

# IMPACT OF DEBENTURES ON COMPANY AND ITS STAKEHOLDERS

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## ABSTRACT

Introducing debt into the business creates financial obligations for a company, due to its high interest rates and needs for preferential payment. It is a very crucial decision and the company needs to think through all the consequences before making a decision. The debt capital affects the dividend rates of the existing shares. Also, the company before making such a decision should ensure that it would be able to handle the baggage of the financial distress that comes along with their issuance. These days companies are not preferring the issue of debentures for raising capital and look for other alternatives to do the same. Through this study, we aim to analyse the reasons and the after effects of a debenture issue on various industries, by analysing the companies opting for debentures. We also would look at the various ways in which companies have taken other decisions to create a balance amongst all the stakeholders, by keeping in mind the profitability and smooth functioning of the business alongside. Also, we would look at some of the reasons because of which the investors choose to go for debentures and the various aspects of a company that attract the investors.

**Key Words:** *Debenture, interest rate, stakeholders, profitability*

## I. INTRODUCTION

In every organisation, whether it operates on any scale, there is a need for funds, for conducting various business activities. There has to be sufficient capital, based on the appetite of the firm, in order to ensure a smooth functioning. There are various methods adopted by companies to raise funds and capital, but some companies might opt for issuing debentures, specially when there is a need for raising funds for a long term. While debentures used to hold great popularity earlier, they have become less common now a days. Through this study, we aim to analyse the companies issuing debentures and the investors investing in these debentures. The companies considered are- Dewan Housing and PNB Housing Finance (Housing Finance Industry), IL&FS Transportation Network and Shriram Transportation Network (Transport Industry), India Infoline Finance and Muthoot Finance (Banking and Finance Industry), Tata Communications and Reliance Communications (Telecom Industry), Oberoi Realty Ltd and Indiabulls (Real estate Industry). The main assumption is that the relationship established by both the companies would represent the industry pattern on a whole. The aim is to establish the industry in which debentures work best for the companies as well as the investors.

## II. LITERATURE REVIEW

1. If a firm is raising money by the way of debt, it is a very crucial decision, as it affects the entire firm and not just the debt of the firm. All the stakeholders are affected, and this decision is followed by a series of other decisions as well. "It is therefore puzzling that firms do not make advance arrangements to re-capitalize themselves if large losses occur." (Flannery, 2003)
2. In some cases, the companies might choose to issue redeemable debentures to their shareholders, instead of declaring dividend or issuing bonus shares. This can be done by the company for two major reasons- in order to raise debt capital, or when the company is unable to pay dividends or cannot accommodate a reduced share price. "This innovative technique has important implications for the capital structure of the company, the dividend policy and the agency relationship between managers and shareholders." (Yatin Bhagwat, 2001)
3. Usually, whenever a company issues debentures, the risk perception of the equity shareholders increases, as debenture holders have to be paid interest, before paying any amount to the other stakeholders of the company. As a result, the company has to increase the dividend payout ratio, in order to create a balance and retain its existing shareholders and keep them satisfied, even after the issue of debentures. (Premchand, 1989)
4. While this temporal categorization of financing behavior is important in analyzing the determinants of debt-equity mix, another classification of borrowing based on whether borrowing is secured or unsecured has received scant attention. (Majumdar, 2012)

5. We use both approaches to characterize and to compare the financial structures of Indian companies over time; between quoted and unquoted companies; and between companies which belong to a business group and those that do not. (Christopher J. Green, 2003)

### III. RESEARCH DESIGN

#### Statement of Problem

Debentures were used in previous times as a fixed income but investor friendly way of channelizing funds into useful sources. But due to new securities being issued by companies, debentures have lost their value and investors are less enticed to go for it. Through this study we aim to find out the reason the existing companies went with debentures- and also why other companies are still issuing debentures. This will also help us examine the impact debentures issue has on companies as well as its various stakeholders.

