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BOND ISSUANCE TOOL KIT

FOR EMERGING MARKET CORPORATE ISSUERS

This publication was produced for review by the United States Agency for International Development.
It was prepared by Emerging Markets Group, Ltd.



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Submitted by:
Emerging Markets Group, Ltd.

In association with:
NewLine Advisors, LLC

Submitted to:
USAID

Submitted on:
July 8, 2005

Contract No.:
PCE-I-00-99-00008-00

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OBJECTIVES

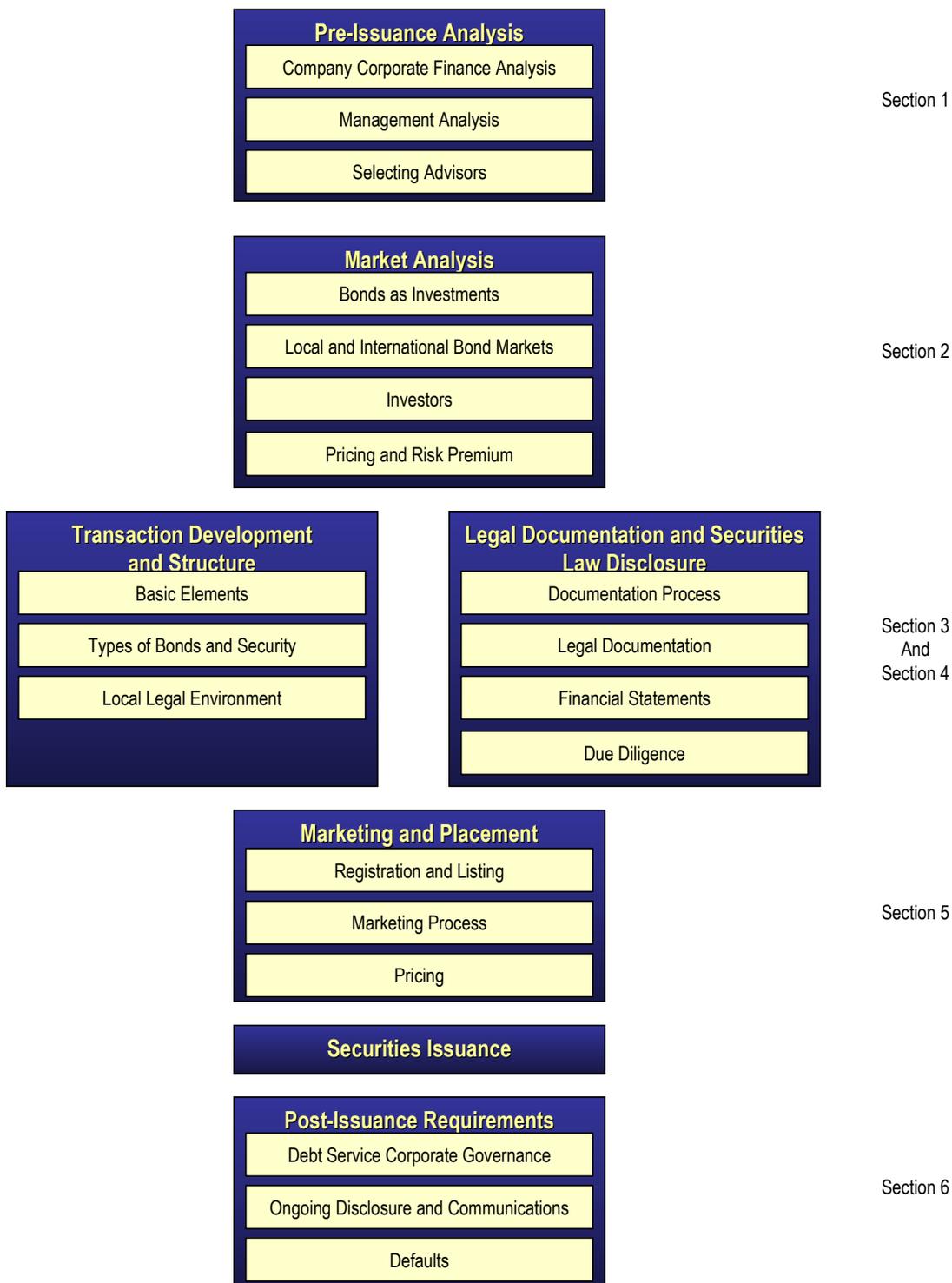
The purpose of this Tool Kit is to set out detailed best practice guidelines on common procedures, key issues and components of bond issuance and to highlight special considerations that are likely to arise in emerging markets. In particular it provides:

- Assistance to potential issuers, advisors, and market participants in understanding fundamental concepts in debt issuance, with special emphasis on the importance of corporate finance analysis and planning at a company level
- Practical examples from emerging markets
- Guidance on international best practices
- Links to references and resources

The Tool Kit is further designed to facilitate the transfer of knowledge to market operators to assist towards building sustainable capacity for debt issuance. Secondly, the Tool Kit may be used to help lay the groundwork for better understanding how debt market practices can be harmonized in the Central and Eastern European region and for sharpening understanding of what tools are needed to help issuers and intermediaries develop debt issuance.



