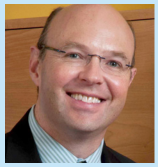
previously published in 2004 in
Calculated Statements,
The Business Journal



Nigel Roberts, MBA, CFA **is the president of Bluenose Investment Management Inc.** Bluenose provides comprehensive investment counselling and portfolio management services to individuals and institutions. For other articles visit **www.bimi.ca**
To contact Nigel, call 250-548-3232 or email: nroberts@bimi.ca

Back to Basics Series: **Bonds** (part 1 of 2)

Just as many homebuyers borrow money by taking out a mortgage to buy a house, government and companies borrow money to fund capital needs such as roads, buildings and machinery as well as to finance deficits. One of the ways in which a government or company can raise capital is by issuing a bond.

A bond is a debt that the borrower is promising to repay at a specified future time, called the maturity date, with specified interest payments. Most bonds pay interest twice per year, once on the anniversary of its maturity date and again six months later.

The bond market plays an integral role in funding corporate Canada. Statistics Canada reports that in 2003 corporations had net new bond issues of $32.4 billion compared with $12.7 billion of preferred and common stock issues. A similar pattern can be seen over the past 5 years, when the net new issuance of corporate bonds was $167 billion compared with $85 billion for preferred and common stock issues. These numbers show that, on average, bond issues have been used to raise twice as much capital as preferred and common stock issues.

Bond issuers vary in credit quality, that is, some issuers are very likely to pay all the interest payments and principal at maturity while others could run into financial difficulty, preventing them from meeting their obligations.

There are credit rating agencies that analyze the credit quality of bond issuers and assign a rating to each bond. The rating is based on a set of criteria that primarily relate to the ability of the bond issuer to meet its obligations. The Dominion Bond Rating Service (DBRS) for example has a rating scale that is AAA, AA, A, BBB, BB, B, CCC, CC, C and D. Using this rating scale, Canadian federal government debt carries the highest rating (AAA) while provincial government debt ranges from AAA to A. Corporate debt can fall anywhere in the range. The term "investment grade" is used to refer to debt that is rated BBB or higher. Debt rated below BBB is considered to have at least some speculative element or is currently in default (ie. not paying interest or repaying principal upon maturity).

Most bonds are marketable, that is, they are transferable and therefore can be traded in the secondary market. This means that the original purchaser, as well as any subsequent owners of the bond, can resell the bond. One exception is Canada Savings Bonds that are sold directly by the federal government to the owner and are not transferable and therefore not marketable. Canada Savings Bonds are unique in that they may be cashed in at any time at their face value with accrued interest.

Most smaller businesses make use of debt in their business through demand loans, term loans or private placements where the terms are negotiated directly with a lender. Issuing marketable bonds is a major undertaking that requires meeting many of the same requirements as those of a publicly traded stock. This can include developing an initial offering prospectus and filing audited financial statements. As the initial and on-going cost of issuing marketable debt can be considerable, it is only cost effective for amounts greater than $5 million. In addition, most investors require newly issued debt to be of investment grade quality.

Corporations often prefer to issue bonds rather than equity to increase their financial leverage. As long as a company is profitable, return on equity increases as the amount of debt increases. More profits will accrue to the shareholders as long as the company uses the money to buy assets that generate a higher rate of return than the interest cost of the debt. To understand how financial leverage works, consider how a home can be financed. Suppose that a house is purchased for $100,000 and sold one year later for $110,000. If the house was financed with all equity, then the return on equity is 10% ($10,000 / $100,000). If however, only $20,000 was financed with equity and the remaining balance of $80,000 was debt at a 5% interest rate, then the return on equity increases to 30% ($10,000 minus interest cost of $4,000 divided by the $20,000 in equity). Similarly, in cases of unprofitable ventures the losses are magnified. For businesses, debt is even more attractive because it is tax-deductible which makes the return on equity even higher.

There can be many other reasons that companies will choose to issue bonds including:

- a lack of demand in the capital markets for new equity issues
- a perceived low share price making issuing equity unattractive
- greater flexibility since it is often easier to retire debt than it is to buy back equity
- to take advantage of low cost capital by issuing debt in low interest rate environments
- to access investors who are willing to lend money for medium to long-term time horizons (5 years and longer). Commercial lenders, such as banks, have a typical maximum time horizon of 5 years.

The concluding section of this article to be published in the next issue will discuss how bonds are traded and how changes in interest rates affect their price.