#### Sources of Data

We have primarily used secondary data from various journals and research papers along with statistical and financial data given by the company itself.

#### Objectives

- To analyze the role of debentures in various industries.
- The role debentures have on profitability of the companies and its existing stakeholders.
- To examine the reasons investors go for debentures in current times.

#### Hypothesis

H0 (Null hypothesis) Debentures do not impact the profitability of the company and the returns of the existing shareholders.

H1 (Alternate Hypothesis) Debentures have an impact on the profitability as well as shareholder perception and returns.

#### Data Analysis Tools

Companies	ICR	EPS(B)	EPS(A)	D/E	GP(%)	NP(%)	DEB INT(%)	AVG INT (%)
Muthoot Finance	2.42	29.56	43.04	2.41	76.22	27.91	9	7
IIFL Finance	TBA	6.42	TBA	0	99.83	128.71	10.5	7
PNB Housing	1.36	36.72	49.89	8.03	87.62	15.05	9.40	7
Dewan Housing	1.23	25	37.39	8.98	89.46	11.21	9.25	7
Shriram Transport	1.42	55.42	69.11	3.82	62.61	12.85	9.7	7
IL&FS Transport	1.20	7.19	7.65	3.38	56.44	7.11	8.9	7
Tata Comm	18.94	24.2	9.36	0.06	31.12	5.12	10.25	7
Reliance Comm	0	(7.2)	(38.22)	3	11.83	(442.40)	7.17	7
Oberoi Realty	230.71	9.29	12.28	0.2	64.99	42.82	9	7
Indiabulls	1.62	(0.42)	TBA	0.35	419.76	(23.98)	9.5	7

Abbreviations:

ICR: Interest Coverage Ratio

EPS(B): Earnings Per Share (Before debenture issue)

EPS(A): Earnings Per Share (After debenture issue)