STEPS TO DEBT ISSUANCE





SECTION I — PREPARATION: PRE-ISSUANCE COMPANY ANALYSIS



Pre-Issuance Analysis

Company Corporate Finance Analysis

- ✓ What are the company's funding needs?
- ✓ What is its current and optimal future capital structure?
- ✓ What sources of funds are available?
 - What do they cost?
 - What are the terms of each source?
 - How do those terms and costs fit with the company's business?

Management Analysis

- ✓ Does the company have the resources, or the commitment to build the resources necessary, to issue and service bonds?
 - Staffing expertise and availability
 - MIS and IT
 - A philosophical commitment to ongoing debt services and disclosure

Selecting Advisors

- ✓ What types of advisors will the company need to issue bonds?
- ✓ What firms provide this advice?
- ✓ How should the company select advisors?
- ✓ How much will advice cost and what are the terms?
- ✓ How should a company manage and work with its advisors?



SECTION I — PREPARATION: PRE-ISSUANCE COMPANY ANALYSIS

This section lays out the steps a company that is considering issuing bonds should take to determine whether bond financing is an appropriate means to meet its funding needs. It starts with the definition of a bond and continues with a general overview of how a company might conduct an analysis of its overall capital structure, including the most appropriate and cost effective ways of raising additional capital. It outlines the demands that bond issuance may place on management capacity. It ends with a summary of the roles of advisors in bond issuance and aspects management may want to consider in selecting and working with advisors. It is intended to be of use first, to companies considering bond issuance, and second, to policy makers and market participants seeking background information about corporate decision-making and the business activities of certain fixed income capital markets participants.

Definition of a Bond

A bond is a contract to pay interest and repay principal. It is both a financial instrument and a legal obligation enforceable in court. When bonds are sold, the market assesses the risk that the company issuing bonds will fail to make those payments and prices the bonds according to that perceived risk. Investors and market participants analyze the issue and the ability of the issuer to repay carefully and look especially closely at new issuers. Risks that cannot be eliminated or minimized by legal, structural or other procedures will be priced into the issue. The cost to the issuer of the financing—as reflected in the bond’s yield at issuance—will reflect the market’s perception of the bond’s risk, as well as country, region and currency risk, where applicable. Regulators, legal systems and market forces are imperfect, so pricing does not always accurately reflect a financial instrument’s true risk profile.

In determining whether or not to enter the fixed income market and issue bonds, a company’s management must make a series of decisions, often made in conjunction with external financial and legal advisors, about the financial and strategic position and goals of its business in the context of the legal, regulatory, political, economic and market environment in which it operates. A bond issuer will want to try to reduce the cost of issuing debt by making decisions that reassure the market of its creditworthiness.

Corporate Finance Analysis

The *first step* that a company considering issuing bonds should undertake is a careful and detailed analysis of the company’s financing needs and its present capital structure within the framework of its short-, medium- and longer term business strategy.

In the *second step*, a company will then want to assess the sources of funds available to it, how much those funds cost and whether their characteristics are appropriate to the company’s financing needs. This analysis should take into account the company’s stage in the business life cycle (a start-up will have different alternatives and make different choices than a large publicly traded company); its growth potential; the external factors that will affect the financing; and the impact various alternatives and choices may have on the company’s finances and business. The analysis may be undertaken internally, usually by the treasury or finance department, or may be conducted by or with the assistance of the company’s external financial advisors and bankers.

In the *third step*, the company should select external financial advisors, as necessary to execute its chosen financial structure. In most cases, a bond offering will require the use of external advisors.

ANALYSIS OF A COMPANY’S FINANCING NEEDS AND CAPITAL STRUCTURE

The management of the capital structure of a company is a repetitive cycle involving:



-
- Estimates of a company's total external funding needs and how these requirements will change or vary over time
 - Organization of these external capital requirements into broad categories: long-term, short-term and contingency funding
 - Development of funding plans: how, from where, and when to obtain the required funds: by issuing equity or by some form of borrowing (debt financing)

The estimate of a company's future funding requirements is the first step to take to raise new capital. The company will want to determine the amount and the time frame in which it needs funds. Each successive financing will require review of the overall needs and integration of the previous financings into the analysis.

The process should also include an analysis of whether the purposes for which the company raises funds—whether for plant expansion, product development, distribution enhancement, acquisitions, geographic expansion—are good investments in the market context of the time. Clearly, investment projects must have the potential to earn more than they cost to develop and finance. Profitability analyses of particular investments also merit periodic review and reassessment.

For most companies in most years, or at least at some point in the course of the year, there will be a gap between the amount of cash the company generates internally and the optimal amount of capital it needs to finance its activities or grow its business. This financing deficit must be made up by external financing.

Cash Flow Forecast

A cash flow projection, which includes estimates of major investments and expenditures, should enable the company to assess how much funding the company will require, when it will be needed and for how long.

