity Ratio is a measure of the gearing of a business. It is calculated as long-term debt (usually including preference shares) divided by the shareholder funds. It is an important indicator for banks: they are extremely reluctant to lend money to businesses that are highly geared (see Chapter 3.3 on internal equity).

Discounting is a means of raising money against the value of unpaid invoices. A discounter will purchase invoices (bills) at a discount to their face value, hoping to make a profit on redemption. **Factoring** is the more common form of invoice finance in use today.

Debentures are secured long term. The security usually comes in the form of a floating charge over the assets of the business. This gives the holder of the debenture the right to appoint an administrative receiver in the event of default, giving it enormous powers over the business (see Chapters 1.5 and 2.4). The advantage of debentures for borrowers is that they generally pay a lower rate of interest than an overdraft, and they are **committed facilities**.

Eurobonds: see **bonds**.

Factoring is a means of raising working capital against trade debtors (see Chapter 2.2). There are two sorts. *With service factoring* involves assuming the credit risk for collecting debts, but only advancing the money as it becomes payable. *With service plus finance factoring* involves paying a percentage of the value of the invoice as soon as the goods are delivered.

Forfeiting is a form of invoice **discounting** used by exporters.

Gearing: see **debt to equity ratio**.

Hire Purchase is a means of structuring the purchase of capital assets such that ownership of the asset only changes hands once a certain number of instalments towards the final consideration have been made (see Chapter 2.2).

Interest cover is one of the most important ratios a bank will look at in determining whether to advance a loan. It looks at the number of times a company would be able to pay interest out of its earnings before interest and tax. It indicates at a very basic level whether or not a business will be able to service its debts. For this reason, it is more important than analysing the value of the security (ie asset cover) in reaching decisions about loans. The level of earnings at which most banks will start to get uncomfortable will be between two and three times interest.

Leasing is a means of hiring fixed assets. It is covered in detail in Chapter 2.2.

Letter of credit is a means of trade finance involving an importer's bank (the issuing bank) writing to a bank in the exporter's country (the negotiating bank) authorising the payment of a specified sum to the exporter on presentation of the shipping documents.

Loan stock is a tradable debt instrument that can either be secured or unsecured. Secured loan stock is a **debenture**. Unsecured loan stock is

very similar to **preference shares** but it ranks above preference shares on liquidation. Loan stock is used in structuring venture capital deals and in situations in which loans to large companies are syndicated among a number of banks.

Mezzanine finance is a generic term for financial instruments that have the characteristics of both debt and equity. It may be secured or unsecured, and it may or may not involve a degree of participation in the up-side of the sale of the business. It usually comes in the form of variations on **preference shares** or **loan stock**. It is usually provided by mezzanine finance specialists to back management buy-outs and buy-ins.

Mortgages are loans secured against fixed assets, usually property.

Off balance sheet finance is finance that can be raised without declaring it on the balance sheet. Typically it would involve moving an asset into a separate company which then raises money against it and returns the cash to the original owner of the asset. Until Financial Reporting Standard 5 was introduced, there was no reason why such transactions should be disclosed at all in the company accounts, and it was a very attractive means for quoted companies to raise money without alarming their shareholders. Since FRS 5, companies have been required to divulge related party transactions and it is no longer so attractive.

Overdrafts are uncommitted facilities that exist to meet seasonal working capital needs. Although interest rates are higher, they are cheaper than using a term loan for the same purpose because interest is calculated on the basis of the account at the end of each day rather than the maximum amount borrowed.

Preference shares are equity instruments that behave like debt instruments. They pay interest at a fixed rate rather than dividends. Like debt, they do not participate in any increase in the value of the business, but unlike debt they are unsecured, and therefore vulnerable should the value of the business decrease. On liquidation, preference shares are ranked below loan stock and debentures, but above ordinary shares. Often they can be converted into ordinary shares if interest payments are not met. They do not usually have voting powers.

They can be structured in various different ways:

- *Convertible preference shares*: these can be exchanged for ordinary shares under certain conditions or after a certain date. Convertible preference shares are often used by venture capitalists to structure

ratchets. They enable the investor to dilute the management's equity if certain targets are not achieved.

- *Cumulative preference shares*: where interest payments are rolled into the principal, to be paid off on redemption. They are used by venture capitalists to ensure that a business is not overburdened by interest payments while it is not generating excess cash. Usually the accumulated interest is paid on exit.
- *Redeemable preference shares*: which can be exchanged for their value in cash on or after a specified date or event.

Ranking refers to the order in which holders of a company's securities are paid out in the event of liquidation. The order is as follows:

- Preferred creditors (ie PAYE, NIC, VAT and wages and salaries up to a maximum of £800)
- Holders of fixed charges over the assets (i.e. mortgagees)
- Holders of floating charges over the assets (i.e. debenture holders)
- Senior creditors such as trade creditors and other unsecured debt
- Subordinated creditors such as holders of unsecured loan stock
- Holders of preference shares
- Ordinary shareholders.

A lender will always want to ensure that there are more claimants ranked beneath it than above it. The debt to equity ratio can be seen as a measure of where a lender will be in the queue: a low debt to equity ratio means that there are plenty of equity participants at the back of the queue to absorb any risks, and therefore gives banks comfort. A high debt to equity ratio means that the bank's loans will be more exposed in the event of liquidation.

Receivership refers to the appointment of a licensed insolvency practitioner to realise the value of the assets to repay the value of the outstanding debts after a company has defaulted.

Revolving Facilities are debt instruments that combine the flexibility of an overdraft with the commitment of term debt. They are negotiated for a specific credit limit for a specific period, during which time they can be drawn down or repaid. As **committed facilities** they usually involve **covenants**. Interest is payable on the whole facility whether or not it is drawn, although there will usually be one interest rate for the drawn part of the facility, and another, slightly lower, interest rate for the undrawn part of the facility.

Securitisation is traditionally defined as the replacement of bank borrowing by bond issues, but in recent years it has a more specific meaning. It is the issuance of bonds against the security of receivables. It involves transferring legal title to an income stream to a separate company, which then issues a bond back by that income stream. Should the income stream be more than enough to cover the interest payments on the bonds, then the excess is returned to the original company; should the income stream be insufficient, then the bond holders have the right to sell-on the income stream. Usually the bond holders will be protected against default by **credit wrapping**. Securitisation has been one of the growth areas of finance in the late 1990s. It is used by leasing companies and mortgage lenders as well as pop stars (securitising their royalties) and utilities.

Syndication is used where one bank is either reluctant or unable to provide the full amount to be borrowed itself. It is usually required only for the largest loans, unless there is undue risk involved.

Yield refers to the income (expressed in terms of per cent per annum) from a bond, taking into account both the interest receivable and the discount from the redemption value at which the bond is purchased. For example a ten-year 8 per cent bond due for redemption in five years' time may be trading at £90. The actual income expressed in percentage terms will be different from 8 per cent for two reasons. First, because the coupon pays interest as 8 per cent of £100 rather than 8 per cent of £90, and, second, because when the bond is eventually redeemed the holder of it will receive £100 rather than the £90 it costs on the current market. Taking both of these factors into account involves some quite complex mathematics because, strictly speaking, the value of the discount should not be amortised evenly across the remaining life of the bond. Bond analysts use 'yield curves' to calculate the yield to maturity. When the price of bonds falls, the yields rise and vice versa.