

Memo to the board

Finance



Memo to the Board Companies have different options available when seeking the sources for arrangement of finance for their expansion purposes. One source is raising equity through either the private placements or through an Initial public offering on any stock exchange. However, companies also issue bonds to generate the required funds to finance their expansion.

Payment of Interest on Bonds

Bonds are generally issued with periodic interest payments and the repayment of principal amount at the maturity. However, there are also bonds which pay no interest and are also being sold in the market. Such bonds are called zero coupon bonds and they are sold at the discount i. e. lower than their face value. A zero coupon bond is bought or issued at the price lower than the face value and the actual face value of the bond is paid at the maturity of the bond. As such the difference between the value paid on maturity and the actual purchase price of the bond is considered as the interest payments. (Mobius, 2012)

The overall proceeds received from the zero coupon bonds therefore are less than the total face value of the bond and the interest is not paid during the currency of the bond. Rather a full or bullet payment is made at the end of the maturity period to the holder of the bond.

Proceeds of the bonds

In case of bonds issued with face value of \$100, 000 and rate of interest is 10%, for 10 years, the overall proceeds of the bond issued will be equal to \$38, 554/.

Tenor

Face Value

Interest rate

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Total Proceeds

10

\$ 100, 000. 00

10%

\$ 38, 554. 33

For other bonds which interest payments after 5 years, the overall proceeds will be equal to the face value of the bond i. e. \$100, 000/ because at the time of issue, no discount is offered. The only instance where total proceeds received are less than the face value is when the bonds are sold as zero coupon bonds as the same are paid. Similarly, for any bond paying the annual interest, the proceeds will be equal to the face value of the bond. (Veronesi, 2010)

Factors to be considered when deciding upon interest payments

There are different factors which a company needs to take into consideration when deciding upon the interest payments and other terms of the bond issue. One of the key assumptions to be made while setting up the interest terms is the growth assumption in revenue. Since bonds are normally issued to incur capital expenditure therefore it is assumed with the new funds, firms will be increasing their capacity and thus revenue will increase. Based upon the expectations of an increase in revenue and cash flows, firm decides to set the payment terms.

Apart from this, the firm's overall credit ratings, the securitization of bond issue as well as the position of the firm in industry and market are also other important considerations. A firm with high overall credit ratings would be paying low interest rates and vice versa. (Wilson & Fabozzi , 1995)

References

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Mobius, M. (2012). Bonds: An Introduction to the Core Concepts. Washington: John Wiley & Sons.

Veronesi, P. (2010). Fixed Income Securities: Valuation, Risk, and Risk Management. Washington: John Wiley & Sons.

Wilson, R. C., & Fabozzi, F. (1995). Corporate Bonds: Structure and Analysis. New York: John Wiley & Sons.