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ARTICLE SERIES

# UNDERSTANDING DEBT CAPITAL MARKET TRANSACTION STRUCTURING: A PRACTICAL APPROACH


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Capital is the lifeblood of every corporate organization. Every company needs capital to run its operations and achieve its corporate goals efficiently. There are typically three types of capital a company can raise: debt capital, equity capital, and hybrid capital (which is a mix of debt and equity capital). A company can raise equity capital by issuing shares. In contrast, debt capital can typically be raised via the capital market or as a loan from its shareholders (Shareholders' loan) or banks (traditional bank lending). Each capital raise option comes with its merits and demerits. For example, while shares issuance may dilute the ownership interest of the existing shareholders, the company is not required to repay the money (as in the case of a loan) because the company's success is also that of its shareholders. Shareholders are entitled to profit distribution in the form of dividends. Conversely, debt will not dilute the existing shareholders' interest but may leave the company highly leveraged and unable to satisfy its repayment obligations. Based on this, a company must always determine what option best serves its purpose.

There are several ways a company can raise capital via the capital market. They include but are not limited to bond issuance (typically for a tenor above three years), notes issuance (typically for a tenor less than three years but above one year), or issuance of commercial paper (about 270 days (less than one year)). When structuring a debt capital market transaction, there are vital things to look out for, and I have identified some of them in this article.

## CORPORATE AUTHORIZATION

It must be ascertained that the company raising the capital (issuer) has the proper authorizations. These authorizations are usually in the form of resolutions of the shareholders and board of directors approving the capital raise. The transaction may be structured as a programme under which the capital can be raised in such tranches/series and on such terms as the directors may approve. It can also be structured as a one-off issuance (discreet issue), which means the capital can only be raised once as a standalone issuance. Where it is structured as a programme, the shareholders usually pass a resolution establishing the programme and empowering the directors to determine the method and terms for raising the capital. The directors, on the other hand, will then pass a board resolution approving each series of issuance. Establishing a programme makes subsequent series easier for the issuer and professional parties, as the primary transaction documents will already be in place. All that needs to be drafted is the series trust deed and possibly a vending agreement.

## DIRECT OR INDIRECT CAPITAL RAISE

Another consideration is whether the company intends to raise the capital directly or through a special purpose vehicle (SPV). The Securities and Exchange Commission (SEC) regulates capital raises by public companies and sub-nationals via the capital market.

To avoid this supervision and regulation, public companies tend to set up a private company SPV to issue the debt instrument indirectly for them. Most state governments use this approach to raise funds from the capital market to develop government-owned projects. This way, it becomes a private company issuance. Companies (including private companies) may decide to raise capital through an SPV for several reasons, such as:

- to avoid full recourse to the originator/sponsor (the company/entity that needs the money);
- to keep the debt off the originator's balance sheet;
- to avoid supervision by the regulators of the originator's industry;
- in transaction structures where specific assets are carved out and transferred to the SPV, with the intention of using such assets to secure the debt; and
- in sharia-compliant structures where an SPV must own the underlying asset on behalf of the Sukuk holders.

When the SPV finally raises the capital, it may be directly utilized at the SPV level to undertake the relevant project or activity; or transferred to the originator/sponsor via an asset purchase, receivables purchase, or loan (typically intercompany loan). The originator can also receive the capital as payment for a service to be rendered to the SPV. It can also be structured so that the originator will issue debt instruments while the SPV will apply the capital in subscribing to such instruments. Upon receiving repayments from the originator, the SPV will repay its investors.

## INTEREST BEARING OR ZERO COUPON

Another thing to consider is whether the instrument to be issued will be interest-bearing or discounted (that is, zero coupon). Where it is discounted, the investors/noteholders pay a discounted fee for the instrument, and upon maturity, they get the face value of the instrument. The implied yield is the difference between the invested sum and the face value received upon maturity. Zero coupon notes suit the investment appetite of most ethical investors (specifically investors that adhere to shariah principles) since it does not involve payment of interest.

## REPAYMENT SOURCE

The repayment source of the debt is another essential thing to consider when structuring a capital market transaction. The borrower's cash flow or specific receivables is often applied toward the loan repayment. For receivables, a collection account is usually established to receive all of such receivables and from which a debt service account/sinking fund will be funded. The debt service account is the account from which the investors will be repaid. The borrower is typically appointed as the servicer to coordinate the collection of the receivables and ensure they are deposited directly into the collection account. Where the borrower's cash flow is the intended repayment source, lenders prefer to create a charge over all the borrower's accounts and ensure that the borrower does not create another bank account without their consent.

That way, the risk of diversion of cash flow is reduced. For subnational debt instruments, the repayment source is usually the state's internally generated revenue or the state's share of the federal allocation.

## INSTRUMENT RATING

Most debt instruments are typically rated, and the rating assigned to them usually strengthens the confidence of the investors where they are highly rated. In rating an instrument, the debt portfolio of the borrower/issuer, its creditworthiness, the repayment source of the loan, corporate authorizations, security structure/credit enhancement, and the issuer's track record (and/or guarantor/sponsor), amongst others are taken into consideration. AAA-rated instruments tend to be purchased more by investors than their lower-rated counterparts.

## LISTING/NOTING

Determining whether the instrument will be listed on an exchange or traded over the counter is essential. Where an instrument is listed, it becomes very marketable and more liquid, as it can be easily sold and transferred. For corporate debt instruments (e.g., corporate bonds), it is important to note that only public companies can list such instruments. Since such may amount to offering an instrument or sourcing funds from the public, However, private companies can have their debt instruments noted on the private market portal of the Financial Markets Dealers Quotations(FMDQ).

To be able to note on the FMDQ private market portal, the issuer must comply with the Private Companies Securities Noting Guidelines of the FMDQ.

## DEMATERIALIZED/PHYSICAL FORM

Recently, the practice has been to issue certificates evidencing ownership of the subscribed debt instrument in dematerialized form rather than a physical certificate. Dematerialization simply means to have the instrument in the digitalized form to prevent loss, wear, and tear that may arise with a paper certificate. The central securities depository (CSD) account of the investor with the Central Securities Clearing System (CSCS) or FMDQ Depository Limited is usually credited with the number of instruments such an investor purchases.

## SECURITY STRUCTURE AND DOCUMENTATION

The security structure of the transaction will determine the type and number of security documents to be drafted for the transaction. Where all the assets of the borrower/issuer will be used to secure the loan, then an all-asset debenture is drafted. Where a different party or the sponsor provides security, a 3rd party legal mortgage may be drafted. The overall structure of the transaction will determine the number of documents to be drafted. Still, the key documents remain the programme trust deed, series trust deed ( if applicable), the security document, and the vending agreement.

For commercial papers, the documents are usually the dealer agreement, deed of covenant, deed of guarantee, issuing, calculation and paying agency agreement, custodian agreement and collateral management agreement, among others.

## PROFESSIONAL PARTIES AND PARTICIPANTS

Several professional parties are involved in debt capital market transactions to ensure a smooth issuance process. They include but are not limited to the arranger/issuing house, the rating agency, auditors, solicitor to the issuer, solicitor to the issue, solicitor to the trustee, the trustee, and guarantee companies (if applicable). Other participants are the issuer, sponsor, guarantors, the exchange, the SEC, and institutional investors.

## CONCLUSION

A company seeking to raise capital from the capital market has to consider the above-stated information to determine the most effective structure that suits its objective. A lawyer with a good understanding of the market and regulatory framework must ensure good structuring and regulatory compliance. For further information or clarification, please contact the author.

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