Debentures: Meaning, Types, Issue, and Redemption

1. Meaning of Debentures

A debenture is a long-term debt instrument used by companies to borrow funds from the public. It is like a loan taken by the company, but instead of borrowing from banks, the company borrows from investors.
A debenture is a written acknowledgment of debt issued under the common seal of the company.
It specifies the amount borrowed, the interest rate, repayment terms, and security (if any).
Debenture holders are creditors of the company and not shareholders.

Key Features:

1. Loan Instrument – Evidence of a loan taken by a company.
2. Fixed Rate of Interest – Interest is payable at a predetermined rate (e.g., 10% debenture).
3. Interest before Dividend – Interest is paid irrespective of profit, unlike dividends.
4. Priority of Payment – Debenture holders have priority over shareholders at the time of liquidation.
5. Security – Often secured against assets.
6. No Voting Rights – Debenture holders cannot vote in company meetings.

Example:
If a company issues 10,000 debentures of ₹100 each @ 12% interest, it means the company borrows ₹10,00,000 and will pay interest of ₹1,20,000 annually to debenture holders.

2. Types of Debentures

Debentures can be classified under different categories:

A. On the Basis of Security

1. Secured/Mortgage Debentures

Backed by a charge on the company's assets.
Holders can sell the charged assets if the company fails to repay.
Two types of charges:
Fixed Charge (on specific assets like land building).
Floating Charge (on general assets like stock, receivables).

2. Unsecured/Naked Debentures

No security attached.
Holders rely only on company's creditworthiness.

B. On the Basis of Convertibility

1. Convertible Debentures (CDs)

Can be converted into equity or preference shares after a fixed period.
Fully Convertible – Entire debenture converts into shares.
Partly Convertible – Only a part converts, rest is redeemed in cash.

2. Non-Convertible Debentures (NCDs)

Cannot be converted into shares.
Redeemed only in cash.

C. On the Basis of Redemption

1. Redeemable Debentures

Repaid after a fixed term or in installments.
Most common type today.

2. Irredeemable (Perpetual) Debentures

Not repayable during the lifetime of the company.
Redeemed only upon liquidation.
Now prohibited under Indian law.

D. On the Basis of Registration

1. Registered Debentures

Name and details of holders are entered in company's register.
Transfer requires proper transfer deed.

2. Bearer Debentures

Payable to whoever holds them (like currency notes).
Transferable by mere delivery.

E. On the Basis of Priority

1. First Debentures – Priority claim over assets.
2. Second Debentures – Claim only after first debentures are satisfied.

3. Issue of Debentures
Companies issue debentures to raise long-term finance.
A. Modes of Issue
1. At Par – Issued at face value (₹100 debenture issued at ₹100).
2. At Premium – Issued above face value (₹100 debenture issued at ₹110).
3. At Discount – Issued below face value (₹100 debenture issued at ₹95).
B. Consideration for Issue
1. For Cash – Most common method.
2. For Consideration Other than Cash – Issued to suppliers/vendors in exchange for assets.
Example: Debentures issued to acquire machinery.
3. As Collateral Security – Issued to lenders as additional security for loans.
C. Legal Provisions (Companies Act, 2013 & SEBI Guidelines)
Must be authorized by Articles of Association.
Prospectus/offer letter needed for public issue.
Creation of Debenture Trust Deed and appointment of a Debenture Trustee (for public issue).
Listed companies must follow SEBI regulations.
Certain companies must create Debenture Redemption Reserve (DRR).
D. Methods of Issue
1. Public Issue – Invitation to public via prospectus.
2. Private Placement – Direct issue to selected investors.
3. Rights Issue – Offered to existing shareholders.
4. Preferential Allotment – Issued to promoters or institutions at special terms.
4. Redemption of Debentures
Redemption means repayment of the principal amount to debenture holders.
Methods of Redemption
1. Lump Sum Payment
Entire amount repaid at maturity in one installment.
Example: 5-year debenture repaid in full at the end of 5 years.
2. By Installments (Draw of Lots)
Redeemed in parts over time by drawing lots.
3. Purchase in Open Market
Company buys back its own debentures if market price is low.
4. Conversion into Shares
Convertible debentures redeemed by converting into equity shares.
5. Sinking Fund Method
Company creates a fund by investing fixed amount annually.
At maturity, fund is used to redeem debentures.
6. Insurance Policy Method
Company takes insurance policy for redemption amount.
At maturity, insurance money is used for repayment.
Debenture Redemption Reserve (DRR)
A reserve created out of profits to safeguard debenture holders.
Acts as a cushion for repayment.
Required under Companies Act for certain companies (esp. public issues).
Priority at Redemption
Secured debenture holders have first claim over assets.
In liquidation, debenture holders are paid before shareholders.