D/E: Debt/ Equity

GP%: Gross Profit%

NP%: Net Profit %

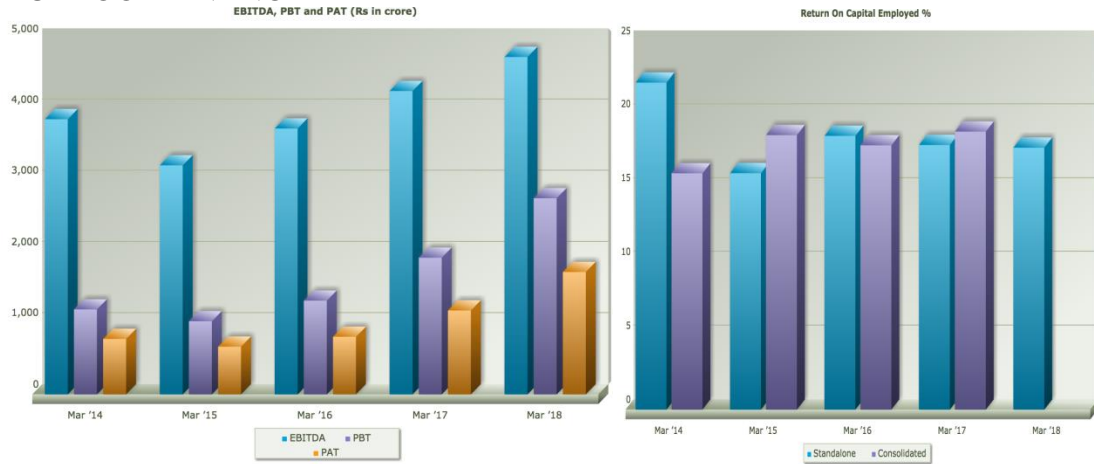
Deb Int%: Debenture Interest

Avg Int%: Average Market Interest Paid by Banks

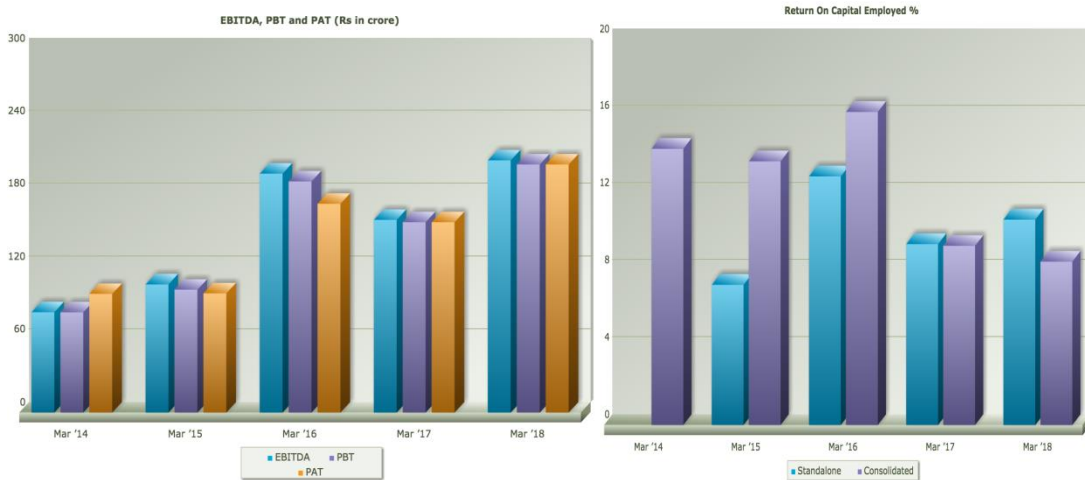
TBA: To Be Announced

The ratios have been taken from reliable online sources (moneycontrol) and company website for details relating to debenture interest and time of issue.