Funding requirements can generally be categorized as follows:

- Long-term, core, funding requirements
- Short-term or medium term funding requirements
- Contingency requirements

Which funding requirements fall within which category will depend in part upon the nature of a company's business. Long term funding is used to finance a company's core business assets, such as land, buildings, equipment. Shorter-term working capital is used to fund cyclical variations in cash flow. The cash flow of most businesses is cyclical or subject to seasonal fluctuations. Even companies with relatively steady income streams experience short-term cash flow variations, e.g. when making payroll tax payments, sales tax payments, interest payments, or meeting other types of lump sum payment obligations. The length of business cycles will also vary from industry to industry, for example, it may be seasonal in retail, years in some types of agricultural or forestry businesses. Short-term or cyclical cash needs are not efficiently financed with long-term funding, but companies should seek to match funding to the length of the business cycle. A company can usually project its historical seasonal patterns forward, making adjustments for predictable changes in circumstances. It is more difficult to forecast funding requirements for companies that go through longer cycles of growth and recession, and may be particularly challenging in transition economies with high degrees of volatility.

A company should have access to contingency funds to meet unforeseen requirements, such as an unexpected downturn in one of its markets, an unbudgeted expenditure or an unanticipated opportunity. The level of contingency funding will depend on a number of factors in a company's operating



environment, including the volatility of the company's markets, the vulnerability of its earnings to recession in its markets, its dependence upon a single or a few major customers to make sales targets, or a management strategy to grow through acquisitions.

The cash flow forecast should include the following items:

- Estimated capital expenditures and timing
- Cash flows from operating activities
- Repayment of principal on loans
- Existing interest payments (and receipts)
- Dividend payments (and receipts)
- Tax payments

The cash flow forecast should exclude estimates of new funding sources unless it is absolutely certain that funding will be obtained. Large, potential one-off items that are discretionary would also normally be excluded.

A cash flow forecast should be for a defined time period, with an end date or planning horizon. Clearly, long-term forecasts will be less precise than those focused on a shorter term. The appropriate planning horizon will depend upon the company, but should relate to the amount of time a company expects to borrow funds. For example a large company that intends to regularly borrow for terms of five to ten years should forecast for at least five to ten years. A small company that relies on operating cash flows and short-term bank credits will look at a much shorter planning horizon, probably two years or less.

Cash flow forecasts should be broken into periods of time (weeks/months/year) that reflect the company's cash flow events as closely as possible. For example, a large company with a high volume of cash flows might need a six week forecast that is updated weekly, a 12-month rolling forecast updated monthly, and a five or ten year forecast prepared annually.

Management Note:

For a cash flow forecast to be useful, it must be as accurate as possible as to amounts and timing of cash flows. Management should consider the track record of its financial planners for accurate forecasts and ensure that the goal of the forecast is accuracy rather than meeting perceived expectations. This is often a difficult question of corporate culture in developed economies and may be particularly challenging in transition economies. The volatility of the economic environment makes accurate forecasting more difficult, and at the same time traditions of hierarchical management and a certain political history of an element of fiction in economic planning may create an environment where financial analysts find it difficult to conduct an objective analysis. Management will need to convey a desire for rigorous objectivity and accuracy, along with a reasonable tolerance for an honest (and inevitable) margin of error.

Forecasting in transition economies presents another potential challenge in that, because forecasting starts with the past, market and business distortions must be identified, and to the extent that they are not reoccurring, separated out. In transition economies that are still working out severe systemic distortions or where forecasting involves product lines that are relatively new in the market, forecasting may be particularly difficult. Reference to market performance in other countries may be useful, although comparisons must always be made with caution.

It is worth noting that forecasting, business planning and analytical capacity have evolved in developed markets over the past couple of decades as technological advances and computer modeling tools enable much more sophisticated analysis.



Capital Structure Planning

To determine the optimal capital structure for the company over a short and long term planning horizon a company will want to

- Ensure that funds will always be available when needed to meet loan repayment obligations and that refinancing options are being explored as available
- Decide how much to borrow, who or where from, when and for how long and in what currency
- Ensure that funds are available to finance the company’s growth and development
- Monitor exposure to interest rate and currency risk and taking measure to hedge the risk when appropriate
- Monitor and planning tactics to manage other external shocks
- Worst case scenario or contingency planning—ensuring that a company has the financial resources to continue business in the event of a downturn in one of its markets, a recession or other severe external shock

To achieve the optimal cost of capital, each funding requirement will ideally be funded in the way most appropriate to the size, type and timing of the funding need.

