Why Do Companies Issue Bonds?

Advantages and Disadvantages of Issuing Bonds

At some point in a company's life, it will need to generate funds to finance major projects or plant expansion. There are a few methods of financing these projects - notes payable, leasing and the issuance of bonds or common shares.

The first two methods, unfortunately, may not generate large sums of money, as they involve finding individuals, companies or financial institutions who are willing to supply the needed funds.

Large amounts of long-term capital (sums that won't have to be repaid quickly) are more readily available through the issuance of bonds or common shares. As seen previously, selling shares will allow investors a certain measure of control over the corporate activities, in the form of votes. This may not be in the best interest of the corporation. Bonds are a form of interest-bearing note payable (long-term liabilities where you borrow money from investors and promise to repay the capital and add interest).

They have the following advantages:

• Shareholder control is not affected, as bondholders do not have voting rights. Therefore, existing shareholders retain full control of the company.
• Tax savings will result, as bond interest is deductible for income tax purposes. Dividends are not.
• Earnings per share may be higher, as the dividends paid will not be diluted further by additional shares. Therefore, each share retains its earning per share ratio.

Note that there are disadvantages to issuing bonds:

• Interest must be paid on a periodic basis.
• The principal (face value) will have to be repaid upon maturity of the bond. By comparison, common shareholders are not promised dividends on a regular basis, and their investment does not have to be repaid at any time.

Types of Bonds

Secured and Unsecured:
Secured bonds have specific assets assigned to them as collateral. Unsecured or debenture bonds are issued against the general credit of the company. Therefore, these are used by companies with a good credit rating.

Term and Serial:
When bonds mature at a single, specified date, they are know as term bonds. Serial
bonds will mature in installments, so the principal will be payable to the bearer over a number of payments.

Registered and Bearer:
Bonds issued in the name of the bearer are registered bonds. Bearer bonds are transferable and become the property of the bearer at the time.

Convertible:
Bondholders may want to convert their bonds to company shares at a later date if they believe the company is going to do well. In that case, they would want to purchase convertible bonds.

Redeemable/Retractable:
Redeemable or callable bonds can be retired (repaid) for a stated dollar amount prior to their maturity, at the option of the issuer. Retractable bonds can be redeemed any time before maturity, at the option of the bondholder.

How are bonds issued?
When a Corporation issues bonds, the Board of Directors must state the number of bonds to be authorized, the total face value and the contractual interest rate.

The face value is the amount of principal the issuer must pay at maturity date.

The contractual interest rate is the rate stated on the bond certificate.

When bonds are issued, a bond indenture document is prepared. This states:

• the terms of the bond issue
• a summary of the rights of the bondholders and their trustees
• the obligations of the issuing company
• Once the bond indenture is prepared, the bond certificates are printed.

How are bonds traded?

Bonds are generally sold through investment companies specializing in debt securities. Corporate bonds are traded on organized securities exchanges. Therefore, bondholders have the opportunity to convert their bonds into cash at any time, just as shareholders could sell their shares.

How to determine the market value of bonds

When deciding if an investor should purchase bonds, one should consider the current market value of the bond, the interest rate being paid over the period to maturity, and the amount of time until maturity of the bond.

Price In The Market
... the factor that influences a bond more than any other is the level of prevailing interest rates in the economy. When interest rates rise, the prices of bonds in the market fall, thereby raising the yield of the older bonds and bringing them into line with newer bonds being issued with higher coupons. When interest rates fall, the prices of bonds in the market rise, thereby lowering the yield of the older bonds and bringing them into line with newer bonds being issued with lower coupons.