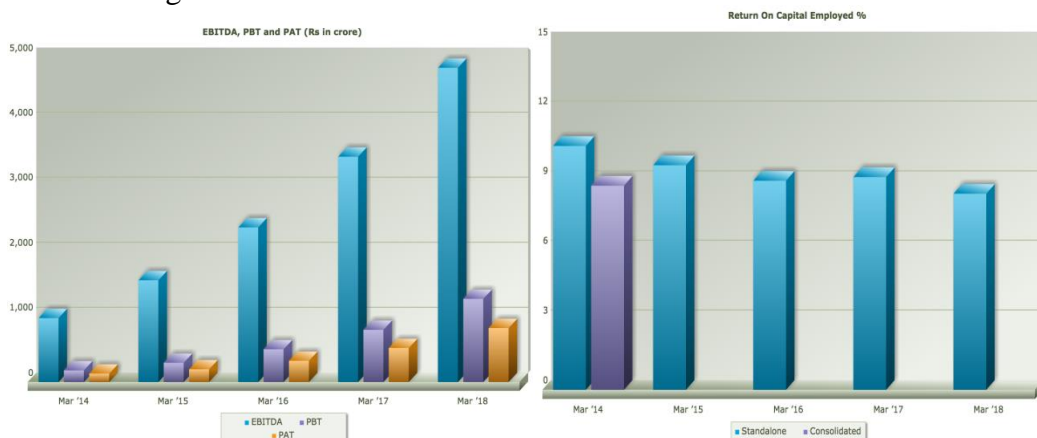
### MUTHOOT FINANCE



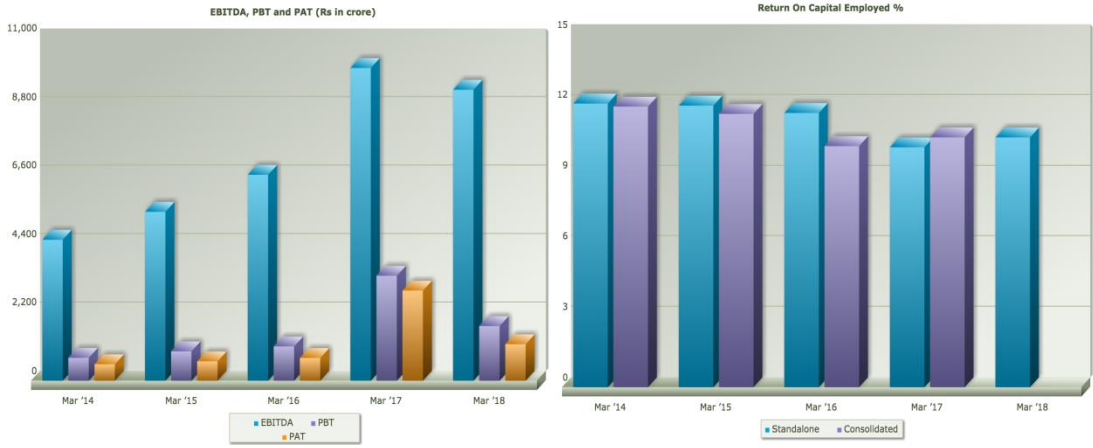
### INDIA INFOLINE FINANCE



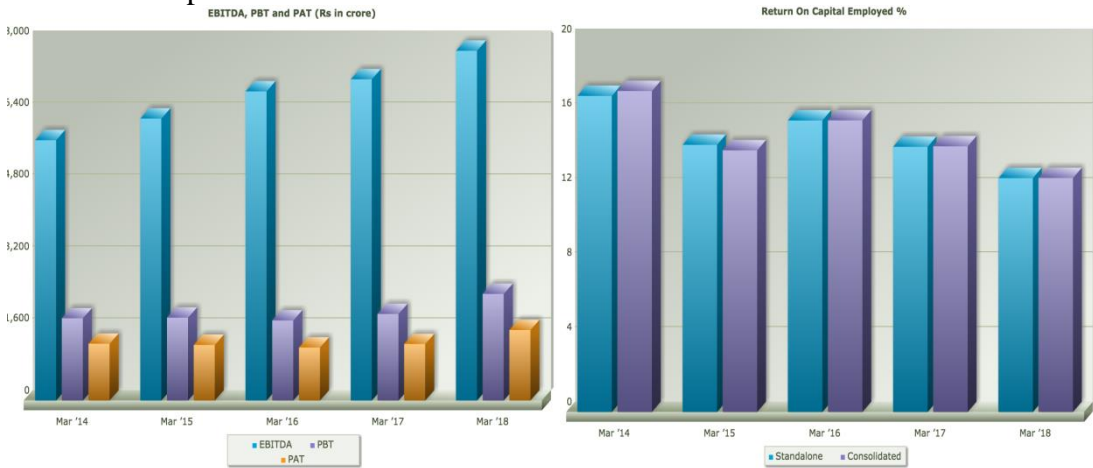
### PNB Housing



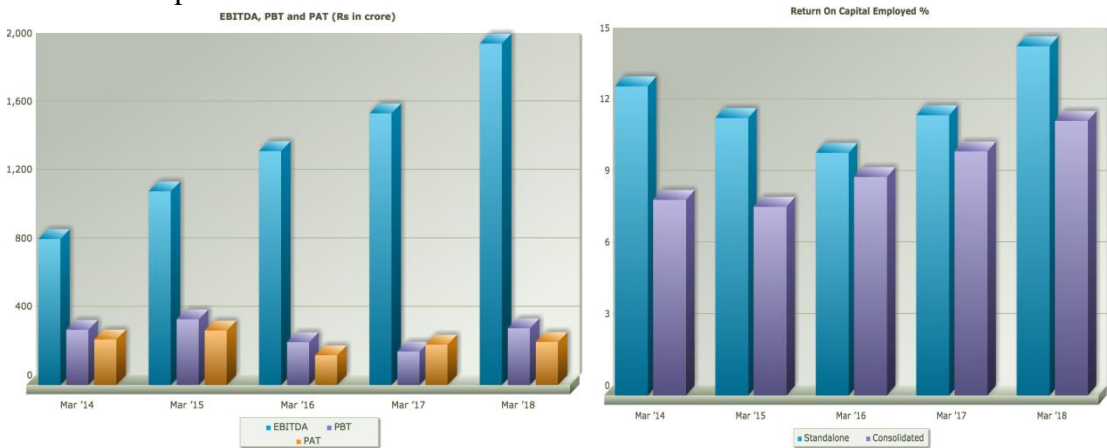