Funding Needs and Potential Sources

Contingency Funding	Cyclical Needs	Short/Medium-term Business Activities	Core Business Activities	TIME →
Committed Bank Facility	Committed Bank Facility or Short-term Debt Trade Credit	Short- or Medium-Term Debt	Equity or Perpetual/Long-Term Debt	

Source: Coyle, Brian, *Capital Structuring*

Optimal capital structure varies across industries and according to the size and life cycle position of the company. A number of factors influence this optimal structure and in some cases, companies may choose to adopt capital structures that do not necessarily minimize their cost of capital. These factors include:

- Business Risk, which reflect the fundamentals of the business itself:
 - Company’s cost structure (fixed versus variable)
 - Sensitivity of company cash flow to external, macroeconomic changes (recessions, etc)
 - How diversified the company is across product lines
 - Company’s competitive position within its industry
 - Price sensitivity—the degree to which the company controls prices of its goods or services (commodity goods or differentiated goods)
 - Market, suppliers or client pool—dependence upon a small number of suppliers or clients or a large market, multiple suppliers
 - Technological change in the industry—whether the company faces a the potential of product obsolescence



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- Government and regulatory environment—risks of government intervention or legislation or regulatory changes affecting the company’s business
 - Relative cost of financing alternatives, especially debt vs. equity
 - Tax advantages of debt financing,
 - External financing requirements in the near and longer term (see above)
 - Capital structure norms of the company’s industry
 - Competitive position in the industry
 - Management’s preferences and attitudes
 - risk preference (risk tolerant management may tend toward higher debt levels)
 - view of stock valuation (if management believes that the company’s shares are undervalued or where it expects rapid growth that is not yet reflected in the stock price, debt is likely to be more attractive than in converse situations)
 - concerns regarding control (debt may be viewed as attractive if management is concerned with maintaining control)

A company’s management should try to assess its business risk by reviewing the relative historical volatility of revenue, cost and cash flow over different economic cycles, although this may be challenging in transition economies because of economic volatility and historical distortions. Financial risks are related to the amount of debt in a company’s capital structure. The higher the level of debt, the higher the financial risk. Companies with lower levels of business risk, and thus more predictable cash flow, can support higher levels of debt in their capital structures. For example, the capital structure of a utility is likely to be much more highly leveraged than that of a high technology firm.

The size of a company’s capital requirements and its external funding requirements will influence a company’s capital structure. Companies whose businesses involved large and non-deferrable capital requirements are more dependent on external finance than companies that are less capital intensive. Capital-intensive companies tend to prefer a lower debt-to-equity ratio to ensure continued access to external funding. Such companies also need to pay close attention to industry capital structure norms and their own competitive position within the industry—factors that influence investors’ or banks’ willingness to lend, as well as the cost of borrowed funds.

Interest payments on bonds and loans are generally deductible from a company’s gross profits for tax purposes. Dividends are generally not deductible, as they are considered payments to the company’s owners. This has the effect of reducing the cost of debt versus equity; therefore, it may be economically rational for a company to incur debt as long as the return on the use of the borrowed funds exceeds the cost of debt. A company will need to understand the tax treatment of dividend and interest payments to shareholders and creditors in the jurisdiction(s) where the company operates to assess the full cost of various sources of funds.



Government Policy Factors Affecting Company Capital Structures:

- Tax
 - Corporate tax: permitted deductions
 - Deductibility of different types of payments to investors in company securities
- Bankruptcy law – seniority of payment rights to different types of creditors
- Government monetary and fiscal policy, which affect cost of funds and availability of longer term borrowing
- Securities market and new issuance regulation
- Currency regulation

ASSESSMENT OF SOURCES OF FUNDING AVAILABLE

Preliminary Assessment of Funding Sources, Including Availability, Stability of Funding Supply and Cost of Funds

Once a company determines the amount and likely duration of its funding needs it should assess the funding sources available to it and their terms and costs, as well as the stability of the funding sources and the potential effects of market changes. Even in an economy with funding sources as large and diversified as the US, funding availability from particular sources goes through cycles that result in certain sources becoming unattractive or unavailable for a period of time (as many technology companies that hoped to raise equity funding discovered after the dot com initial public offering market collapsed in 2000-2001).

There are three primary sources of funding to be considered for companies:

- Internally generated funds: cash surplus from operating activities
- Equity: raising funds from shareholders who will hold an ownership interest in the company's stock and who look to see the value of their investment rise
- Debt: borrowing from bank or non-bank sources. Bank debt will typically be in the form of a loan to the company. Capital markets debt investors will subscribe for corporate bonds and other securities. Debt investors seek repayment on defined terms, with a defined return, as set out in the relevant loan agreement or bond indenture.

Equity and capital markets debt funding may be obtained from private placements or public offerings of securities. Each has different advantages, disadvantages and costs. Market conditions and company characteristics affect the availability, cost and appropriateness of all external funding alternatives. Thus, when a company is considering any given funding source it may want to consider the following questions:

1. **Availability — in the present and over time:** Bank lending and capital markets funding are subject to market related fluctuations and company specific factors in the developed countries. These fluctuations are more severe and are likely to have a more restrictive effect on company financing plans in developing economies with volatile macroeconomic conditions and a more limited range of funding sources.
2. **Cost — initially and over time.** Companies should look carefully at the true cost of funds, and at both financial and opportunity costs. Floating interest rates are the most obvious example of a fluctuating cost of funds, but a company should also consider how a financing source used today



might affect the cost of future funding. As noted above, a company should determine the tax treatment of various sources of funds so it can calculate the after tax cost of a financing instrument.

