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**CORPORATE BONDS AS A SOURCE
OF FUNDS IN THE CZECH INDUSTRY**

Liběna TETŘEVOVÁ¹ and Eva HÁVOVÁ
Department of Economy and Management of Chemical and Food Industry,
University of Pardubice, CZ-532 10 Pardubice

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The article deals with problems of corporate bonds as a source of funds of the Czech industrial firms. Corporate bonds represent a long-term external source of funds. First the term corporate bond is explained and then a short characteristic of corporate bonds and finally their advantages and disadvantages are mentioned. Attention is paid to a process of decision which type of corporate bonds to choose, how to realize their issuing and what are the costs of issue. The financial structure of the Czech firms only seldom contains the corporate bonds, which has several reasons. These reasons are on the side of demand for capital which is represented by issuers and also on the side of supply of capital created by investors. The reasons for low utilization of the corporate bonds and feasibility of their larger utilization are mentioned at the end of the article.

¹ To whom correspondence should be addressed.

Introduction

Industrial firms in the Czech Republic are still facing a lack of sources of funds to realize their business aims. This lack is evident in the sphere of the long-term sources of funds. Many of the firms create or develop their place in the market and so they need to invest capital in a long-term period to cover their investment activities. One of the long-term sources of funds which could help to solve this problem is corporate bonds. In spite of their obvious advantages they have not spread among Czech industrial firms.

The corporate bonds are a common instrument in the world. They can be used to finance developing activities of prosperous firms but they also represent one of the instruments of restructuralization. There are many firms which could use issues of the corporate bonds for the first or the second reason in the Czech Republic.

Long-term Financial Decision and Long-term Sources of Funds

A firm's prosperity and successful development in difficult conditions of market economy require to realize business projects which ensure developing strategy of the firm. Finance and economics play significant role in creating and realization of the firm's investment activities.

The target of every financial manager is to get enough sources of funds in optimal financial structure for financing effective investment projects. A task of *long-term financial decision making* is to decide on a total volume, structure and use of sources of funds which finance firm's investment activities. Selection of the effective investment projects is the task of investment decision making. Resulting effects of financial and investment decision influence the process of long-term financial planing.

Our attention is paid to the financing of corporations. Corporations represent important form of business organization in the Czech Republic. They can use the widest range of the sources of funds. (Fig. 1 shows *long-term sources of funds* that can be used by Czech corporations.) Besides, the corporations issue bonds most frequently.

When financial managers choose from the sources of funds, they have to take into consideration the costs of capital and also other items such as the character and the situation of the firm (for example branch of business, structure of assets, volume and stability of earning, control of the firm, etc.).

Nowadays the choice of the sources of funds by managers of the Czech corporations remains mainly the theory of hierarchical order when the firms prefer internal sources and when they have to use external sources, they apply for bank loans and lease. If they cannot use these forms of capital, they issue corporate bonds and then stocks [1].

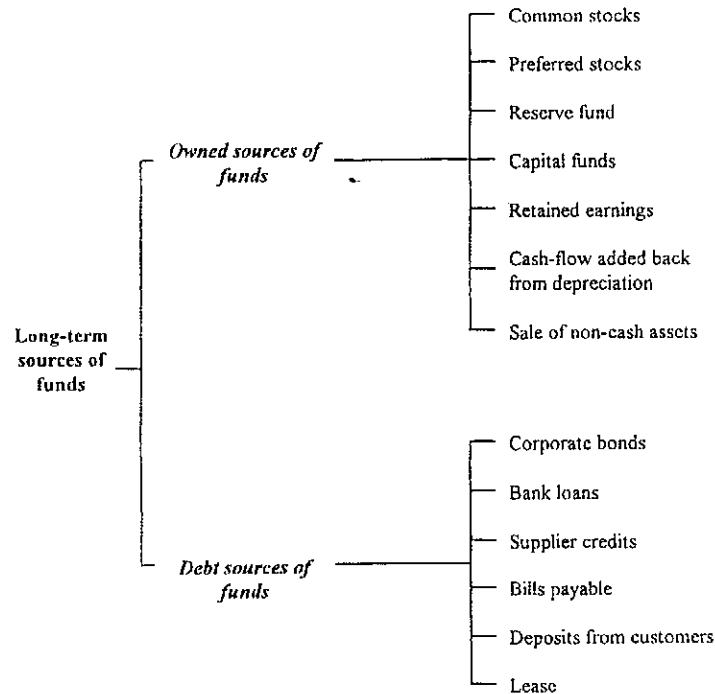


Fig. 1 Long-term sources of funds

When Czech corporate financial managers decide on the type of financing of developing activities, they submit for consideration a possible form of financing from internal sources (first of all retained earnings and cash flow added back from depreciation), then from external sources of funds (mainly bank loans, lease, supplier credits, issuing of corporate bonds and stocks).

