Chapter 16

BONDS

INTRODUCTION

Bonds are long term debt instruments. Generally, the creditworthiness of the company issuing a bond is all that stands between the investor and the loss of their investment. Bond rating agencies provide information on issuer creditworthiness and this information bears on how much interest an issuer will have to pay to attract investors. Unlike venture capitalists or equity investors who may have one or more seats on a company's board of directors or a bank which has extensive covenants and on-going reporting requirements that they use to manage risk, bondholders have very limited control once they make an investment. In addition, bonds generally have limited upside potential if a company prospers, but bondholders can lose everything if a company collapses and since bonds tie up invested capital for years or even decades it is easy to see why bonds have a unique risk / reward profile.

This chapter discusses the general features of bonds and the motivation that a company has to sell bonds or an investor to buy them. This will include a discussion of bond ratings and other ways that buyers evaluate risk as well as how bonds can be made more attractive by adding features that reduce risk or increase the potential reward for investors. Junk bonds and how they differ from ordinary corporate bonds will be discussed as well as bond valuation, premiums and discounts, bond underwriting, the secondary market in bonds and legal considerations when using bonds.

GENERAL CHARACTERISTICS OF BONDS

Bonds are means for a company to raise capital without giving up equity. This feature alone makes them a highly attractive source of capital. But there are other benefits as well. Interest on bonds is tax deductible, which means that the tax code subsidizes the cost of interest.[1] Bonds are usually a means of permanent, that is, long term financing. Ten, twenty or thirty year bonds are not uncommon. Contrast this to banks which rarely extend term loans beyond five to seven years. Bonds are subject to less ongoing monitoring than bank loans. Whereas bank covenants monitored monthly can trigger acceleration of a loan, generally bond indenture agreements provide little pre-maturity relief as long as the debt is being properly serviced. Proper service means that interest and sinking fund payments are being made timely. A sinking fund is a fund into which a company makes regular payments so that when the bond matures there will be enough money set aside to repay bondholders. Not all bond indenture agreements require sinking funds.

Bonds pay interest twice a year. The amount of the interest payment is equal half the coupon rate times the face value of the bond to reflect the fact that half the interest is paid every six months. Unlike bank interest rates which generally float up and down as the prime rate or LIBOR (London Interbank Offer Rate) change, bond interest rates remain fixed over the life of the bond. For companies with good credit, bonds generally have lower interest rates than bank loans. For companies with marginal credit, high yield bonds, also as junk bonds, may provide an alternative to banks afraid to lend but interest is likely to be higher than bank rates.

RISK MINIMAZATION

When a person buys a corporate bond, he or she can only look to the corporation for payment. The higher the risk that investors perceive in any particular investment, the greater the reward he or she will demand to compensate for that risk. Here we run into the problem of asymmetric information. Bond issuers know more about their company and its creditworthiness than bond buyers. To be "safe" bond buyers assume a worst case risk scenario and set the required reward to match that estimated level of risk. The strategy from the issuers' perspective is to provide purchasers with a realistic assessment of the risk so that buyers do not indulge their natural tendency to overstate it. One way to provide accurate risk information is to have bonds rated by independent agencies.