All you need to know about:

Capital Structure: Gearing and Split Capital Funds

Companies need money to fund their activities and to do this they use a mix of permanent capital in the form of shares (Equity) and borrowed money (Debt).

Investment companies and investment trusts have the ability to borrow money and issue different types of shares. Often the objective in doing this is to enhance, "gear up" or "leverage", the return earned by the ordinary shareholders.

In this guide we explain workings and the benefits and pitfalls of various capital structures.

All about: Ordinary shares

The simplest companies just have ordinary shares and no debt

The simplest companies have just one type (or class) of share, usually called ordinary shares, and no debt. The owners of these ordinary shares are entitled to receive a share of the profits that the company makes and so can receive income in the form of dividends. If the owners decide to wind up the company, the company's assets (after paying all the debt it owes) are distributed amongst the ordinary shareholders. The ordinary shareholders tend to call the shots. While the Directors run the company on a day-to-day basis, most really big decisions affecting the company will need the approval of the ordinary shareholders.

Non-voting shares

A dwindling number of companies have both voting and non-voting shares. Non-voting shares get all the risks and rewards of owning shares in the company but have little or no say in the way it is run.

Restricted voting shares

A few companies have restricted voting shares – the way these work can differ from company to company. It might be that they have a fraction of a vote compared to an ordinary share or that they can only vote on certain matters.

Treasury shares

Companies can shrink themselves by buying back shares, subject to certain conditions. These shares can be cancelled or, if shareholders have approved it, held in Treasury. Treasury shares have no votes and are not entitled to dividends but they can be reissued and that process is much simpler than creating brand new shares.

All about: Borrowing money

Companies borrow, aiming to enhance returns

The most common way that companies alter their capital structure is by borrowing money. For an investment company the appeal of borrowing money to invest is that, as long as you earn more than the cost of paying the interest, you can boost the return earned by shareholders.

Loan structure

Companies can borrow from a variety of sources including banks. Bank lending can come via a revolving credit facility that allows the borrower to decide, within limits, how much to borrow and when to make repayments or as a term loan where the loan amortises (is paid off gradually over the life

of the loan), has predefined repayment dates or is paid back on one fixed day in the future (also called a Bullet repayment).

Secured or unsecured

Lenders may ask that the loan is secured on a specific asset or assets so that, if the company can't pay back the loan or the interest, they can get their money back by selling the asset. To get their money back on an unsecured loan however, they might request that the company is put into liquidation (selling off all the company's assets to repay its debts).

SPVs and non-recourse debt

For a company looking to borrow money, one way of arranging your capital structure to suit secured lending is to set up special purpose vehicles or SPVs owned by the main company to hold certain assets and then have the SPVs borrow money secured against those assets. This debt may be non-recourse to the main company – that means that if the SPV can't pay its debts, the lender has no right to come after the main company for the money.

Covenants

As a way of protecting themselves, lenders sometimes insert covenants into the terms of the debt. These can be triggers for an early repayment of the debt, a higher rate of interest or some other penalty.

Loan to Value

Interest Cover

Covenants typically look at how indebted the company is using measures of Loan-to-Value (the size of all the company's debts relative to the value of its assets) or the company's ability to pay its debts using interest cover ratios (the relationship between the company's interest bill and its earnings) but can also include any other factor the lender thinks is important (such as stipulating that the key personnel in the company stay working in the business).

Bonds

As an alternative to bank finance the company can issue a bond (sometimes also referred to as a debenture or loan stock). Although bond issues can be sold to one buyer, they are an easy way for a company to raise finance from multiple sources.

Trading in debt

Although some loan agreements might stipulate that the debt cannot be assigned to anyone else (can't be traded), it is usually possible for lenders to sell on the loans they have made. This is true even of bank loans (and there are some funds that buy loans the banks have made) but it is easier in the case of bond issues – these can even be listed on a stock exchange.

The value of debt to the buyer and seller depends chiefly on: the relationship between the interest rate (sometimes called coupon) on the debt and the market interest rate (as represented by LIBOR, central bank base rates or more usually a government bond with a similar maturity; the time to maturity; and the perceived riskiness of the debt – how likely it is that the borrower will not pay the interest and/or repay the debt (credit risk).

Multi-currency

Most companies will borrow in their home currency but they don't have to and some investment companies will make an asset allocation decision to borrow in a foreign currency as a way of offsetting the currency exposure they have in their portfolio.

Some companies borrow money in a foreign currency without having assets in that country to support that debt. This can be a risky strategy as changes in exchange rates could make the value of the debt in the company's home currency rise.