3. **Terms:** What do the terms of the financial instrument require the company to do or not do? Beyond payment schedules, debt instruments often contain terms that restrict a borrower's actions in certain matters, especially future borrowing and may limit the company's choices in the future. The company should consider how the terms of the financing may affect its business over a range of possibilities, including current and future business decisions, reduced flexibility, shareholder perceptions, interests and stock price, market perception and so on.
4. **Repayment:** What sources of funds will be used to repay and service the debt?
5. **External Conditions:** How will changes in the external economic, political or industry environment affect the funding source? How vulnerable is the funding to severe external shocks beyond the company's control, or changes in the company's financial condition?

Funding Alternatives

The following is a brief overview of funding alternatives based on financing practices in developed markets and the entities that provide them. Not all forms of financing are available in developing economies and to the extent they are available, costs and terms may vary.

1. Short term Finance

Trade Credit is credit extended by one company to another, based on sales of goods and services, and is essentially a loan from one company to another tied to a purchase. A seller specifies the payment due date and may offer a cash discount if payment is made before the due date. (For example, "2/10 net 30" means that the buyer can take a 2% cash discount from the purchase price if payment is made within the ten day discount period, otherwise full payment is due in 30 days.) Trade credit is the largest source of short-term funds for non-financial businesses in the US and is especially important to small businesses because it is often less expensive than short-term bank financing, has virtually no transaction costs, and is usually more flexible than other forms of financing.

Trade credits have no cost if there is no discount or if payment is made in time to take the discount. If a discount is offered but payment is not made in the specified period the cost of the trade credit is the foregone discount. This can be calculated as nominal annual percentage rate or more appropriately, effective annual percentage rate, which includes the effect of compounding interest.

If a firm foregoes the discount, it may be tempted to stretch its accounts payable, effectively lowering the cost of the loan by extending it without additional charges. Depending upon a buyer's relationship with its supplier, the supplier may tolerate this in certain circumstances but it is unlikely to be a successful or economically healthy long-term strategy. (The payment arrears problem is a form of this zero sum game that has been played in some of the transition countries.)

Short term unsecured bank debt is commercial bank funding available short term on an unsecured basis, generally in one of three forms: a transaction loan, a line of credit or a revolving credit. The lender usually expects that these types of loans will be self-liquidating in that the assets purchased with the loan proceeds will generate the cash to repay the loan with a year. The loan is documented with a promissory note that specifies the amount of the loan, the interest rate—normally a floating rate set off a short-term reference rate—and repayment terms.

Transaction Loans include *bridge loans*, which provide temporary funds between the time of the initial expenditure and the time when long term funding is put in place and *project loans*, which require the borrower to use the loan proceeds exclusively for a project that is expected to pay all interest and



principal. If the loan is non-recourse, then payment must be covered exclusively from the cash flow of the specified project (without recourse to the project's sponsor/borrower).

A **Line of Credit** allows a borrower to draw up to a specified maximum loan balance at any one time. The term of a credit line is normally one year with annual reviews and possible renewals. Banks generally require borrowers to have a zero loan balance periodically for some specified amount of time during the course of the year. Credit lines are generally informal agreements, so if a borrower's credit deteriorates, the bank has no contractual (legal) obligation to advance funds.

A **Revolving Credit Facility** is a contractual (legal) commitment to lend up to a set maximum amount during a specific period, for which the borrower must pay a commitment fee—typically between 25 and 50 basis points (0.25% to 0.5%) on the difference between the maximum amount and the amount actually borrowed. The fee increases the firm's cost of borrowing in exchange for the bank's commitment to make funds available. Revolving credits are documented by short-term notes, usually maturing in ninety days, that can be automatically rolled over if the notes mature before the revolving credit agreement expires. Revolving credits may extend beyond one year and the borrower may have the option to convert to a term loan upon expiration.

The cost of a short-term loan is the interest cost plus any commitment or other fees.

Commercial Paper: unsecured promissory notes that have a maturity of from 1 to 270 days, (or longer if registered with the SEC) that are sold into the capital markets. Commercial paper is a funding option available to the largest and most creditworthy firms and is sold either directly or through dealers. Dealers typically charge a commission of 12.5 basis points (1/8 of 1%) on an annualized basis. Dealer-placed paper usually has a maturity of between 30 and 180 days and is sold to other businesses, insurance companies and banks. Issuers of commercial paper often obtain a standby letter of credit facility, which provides insurance if the issuer is unable to repay or refinance its debt. Banks typically charge an annualized fee of 25 to 50 basis points for standby letters of credit.

A significant portion of commercial paper is sold directly to investors by large finance companies like General Motors Acceptance Corporation and [GE Capital]. This paper is tailored to meet the needs of investors, usually other corporations with excess cash. Large finance companies issue new commercial paper on an ongoing basis, making it a permanent source of funds.

Commercial paper is rated by the rating agencies, with the higher rated paper having the lowest cost. Irrevocable letters of credit may be used to obtain a higher rating.

Commercial paper is issued at a discount, so the cost of funds is higher than the stated interest rate and also includes the transaction costs (dealer fees) and the cost of any liquidity facility or credit enhancement.

