Debentures

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What are debentures?

- A type of unsecured debt instrument.
- **"Unsecured"** means that the debentures are only backed by the company's creditworthiness and reputation and not by physical assets or collateral.
    - As an example: A company issues a R100 million rand debenture and has R300 million assets in total. Should the issuing company not be able to repay the amount borrowed, the investor can lay claim on the remaining R200 million assets.
- They are usually long-term debt instruments issued by governments and companies, to raise funding.
- They are documented by an agreement called an **indenture**, this stipulates the general agreement between the company issuing the debenture and the investor buying the debenture.
- The indenture would usually specify the interest rate, maturity date, convertibility etc.

What are debentures?

- There are **2 types** of debentures:
- **Convertible debentures** - debentures which can be converted into shares at a specified date or during a period of time.
  - Convertible debentures usually have a lower interest rate compared to non- convertible debentures.

- **Non-convertible debentures –** debentures that are converted into equity shares of the debenture issuing company.
  - These typically carry higher interest rates than their cc counterparts.

How do debentures work?

- The company or government **issues a debenture**.
- An investor offers to **lend the funds** required by the company, to the company in return for interest rate payments at a specified interest rate and for a certain amount of time.
- The return to an investor can either be a **fixed or floating interest rate**.
- At maturity, or at the end of the agreed period, the issuer returns the money initially borrowed from the investor.
- The debenture can either be **held until maturity** (if applicable.)
- The investor can however sell or buy the debenture on the stock exchange through a stockbroker.
- The debenture can also be **converted into shares** at a pre-specified date on the indenture (if applicable).

The benefits of investing in debentures

- Debentures provide **higher rates** of financial return and are usually much more rewarding than government bonds or bank investments
- At the end of the lending period, issuing companies usually offer the choice of **converting the debentures** for shares (stock or equity)
- **Interest is paid** to investors whether or not the issuing company makes a profit or not.
- Debentures are **transferable** from investor to investor.
- The **cost of debt is lower** than the cost of equity or preference shares as interest is tax deductible.

Some things to consider when investing in debentures

- **Credit risk of the issuer:** By investing in a debenture, you are lending your money to a business, with all the risks that this involves.

- **The debt-equity ratio:** The investor should consider the ratio in which debt is used to finance projects and capital compared to that used for equity. If more debt is used to finance the company, the risk of default should be considered.

- **Liquidity of the company:** This refers to a company's ability to turn their assets into cash and how quickly.

How to invest in debentures?

- To buy or sell debentures on the Johannesburg Stock Exchange (JSE) you need to open a brokerage account with an accredited **stockbroker**;
- You can find a list of stockbrokers here.
- Through an IPO period that will typically be announced by the issuing company.

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