Internal sources of funds are usually insufficient to finance investment activities and so it is necessary to get some external sources of funds. The extensive type of debt financing is bank loans. This fact is caused by conservative view of our financial managers and also by advantages of bank loans – flexibility, individual conditions, absence of the costs of issue. Lease and supplier credits represent alternatives to bank loans but these sources of funds are purpose-made limited and they also have other disadvantages. Another alternative creates issuing of stocks but at present this form is not so much used in the Czech Republic, which is probably caused by higher costs of capital and by the fact that issuing of common stocks increases the control of the firm.

Corporate Bonds as a Source of Funds

Corporate bonds represent one of the alternative sources of funds – a long-term external source of funds.

The Term – Corporate Bonds

Corporate bonds represent long-term, wholesale issuing, marketable, debt securities, issued by business units. They claim the obligation of the issuer to pay interest payments and principal to the bondholders on specific dates.

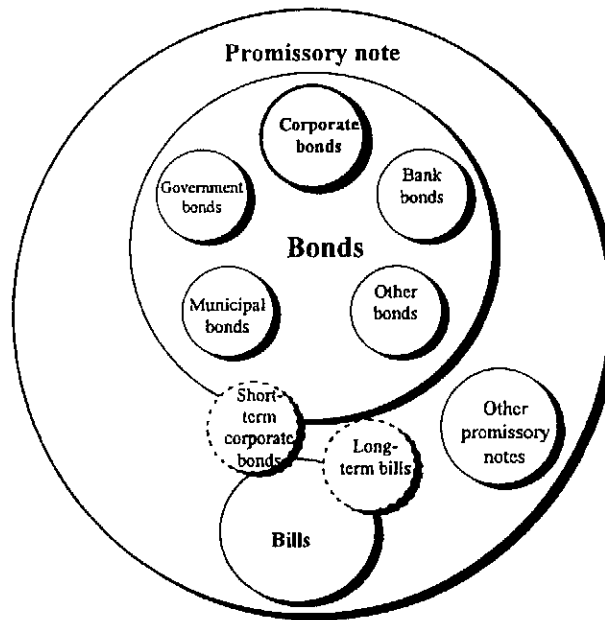


Fig. 2 Corporate bonds and other promissory notes

Some authors confuse the term bond and the term promissory note and bill. Figure 2 explains relationships among these terms. We can summarize the following: corporate bonds represent the type of promissory notes together with bills and other specific forms of promissory notes. The main difference between a corporate bond and a bill is in the number of issued securities (bills are issued individually), the certain distinction is also in maturity (bills usually have shorter maturity than bonds).

Short Characteristic of Corporate Bonds

Corporate bonds are usually issued by large, financially stable firms. They can be issued either as definitive or as book-entry ones. Corporate bonds are connected with payments of interest and with the principal on specific dates. They do not give the right to control the firm but they can be joined with some restrictive conditions. It is not common in the Czech Republic to use a security. They can either be placed on the public market or not. They can be issued in domestic or foreign currencies and they can be placed on domestic or foreign capital market. Owners (investors) can be from home country or a foreign one. We are interested especially in domestic corporate bonds.

Figure 3 gives other characteristics of the corporate bonds.

Advantages and Disadvantages of Corporate Bonds

The corporate bonds as a source of funds are connected with many *benefits*, for example:

1. The corporate bonds provide higher flexibility in capital structure.
2. Interest payments are tax deductible.
3. Stockholders do not lose control over the firm.
4. Many investors provide capital and that is why the issuer does not depend on only one or several creditors.
5. The issuing does not require security.
6. The issuing of the corporate bonds represents a prestige affair that can lead to better relationships with public and to new business partners.

The issuing of the corporate bonds is connected with some *drawbacks*:

1. Interest and principal payment obligations are set by a contract and must be paid, regardless of the economic position of the firm.
2. The issuing of bonds leads to higher financial risk.
3. The issuing is connected with high costs of issue.

Decision on Corporate Bond Issue

Advantages and disadvantages of the corporate bonds must be taken into account during the making of the decision on corporate bonds financing.

So you have to appreciate single alternative sources of funds from qualitative and quantitative points of view.

Within the framework of *qualitative point of view* you have to consider their

advantages and disadvantages. You have to concentrate on the ownership and control of the firm, life and maturity of the source, obligation to provide return, tax status of payment by the firm.

Within the framework of *quantitative point of view* costs of capital are dominant. Net present value of capital and internal rate of return of capital belong among the criteria of effectiveness of finance you have to appreciate above all.

Decision on issuing of the corporate bonds is influenced by:

- a) decision on the character of issue,
- b) decision on the realization of issuing.

Decision on the Character of Issue

When you consider the issuing of corporate bonds, you have to take into account characteristics of each of type of the corporate bonds and their benefits and drawbacks.

Figure 3 represents the basic characterization of the type of corporate bonds.