Short-term secured loans. Banks may require security for loans. For short-term debt, a borrower may pledge liquid assets such as receivables, inventories or marketable securities. It may be a floating lien against a class of assets or a detailed list of collateral.

Finance companies, which usually lend on a secured basis, may be an alternative source of loans when bank financing is unavailable.

Export Finance includes export credits and bankers acceptances, which are methods of financing international trade.

2. Intermediate and Long-term finance

Term Loan is a loan granted by a bank for a specified amount that requires the borrower to repay according to a specified schedule. Generally term loans mature in one to ten years, with repayments in regular intervals of equal installments, although in some cases the loan may provide for a larger final



payment—a balloon payment, or provide that principal be paid at maturity in one lump sum—a bullet maturity.

Term loans usually carry a floating interest rate set off a specified benchmark rate, which is reset at periodic intervals based on market conditions. The interest may be tied to the bank's prime rate or, for larger, more creditworthy customers, may be set off LIBOR (London inter-bank offer rate). Banks may chose to lend at money market rates to their best customers to compete with the commercial paper market. Term loans may carry a compensating-balance requirement of between 10 to 20 percent of the size of the loan, which imposes a cost in addition to the interest rate, and may be set as a minimum or a required average deposit balance during the interest period.

Receivables finance includes *factoring*, when accounts receivables are sold outright to a bank or finance company and *assignment*, which involve a cash advance that carries an interest and service charge and is based on a percent of the face value of the receivables. Marketable goods in inventory may also be financed at a percent of face value, usually at an interest rate considerably above the prime rate.

Leasing, by entering into a rental agreement for assets, is an alternative to financing a purchase of an asset.

Project Finance is debt supported by the assets of the specific project it finances. It may involve pledging revenues under contracts with customers and guarantees local governments or other related parties. In emerging markets, the World Bank and other multilateral financial institutions play a significant role in funding large infrastructure finance with project finance.

Government Finance may be available for purposes that fit specific government policies. For example in the US, states, municipalities and other sub-sovereign government subdivisions may issue debt that is exempt from federal income taxes on the interest. Certain private sector projects may be financed with tax-exempt debt, although uses are much more limited today than in the past. The US federal government also has programs to encourage loans to small business, both in the US and abroad through USAID.

A prospective borrower might wish to investigate programs that might be available to it from its own government, and foreign government and multilateral sources, including European Union funding, especially in the new member states.

Commercial Mortgages are bank loans secured by real property.

Privately placed equity securities: can range from additional capital contributions by founders, to sales of shares to a range of investors from “angel” investors, who are usually wealthy individuals and may be friends and family, to venture capital and private equity.

Publicly placed equity: refers to securities that are registered with the relevant securities regulatory authority and broadly placed with the public. An initial public offering or IPO is the first sale of a company's share to the public, sometimes called going public. Rights offerings are sales of shares to existing shareholders. Most new issues of shares are new issues in companies that are already publicly traded. Stock may be common stock or preferred stock, which carries either a stated dividend or preference over holders of common stock in the line of dividend payments.

Hybrid securities include warrants, which are options for stock, convertible bonds, which can be exchanged for stock, normally at the option of the holder and convertible preferred shares, which can be converted into common stock.

Private placements and quasi-private debt securities are debt securities placed directly with investors rather than sold though the public markets. In the US, private placements are also know as Reg. D and Rule 144A placements, which refer to the SEC regulations that govern them.



Publicly placed debt or bonds are securities that are registered with the relevant securities authority, the Securities and Exchange Commission in the US, and sold into the public markets. Buyers of public debt are usually institutional investors, including insurance companies, pensions funds and investment funds.

The cost of privately or publicly placed debt includes interest cost and the issuance discount and other costs of issuing securities, or flotation costs. In the US, the interest costs on privately placed debt are generally higher than on high grade publicly issued bonds; however, flotation costs are substantial, particularly for first time or infrequent issuers. Because a small issue of bonds generally requires the same process and same amount of work, costs on small issues are significantly higher as a percent of the issue and obviously impacts the cost of funds. Public bond issuance in the US and Eurobond markets is generally cost effective only for relatively large public companies bringing relatively large issues to market.

Publicly and privately placed debt securities are the subject of Sections II through VI of this tool kit and will not be discussed in further detail here.

Comparison of needs with the company's present capital structure and in light of future business plans

A company will next want to determine which available sources of funding are appropriate in light of the company's present capital structure. This will depend upon existing leverage—how much debt the company already has, usually expressed as a percentage of the company's equity capital. It will also depend upon the industry the company is in and that industry's norms, and external macro economic and political conditions.

The funding analysis should include a review of the company's strategic plan and new business opportunities, its expectations and plans for the growth of existing businesses, the maturity level of the company and industry and potential exit strategies for other lines of business, time horizons, and related future financing needs.

Financing decisions made today can have an important impact (both positive and negative) on the ability to obtain financing in the future and its costs, so it is important that they be considered in light of a company's long term strategy and plans.