### Dewan Housing Finance



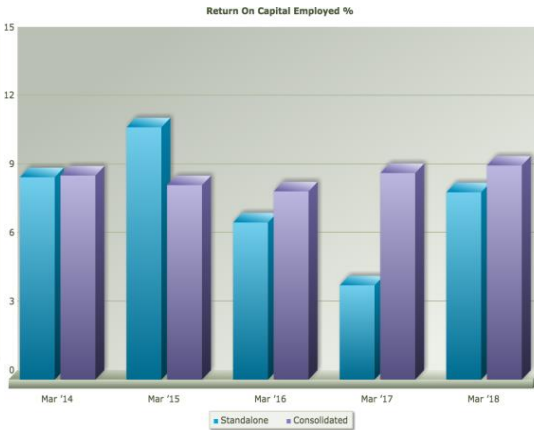
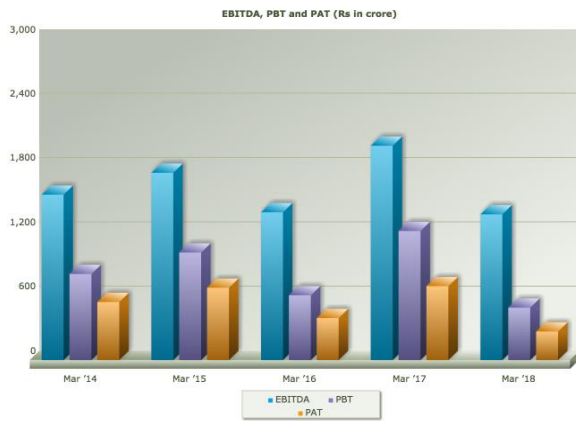
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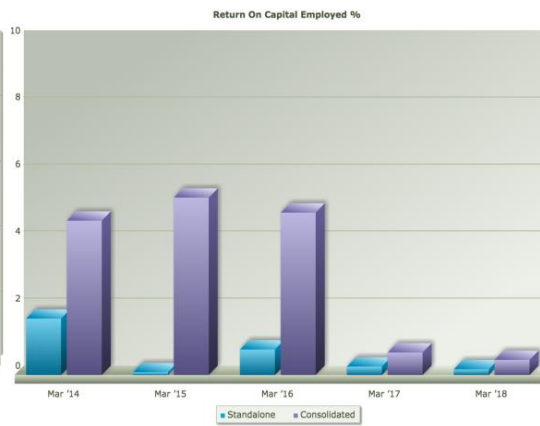
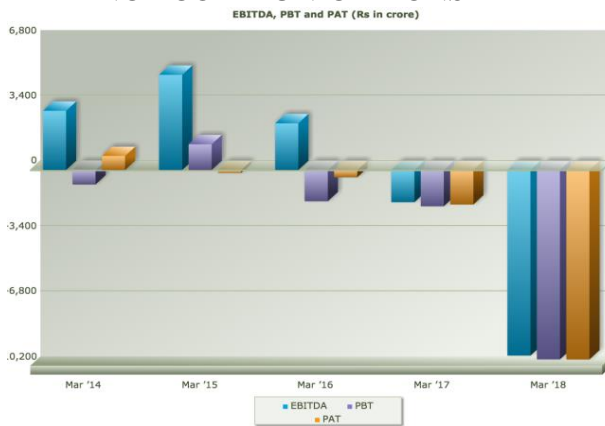
### IL&FS Transportation



