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Redemption and Replacement of Bonded Indebtedness

By EDWIN J. ROCK

Borrowing money, whether as an individual or by a corporation, has one disagreeable feature—it has to be paid back. Worse still, if we are using it in our business we also have to plan how to provide or borrow more after the current debt is settled. One of the biggest and probably the most serious problem business men have to solve is the raising of adequate capital with which to carry on their business activities. Demand for additional capital requirements may arise from need for increased working capital, increased facilities or other manifold causes.

On the whole problem of raising and acquiring capital, redemption of indebtedness and replacement of capital represented thereby, much has been and will be written. Treatment of the whole subject in a single article or volume is impossible. However, if this article, which deals with some of the phases of the subject from the viewpoint of the board of directors of the debtor corporation, induces constructive thought on a few phases of this important problem it will have accomplished its purpose.

The intent is to deal primarily with the redemption of bonded or similar indebtedness, discussion of the best methods for accomplishing it and for replacement after maturity of the capital provided by the indebtedness.

Corporate bond issues, whether mere debentures or those secured by mortgage, cannot always be floated on ideally satisfactory terms to the debtor. Neither in some cases is the method of redemption left entirely to the option or initiative of the debtor. Banks and underwriting syndicates may stipulate various conditions in regard to method and time of redemption. The outline of methods and the discussion thereof which follows is based on the average manufacturing or trading corporation of medium size, which, after having been successful enough to survive for a number of years on original capital raised through sale of stock, has raised additional capital through sale of mortgage or debenture bonds or redeemable preferred stock. However, this does not preclude the methods discussed from being used to advantage, with variations to suit, in corporations of any kind or size.

When directors have successfully floated a bond issue they usually have more or less definite ideas as to how it will be paid off, but they seldom give much thought at that time to how the capital supplied through this medium will be replaced at maturity. Still, for any set of men guiding the activities of a corporation with its future existence and prosperity at heart, there is no better time than this to think, at least to some extent, of what method they will use to raise capital when the present issue matures. Will they borrow money again on a similar costly basis or, better still, will they during the life of the bonds provide to replace this capital with accumulated profits earned by the business?

There are four commonly used methods for redeeming outstanding indebtedness. Some provide merely for redemption, some for replacement and one for both. They can be designated briefly as follows:

1—Reserve method;
2—Ordinary sinking-fund method;
3—Continual redemption sinking-fund method;
4—Combined continual redemption sinking-fund and reserve for sinking-fund method.

The four methods are of course subject to variation in detail to fit particular business. Their general characteristics are given below:

Reserve Method

In the reserve method an appropriation is periodically set aside from surplus in a reserve account.

Advantages

It prevents payment of assets (cash) out of the business in dividends that should be used for redemption of debt.

It provides that the amount of profits so set aside shall be invested in the business where they will earn a higher rate of return than if invested in securities.

It provides for replacement of capital now provided through medium of the bonded indebtedness.

Disadvantages

It does not insure that cash will be available at date of payment. On long-term bond issues due at one date this, in the first few years after issue, is not as important as in short-term bonds or those with instalment maturities.

Ordinary Sinking-Fund Method

In this method an annuity is set aside out of cash, which, invested in securities and compounded at the effective rate of said securities, will be of sufficient amount at time of maturity of indebtedness to equal it.

Advantages

The only advantage of this method is that it provides that sufficient cash shall be on hand at maturity date so that working funds are not suddenly impaired. This in the first years of a long-term issue is of doubtful worth.

Disadvantages

The principle of investing a firm's assets in another business to pay off its own indebtedness is a poor one.

The money was borrowed to produce income through the medium of the borrower's business. This method prevents an ever-increasing portion of it from so doing because it deliberately places the money in another business. Investing the sinking fund in the obligations of corporations or municipalities is equivalent to this.

If a company has to invest its capital in another business to enable it to produce income enough to pay interest on its own obligations, the natural inference is that it is in the wrong business.