A company will also want to develop and review its strategies for the management of external shocks, including their effect of local equity, debt and banking markets and assess whether the proposed new financing will necessitate changes in the strategy.

Cost of Capital

A major goal of a company's financial planning should be to maximize shareholder value by minimizing the company's cost of capital. Each instrument, whether it be equity, debt and bank loan, will have a different cost to the issuer. The cost of a type of instrument will also vary over time, as market indicators change, investor expectations change and as the capital structure of the company changes. Cost analyses should involve comparisons of the cost of capital under various financing strategies that involve different combinations of debt and equity and different combinations of types of debt instruments.

The cost of equity may be calculated as the expected value of future earnings of the company, or as the expected value of expected future dividend payments to investors. Both methods assume an ability to predict future growth, with an implicit assumption as to future risk. The more widely accepted capital asset pricing model ("CAPM") attempts to quantify the risk element more precisely by breaking cost into three components: first, the level of return from a *risk-free security*, representing the lowest range of yields currently experienced in the securities markets and expected by investors. The yields on long term US government obligations are commonly used as a surrogate for this risk-free rate, as these yields are



widely quoted and can be analyzed for both historic and present periods. Second, the model estimates a return over the risk free rate for a comparable security of average risk. For instance, the total expected return from the Standard & Poor's 500 index will offer an approximation of expected return from both dividends and market appreciation for a broad basket of companies. More specific indices are available for companies in specific geographies and sectors of the market. Third, the CAPM model will use a variable for the relative risk of the specific equity security being analyzed, expressed as the expected variability of performance of the individual security from the performance of securities of average risk. This variable, called *beta*, can be calculated for publicly traded securities by linear progression of past monthly total returns of a particular security against a baseline such as the S&P 500 index. The model can be expressed as follows:

$$K_e = R_f + [E(R_m) - R_f] * \beta$$

where R_f is the risk free return rate, $E(R_m)$ is the expected market return and β is the corporation beta.

For a developing economy, cost of equity capital may be analyzed using local government securities of longest available tenor as a proxy for the risk-free rate, local stock market performance indices as the average return, and individual company beta calculated on the basis either of a historic analysis of the variability of stock pricing for the target company against the market index, or, if the company is newly listed or privately held, a proxy beta derived from the beta calculated for a company in the same business sector of similar size and business orientation operating in similar markets.

The Cost of Equity in Transition Economies

Privatization in Central and Eastern Europe occurred in some case without actually raising new funds for the privatized companies. Although this method had its merits as a transition step, when this history is coupled with weak corporate governance and a casual attitude towards the protections of shareholder rights, it seems to have led to the perception among some managers and controlling shareholders that equity is essentially free or without cost in a company's capital structure. However, new sources of equity capital, particularly from institutional investors, will seek a level of return commensurate with the perceived risk of the company, country and region. (See for example, [The New York Times](#), July 3, 2004 "Harvard and Russian Oil Company Clash Over Shareholder Dividends" reporting Harvard University's law suit against Surgutneftegaz over the company's dividend policies.) The perception of cost of equity is thus likely to change as market mechanisms stabilize and new equity investment must be raised.

The cost of debt should be calculated on an after tax cost basis, and should take into account the interest paid on both short term working capital and long term borrowings. This cost can be stated as follows:

$$K_d = \text{Pretax interest cost} * (1-t) / \text{Weighted average borrowings}$$

where t is the corporate tax rate

Finally, the company should analyze its **overall cost of capital** on a weighted basis in order to determine its Weighted Average Cost of Capital, i.e. the after tax cost of debt multiplied by the proportion of debt in the total capital structure added to the cost of equity multiplied by the proportion of equity finance in the total capital structure.

$$K_o = (K_e * \text{Equity/Total Capital}) + (K_d * \text{Debt/Total Capital})$$



This analysis will provide a tool with which the company can measure the overall cost of its capital structure at different points of time. In addition, the company can use the calculation methodology to assess the impact of a particular financing alternative on the company's overall cost of capital.

In developed economies, with defined bankruptcy codes and practice, transparency in financial reporting and securities markets, and tax advantages for debt issuance, it is generally true that a capital structure which combines debt and equity capital will be a lower cost structure than an all-equity capital structure.

Effect of Bankruptcy Law on the Cost of Capital

In the US, and generally in developed markets, debt has a higher priority in bankruptcy and liquidation than equity:

Priority of Claims

Secured Debt
Senior Unsecured Debt
Subordinate Debt
Junior Subordinate Debt
Preferred Stock
Common Stock

Claim priority is uniformly recognized by the legal system and is enforced consistently through a number of mechanisms:

- Contractual
- Reorganization
- Liquidation in bankruptcy

Holders of priority claims have the ability to "cram down" more junior securities to achieve a higher return in a reorganization of the company, and a right to a priority of return over more junior investors in any liquidation of the company's assets. In practice, holders of equity, who hold the most subordinate position, will take the first loss in any company downturn, and will receive little or no return in bankruptcy court supervised reorganization or liquidation. The effect of these preferences is to reduce the perceived future risk of holders of bonds and other debt securities compared to holders of common stock.