### TATA COMMUNICATIONS



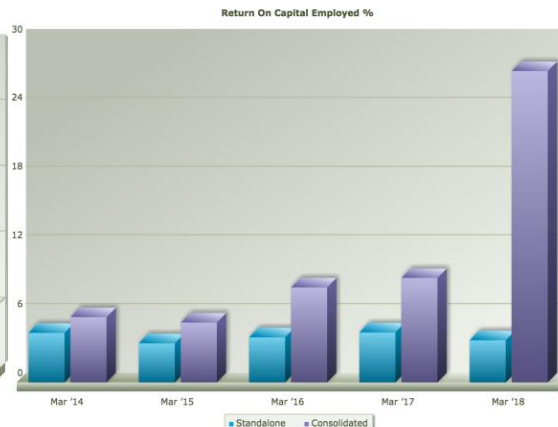
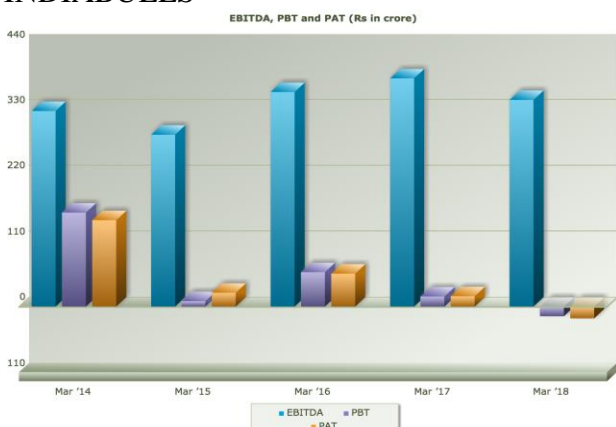
### RELIANCE COMMUNICATIONS



### OBEROI REALTY



### INDIABULLS



**Expected Outcome**

Debentures are one of the safest options for raising long term funds and they can also be converted at a later date. They are also a fixed income for the investor and as they can be converted later- they are more preferable than other bank securities. Also for the non convertible debentures- some investors like to be associated with certain big companies which shall then be beneficial for the company as well as the investors.

**Limitations**

- We can not take into account all companies issuing debentures as well as all the industries.
- The perception will also differ from investor to investor so we can only average it out.
- It is not possible to get primary data from every company and hence acts as a limitation.

**IV. DATA ANALYSIS AND INTERPRETATION**

\*The ideal Interest Coverage Ratio is considered to be between 2-3% and hence forms the base of the below analysis.

**INDUSTRY: FINANCE**

Companies: Muthoot Finance and India Infoline Finance

IIFL issued debentures after March 2018 because of which their EPS post debenture issue can not be estimated. Their dividend has steadily been increasing since March 2014 and hence is also expected to continue growing.

IIFL has a debt-equity ratio of 0 as its their first debenture issue; hence their gross profit and net profit ratio is better than Muthoot finance.

IIFL has lower profits, less number of shares, lower EPS and shareholders as compared with Muthoot Finance. Even with the lower profits the debenture interest paid by IIFL is higher than Muthoot. Muthoot Finance also shows an ideal interest coverage ratio of 2.42%.

**INDUSTRY: HOUSING FINANCE**

Companies: PNB Housing and Dewan Housing

The interest paid to debenture-holders by both companies is similar with PNB Housing paying a slightly higher interest. Both companies have a low interest coverage ratio as compared to the ideal ratio.

After issuing the debentures in March 2017 by PNB Housing their profits rose by almost 40% in the following financial year. Their dividend to shareholders increased from 60% to 90% to make sure shareholders are satisfied.

Both companies witnessed a rise in the EPS after the debenture issue but also have a very high debt-equity ratio. PNB on the other hand has issued debentures for the 8<sup>th</sup> time showing their appetite for risk. Their interest coverage ratio is also lower than the ideal standard.