Fixed or floating interest

Typically companies pay floating rates of interest on the money they borrow (i.e. the interest rate changes with reference to market rates of interest – many rates are linked to LIBOR or central bank base rates). When they

believe that interest rates might rise however, investment companies may choose to fix the cost of their borrowings. As the market rate of interest moves in relation to this fixed borrowing cost, there is an impact on the fund's net asset value (to factor in the cost of repaying the debt early). We explain how this works in All you need to know about : NAVs but to reiterate:

Market value of debt

People who lend companies money at fixed interest rates can generally rely on a predictable level of income until the loan is repaid. They could sell the debt on to someone else but, if the market rate of interest has changed since they lent the money, the debt is more (if interest rates have fallen) or less (if interest rates have risen) valuable in the eyes of the buyer. The fair value of the debt is simply its value if you adjust the value of the debt so that a buyer would be earning the market rate of interest.

For example, say I lend £100 for a year at a fixed 10% interest rate, then say the market rate of interest immediately halves to 5%. If I now sell the loan, a buyer is going to get £110 from owning my loan compared to £105 for making a loan in the open market. My loan is worth more to the buyer so he or she should pay me more. The price he should pay is 110/105 = £104.76.

Seniority

Companies may borrow from more than one source and, as we'll come to in a second, issue other classes of shares in addition to ordinary shares. One of the critical things to think about when analysing a company's capital structure is seniority – where each type of borrowing and class of shares ranks when it comes to receiving a share of income or getting paid in the event that the company is being liquidated. The higher up the ranking you are, the safer your investment. For that reason interest rates on senior ranking loans tend to be lower that interest rates on junior ranking loans. Ordinary shares tend to rank at the bottom of any capital structure.

All about: Other classes of share capital

Preference shares

Companies may issue preference shares. These issues have most of the characteristics of a bond – the capital must be repaid on a predefined date and they tend to generate a predetermined rate of income for holders. They tend to rank above the ordinary shareholders both in terms of the right to receive income and the right to be repaid in a liquidation.

Warrants and subscription shares

Companies may issue warrants or subscription shares. These give the holder the right but not the obligation to buy ordinary shares at a pre-determined price (the strike price or exercise price) on a given date or within a range of dates.

The value of warrants and subscription shares varies in relation to the price of the ordinary shares and the length of time left to exercise them. Each month QuotedData publishes some basic information on the warrants and subscription shares that have been issued by investment companies.

Convertibles

Some other classes of capital are convertible into ordinary shares at a predetermined conversion price on a certain date or within a range of dates. Convertible bonds and convertible preference shares take on some of the characteristics of bonds and preference shares and some of the characteristics of warrants. This can make them complicated to value but, simplistically, they can be thought of as like a bond when the ordinary share price is less than the conversion price and like a warrant when the ordinary share price is higher than the conversion price. If, at the maturity date, the ordinary share price is less than the conversion price, holders of the

convertible will get paid back the amount borrowed. If the ordinary share price is higher, holders of the convertible will convert into the ordinary shares.

All about: Split Capital companies

Split capital companies try to take advantage of the flexibility of capital structures to create new investment opportunities for investors with different risk and reward characteristics than ordinary shares.

Zero dividend preference shares

The most common type of split capital company is one that includes zero dividend preference shares (zeros or ZDPs) within its capital structure. Zeros are shares that will be redeemed at a fixed price at some defined point in the future (provided that sufficient assets are available). Their entitlement to the assets of the company rises in a straight line between their entitlement on issue and their redemption value. They are not entitled to receive dividends. They rank ahead of the ordinary shares in the event of a liquidation.

Gross redemption yield (GRY)

It is possible to calculate a gross redemption yield or GRY – by annualising the total interest cost. ZDPs are usually priced by reference to their GRY. Companies publish a cover ratio – how many times the assets exceed the final cost of the zero. A low cover ratio represents a riskier investment and investors usually demand a higher GRY for a low cover ratio, they will also want to be paid more for an issue invested in volatile assets (as there is a higher chance that the assets will not cover the zero when it matures).

Income and capital shares

Some other split capital companies have two types of share – income shares and capital shares. The idea is that the income shareholders get all or most of the income and the capital shareholders get all or most of the assets. The income shares may be worthless in the event of a liquidation or they may get back a fixed capital entitlement.

Geared ordinary shares

Geared ordinary shares, also called ordinary income shares, get a dividend and what is left of the assets in the event of a liquidation.

Package units

Combinations of the various classes of share capital (i.e. all the bits of the capital structure apart from the debt) are put together to form package units. Package units give you the same effective exposure as you would have had if the company had only issued ordinary shares.