CLIENT NOTE

BONDS AS AN ALTERNATIVE TO BANK LENDING

RAISING FUNDS THROUGH BONDS

Traditionally, the Armenian financial markets have been "bank-centric". This means that businesses mainly lean on banks for their financing needs. While over the past years, we see in an increase in alternative financing in the Armenian economy, the levels are far from being satisfactory. In this client note we try to explain the various types of bonds and the tax advantages under the Armenian Tax Code, with the hope of encouraging more bond issuances in the Armenian markets.

To raise finances, a company may also issue what is known as debt securities, such as bonds.

A bond is an instrument issued by the company that attracts a **principal amount** (also known as the **issue price**) from the investor for a certain period of time, known as the **maturity period**, with the promise of the issuing company to pay a **fixed income** over the maturity period of the bond. The income that the bondholder expects to receive over the maturity period is known as the **coupon rate**. So, if a bond has a face value of AMD 100,000 with a coupon rate of 4% paid annually, the investor knows that she will receive an income of AMD 4,000 for each year she holds the bond until maturity. Therefore, one can say that by purchasing a company-issued bond, the buyer is basically lending funds to the issuing company.

While a bond is known to be a fixed income instrument, the rate may be fixed, such as in the example above, or variable (also known as variable or adjustable). The peculiarity of a variable interest rate bond is that its interest rate may change over the bond's maturity because it may be tied to a particular benchmark or index, such as the Central Bank of Armenia's refinancing rate, LIBOR, the U.S. Federal Reserve Rate, or even inflation. Two factors mainly determine the coupon rate of the bond. The first is the issuer's creditworthiness, and the second is the bond's maturity period. The longer this period is, the higher the coupon rate will usually be.

Typically, a company will issue bonds to attract funds from the public and use the collected funds to make investments, such as purchasing machinery or raw materials, building production facilities, conducting research and development, or financing operating expenditures, such as hiring employees.

TYPES OF BONDS

While the financial markets constantly innovate and develop new sophisticated instruments, few mainstream bond types exist.

Convertible bonds

Convertible bonds allow the bondholders to convert the bonds into equity when certain conditions are met, such as the price of the company's shares hitting a specific price trigger or the company's valuation passing a certain threshold. Usually, convertible bonds will have a lower coupon rate than the rate without the convertibility option. This is because this bond type will give the bondholder the advantage of turning the loan into equity and becoming a company shareholder. On the other hand, it is also beneficial for the issuing company, which can raise funds at a cheaper rate until its shares hit a higher valuation threshold.

Callable bonds

Bond issuers may issue callable bonds that allow them to "call" or redeem those prematurely. The question one should ask is when the issuer would want to call the bond. The answer is when the issuer can refinance its debt owed to bondholders, which happens when either (i) interest rates in the markets drop or (ii) the issuer's creditworthiness improves.

Normally, a callable bond will have a lower value than a non-callable bond because the bondholders know that the issuer will not lose the chance to refinance its debt and issue bonds at a lower coupon rate. That is why callable bonds are comparatively disadvantageous for bondholders.

Puttable bonds

Puttable bonds are the opposite of callable bonds, as they give the bondholder the option to "put" or sell back the bond to the issuer before maturity. Conversely, puttable bonds are known to be more beneficial to bondholders, as they have the peace of mind that they can get rid of the bonds when the interest rates rise. For this reason, puttable bonds normally trade at a higher value in the markets.

Zero-coupon bonds

Zero-coupon bonds do not have a coupon rate embedded into them. Instead, they are sold at a discount from the face value of the bond. For example, a company may issue zero-coupon bonds at a face value of AMD 100,000, but the investor would pay only AMD 90,000 for those bonds. If the bondholder waits until maturity and presents the bond for redemption at the maturity date, she will receive the face value of AMD 100,000, and her profit would be the difference of AMD 10,000. Of course, such as coupon-bonds, zero-coupon bonds can also be traded in the open market or privately.

Tax advantages for investing in corporate bonds

Under Armenian tax law, income derived by individuals from corporate bonds that are publicly listed on the stock exchange is nontaxable unless those bonds are issued by banks and have a maturity of less than two years.

CONCLUSION

To conclude, we would like to summarize the advantages that the issuance of bonds may provide to the issuer. Those we believe are:

- Opportunity to raise unsecured financing.
- Ability to raise significantly larger amounts of finances.
- Ability to negotiate a better deal with banks for future financing.
- Ability to adjust financing-related costs to the market.
- Prominent presence in the financial markets.
- Better debt refinancing options.
- Way to attract new and diversified investors.
- Paving the road for a public equity offering.
- Possible opportunities to get subsidies or better rates on specialty financing instruments such as green bonds.

HOW CAN WE HELP?

Our team has extensive experience in helping businesses with issuing fixed-income instruments. So please, do get in touch when you want to get sophisticated and tailored advice.

#bonds #fixedincome #alternativefinance #debtinstruments

NOTE: This material is for general information only and is not intended to provide legal advice

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