It is observed that Dewan Housing's net profit percentage is lower as compared to their gross profit percentage which goes to say that a lot of their earnings are spent on interest payment.

Even though post the debenture issue the net profit almost tripled; their dividend payout ratio reduced from 80% to 40%.

**INDUSTRY: TRANSPORTATION**

Companies: IL&FS Transport and Shriram Transport

Both companies have an interest coverage ratio which is lesser than the ideal standard. Their EPS has witnessed a slight increase after the debenture issued previously and they have also issued debentures again in October 2018.

Their debt-equity ratio is higher than the ideal and also similar which goes on to say that this industry keeps a high debt equity ratio. Both companies have seen a significant reduction in the gross profit percentage as compared to the net profit percentage.

IL&FS is going through a turbulent time in the industry and is also not able to declare dividend whereas Shriram has a 100% dividend payout ratio from the past 5 years.

IL&FS has been downgraded by ICRA from A1+ to A4 and then BB which has declined their credibility in the market and brought their bond prices down.

**INDUSTRY: COMMUNICATIONS**

Companies: Reliance Communications and Tata Communications

Tata Communications has witnessed a decline in their net profits post the debenture issue and their dividend payout ratio has also reduced. Both companies have evidenced a significant fall in their EPS post the debenture issue.

Reliance has a 0 interest coverage ratio as they have been defaulting their interest payments since a long time and hence have no coverage whereas Tata Communications has a very high interest coverage ratio which reflect in their net profit to gross profit comparison.

Reliance has a positive gross profit percentage whereas its Net profit percentage is sinking beyond level to -442.40%- an all time low. They are also providing a very basic debenture interest value which is just above the bank rates and hence their debentures do not seem profitable.

**INDUSTRY: REAL ESTATE**

Companies: Indiabulls Real Estate and Oberoi Realty

Interest coverage ratio of Oberoi is 230.71 which is way beyond the ideal level with Indiabulls having just 1.62. Oberoi's EPS has increased whereas Indiabulls with its already negative EPS of -0.42 is expected to fall further with its net profit percentage in negative.

Oberoi after its debenture issue testimonied an increase in its EPS to 14.98 but then saw a drop to 9.45 but now it has again recovered to 12.28.

Both companies have a low debt-equity ratio as compared to standards. Indiabulls has a very high gross profit percentage and has a negative net profit percentage which goes to say that it has a high payment of interest which takes over all its earnings.

**I. FINDINGS AND SUGGESTION**

IL &FS are on troublesome waters with a high debt equity ratio and low net profit ratio. All of their earnings are going in paying off interest and hence going for debentures was not a good choice for them. Indiabulls has a very high gross profit ratio and a negative net profit ratio which shows how high their interest payment is and that they should develop or have other source of funds. Reliance Communications has no interest coverage ratio and has a negative net profit ratio of -442.28. This does not work well for the organisation as a whole and it has to get itself out as soon as possible. Debenture does not seem to be a wise choice for the companies in the housing finance industry as both are suffering major losses as compared to other industries. Also they give higher dividends to shareholders just to make sure they are satisfied and are not able to invest otherwise.

**II. CONCLUSION**

Investors have the perspective of getting maximum return possible and debentures as a whole don't seem to be something that gives a lot of returns; but there are investors who do not have the risk appetite as that of a younger person and hence want to invest in something with a good fixed income and these are the people that actually put their money in debentures. Different industries have different ways in which they perceive, view, act and react to market situations but in the end according to the industries taken and the analysis- the housing industry doesn't look like a good industry for debenture investment. Debenture issue decreases the Net Profit percentage as compared to the Gross profit percentage and as IIFL has issued for the first time- it has visibly higher Gross Profit percentage than other companies taken and mentioned in the table. Reliance on the other hand has a negative Gross profit percentage which is bad for any company and should be avoided or eradicated as soon as possible.

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