The lender who induces the borrower to agree to a sinking fund of this nature with the express stipulation that it be invested in "good" securities has this exact point in mind, as the division of the money lent between two or more private corporations lessens his risk. Again, if it is stipulated that the fund be invested in the obligations of federal or other political divisions his risk is lessened to even a greater extent with a further restriction on the earning power of the money placed in the fund.

This method makes no provision for replacement of the capital represented by the bond issue. If earnings are good in spite of the setting aside of working capital in the sinking fund, but the surplus is kept at a nominal figure through the payment of large dividends and no new stock is sold, it will mean that after maturity a new bond issue must be floated to provide necessary capital.

Continual Redemption Sinking-Fund Method

The continual redemption sinking-fund method provides for setting aside out of cash a fund which is used to purchase, usually in the open market, the company's own obligations.

Advantages

At first glance this method is similar to method No. 2 with one variation. However, it is this variation which gives this method any advantages it possesses over the second method.

It is particularly advantageous if instalment maturities have to be considered and where premiums are to be paid at maturity.

It accomplishes what the second method does in having ready cash available but goes further, inasmuch as it utilizes the cash immediately by purchasing the company's own obligations, thereby simultaneously reducing its indebtedness.

Disadvantages

The direct result of this method is to reduce liabilities by reducing assets. No business can grow on this basis. If bonded obligations are incurred it is usually to increase facilities in order to increase production or directly to increase working capital. Unless some other factor is working to replace this capital it cannot be paid out of assets without detriment to the business. The disadvantage discussed in method two—viz., taking money out of working capital—applies to some extent here.

Combined Continual Redemption Sinking-Fund and Reserve for Sinking-Fund Method

The fourth method has two phases:

(a) Setting aside an annuity out of cash in a sinking fund, which, invested in the company's own obligations, gradually redeems them;

(b) Setting aside out of surplus in a reserve for sinking fund an amount equivalent to the annuity placed in the sinking fund.

Interest on bonds paid by the company into its own sinking fund are added to the fund and credited to the reserve for sinking fund.

This method or combination of methods, in the writer's opinion, is subject to less criticism than any of the others. It contains the best characteristics of all of them and eliminates most of their disadvantages.

It may be said to be ambitious, as it lays down a large programme, but if followed it not only accomplishes all the results described as desirable in the methods previously discussed, but goes much further inasmuch as it provides a definite plan of action for the time when the bond issue matures.

Economically and as a good business proposition to the stockholders they should some day themselves provide the capital they are now borrowing. Whether after they do this it may be necessary to borrow more for further expansion or not has no effect on the case in point. This method provides a gradual redemption of outstanding obligations and the gradual accumulation of sufficient profit in a reserve to replace the original indebtedness at maturity.

As soon as periodical payments of cash are made to the sinking fund they are used to purchase or redeem the company's own obligations. This is usually done in the open market, but under certain conditions negotiations can be conducted directly with the holders.

As these payments into the fund are made an appropriation of equal amount is made from surplus into reserve for sinking fund. This insures that payments out of working capital to the sinking fund are permanently replaced by accretions to some class of assets. It is a retention of profits in the business and the reserve is part of the equity of the holders of the common stock. It increases in the same proportion that the bonded indebtedness decreases, which is another way of saying that the common stockholders are leaving part of their share of the profits in the business to replace that portion of the loan that has been paid.

When interest is paid on the bonds the portion payable on those bonds which have been purchased is put into the sinking fund and credited to the reserve for sinking fund. Therefore the two accounts increase at exactly the same rate.

At maturity of the indebtedness the reserve for sinking fund is placed back in surplus. A stock dividend can then be declared. This means that the owners of the corporation have paid off the money borrowed and replaced it with their own, which in my humble opinion is as it should be.

The one disadvantage—if it may be called that—of the last method lies in its completeness. It is not complicated or intricate but in some phases it provides for a plan of action which is not to be executed for some years. All sorts of conditions might arise that would make execution impossible. Nevertheless, this possibility considered to the full does not prevent carrying out the plan as far as possible nor imply in the least that its principles are unsound.