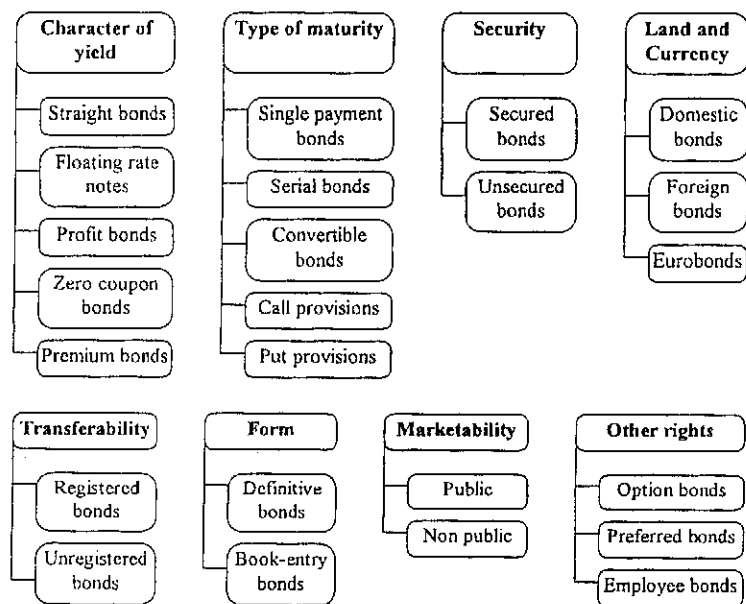


Fig. 3 Type of corporate bonds

You could also think of issuing of innovated type of the corporate bonds – for example cap floating rate notes, floor floating rate notes, minimax floating rate

notes, partly paid bonds, etc. [2]

You have also to decide on the number and the character of investors, principal, volume and life of issue and coupon rate.

During the appreciating of bond issue we have to consider [3]:

- costs of issue,
- how to use the obtained money,
- returns from gained sources (divided into single years of bond life),
- how to ensure amortization at the end of the bond life.

Decision and Direction of Issuing

The process of decision – taking and control of the issuing are also very important. The issuer has to make decision on using of an intermediary, on the range of its services and he has to choose the most convenient subject. The issuing of corporate bonds is time and money consuming and requires good knowledge of law and situation on the capital market. And that is why most financial managers prefer issuing organized by intermediators.

The issuing of corporate bonds involves managing of many activities either with or without an intermediary. The difference between these two types of issuing is in person who will realize all the activities.

First it is necessary to prepare the issue. This step includes formation of financial project, rating of issuer and preparing of documentation. The character of the documents will depend on marketability of the corporate bonds.

In case of book-entry corporate bonds, it is further necessary to make registration at the Center of Securities. In case of definitive bonds, it is necessary to ensure their printing.

Public corporate bonds usually enter stock exchange. Public marketability rises an interest of investors and supports confidence in these securities.

The corporate bonds can be placed on domestic market, foreign market or to chosen clients.

Placement is not the final activity of this process. During the life of the issue other activities are necessary, e. g. activities connected with payment of interest and par value.

The whole process of issue is connected with considerable costs which can be divided into costs of issuing (e.g. costs connected with preparation, licence, registration, publicity and placement of issue) and costs of life (interest payments, issuing disagio, premiums, charges connected with payments of interest and par value) – Fig. 4 [4].

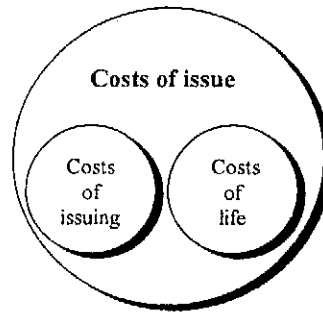


Fig. 4 Costs of issue

Conclusion

In most developed industrial countries predominant sources of investment projects are internal sources of funds. In case of external sources of funds, bank loans prevail in the most countries and issuing of bonds and stocks in U. S. A..

Owned sources of funds and then bank loans and lease as debt sources predominate in the Czech Republic. The issuing of corporate bonds is very little used. Many factors which have influenced the behavior of issuers and investors, have caused this situation. Reasons that cause the situation include:

- insufficient legislature and tax system;
- distrust of investors;
- absence of information;
- apprehension of placement;
- costs of issue;
- license mechanism;
- economic situation of our country and individual firms;
- lack of investment projects.

Lately the number of issues of the corporate bonds has slowly been rising and variability of issue is enlarging. Some issuers issue corporate bonds in several tranches which differ especially in maturity and coupon rates. There are also other rights, e.g. call provisions.

The expected changes in legislature, which will create standard international conditions and harmonize our legislature with the legislature of European Union, can help larger using of corporate bonds as a source of funds by the Czech firms. Besides the activities of the Commission for Securities lead to develop and protection of capital market. The Prague Stock Exchange tries to support new primary issues, too.

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