In developed economies, the combination of higher priority in bankruptcy and workout and preferential tax treatment for interest payments will generally make the cost of debt issuance lower than the cost of new equity. In developing markets, however, the priority advantages may be lacking. Some countries lack the political will to allow large enterprises to fail, or reorganize. Some lack an orderly procedure to address creditors' claims. In markets which lack a clear bankruptcy code, or practice of priority in enforcement of the rights of holders of debt instruments, and where enforcement of commercial contracts in court has been inconsistent and at times arbitrary, the perceived riskiness of debt may be equivalent to that of equity, and the cost advantages of debt may disappear.



Effect of Transparency and Fraud Prevention on the Cost and Availability of Capital

All markets experience occasional and sometimes spectacular fraud, which, in developed markets, usually result in market corrections and subsequent legal reform, as Enron and other recent corporate scandals demonstrate. But if the perception persists that a market is so opaque that risks cannot be estimated and quantified, a market's long-term viability as a source of capital for enterprises may be in question.

Respect for creditors' and shareholders' rights, rooted in the legal and political system as well as business culture, is essential if companies expect to raise funds from investors on an ongoing basis.

Consideration of needs of shareholders and principals of the company

Capital structure planning must take into account the interests of the shareholders and principals of the company. In small family-held or closely held companies, transition planning and exit strategies for the founders or senior generation will be highly important components of capital planning. Companies with private equity investors or strategic investors must also keep in mind considerations relating to the liquidity of their investors' funds and the timing of their exit strategies when reviewing the capital structure and the desirability of new financings. Maximizing shareholder return while ensuring the continued growth/stability of the company is the paramount goal of capital management, but this sometimes involves delicate balancing of interests.



FUNDING ALTERNATIVES

Source	Internally Generated Funds	Bank Financing	Private Capital Infusions	Joint Venture or Partnership	Capital Markets
Type	Cash	Debt	Debt and Equity	Usually Equity	Debt and Equity
Advantages	<ul style="list-style-type: none"> No issuance costs Control Fewer variables in timing 	<ul style="list-style-type: none"> Size of market Availability Costs 	<ul style="list-style-type: none"> Timeliness Amount 	<ul style="list-style-type: none"> Outside Expertise Amount 	<ul style="list-style-type: none"> Size of market (USD & Euro) Availability
Disadvantages	<ul style="list-style-type: none"> Limits on amounts 	<ul style="list-style-type: none"> Non-cash costs Covenants Callable Commitment Fees 	<ul style="list-style-type: none"> Terms may be cumbersome Difficult to locate suitable investor 	<ul style="list-style-type: none"> Terms may be cumbersome Costs may be high 	<ul style="list-style-type: none"> Fees and issuance costs Reporting requirements and investor communications Timing
Company Characteristics	<ul style="list-style-type: none"> All 	<ul style="list-style-type: none"> Most companies can obtain bank financing—assuming they are creditworthy and/or have assets to use as security 	<ul style="list-style-type: none"> Equity: start-up to medium size, often with high growth potential Debt: medium to large 	<ul style="list-style-type: none"> Must be of interest to another business, usually for strategic reasons 	<ul style="list-style-type: none"> Large and usually publicly traded
Other Considerations	<ul style="list-style-type: none"> Exit strategy for principals, shareholders 	<ul style="list-style-type: none"> Development of banking sector varies in emerging markets Potential for cross-border borrowing Currency exposure 	<ul style="list-style-type: none"> Private equity investors have 5-10 year investment horizons, IRR targets of 20% plus and an exit strategy when investment is made. Private placements of debt generally have higher yields than public issues. 	<ul style="list-style-type: none"> Partnership is long term, often-day-by-day commitment, but also may open markets 	<ul style="list-style-type: none"> US and European markets are large and liquid; macroeconomic conditions still affect timing and price Currency exposure. Access of emerging market firms to international markets Local markets may be less developed, less deep, shorter tenor



DEBT VERSUS EQUITY ANALYSIS AND ANALYSIS OF DEBT ISSUANCE

If a company determines that it needs long term financing that it wants to obtain from the capital markets, it generally faces a choice between equity and debt, and a choice between publicly or privately placed securities. At this stage, if the company hasn't engaged financial advisors, it may want to do so. The choice of financial instrument will be influenced by a number of factors, including:

- Availability of funding options
- Relative cost of each available funding option
- Rating on the company's stock, if applicable
- Operational profits and cash flows
- Existing leverage and effect of new issuance on ratios
- Purpose for which funds are required (nature and duration of the projects or activities to be funded)
- Tenor (availability of long term debt may be an issue)
- Company's recent funding measures and impact on new issuances
- Control of the company and concerns about maintaining control
- Management preferences

Most of these factors have already been discussed above, but should be reviewed when narrowing the choice of funding options.

Before making the decision to proceed to issue bonds, a company should once again review:

- Relationship of choice of financing and use of funds
- Existing and prospective capital structure
- Existing and prospective debt service ratios
- Financial history and financial statements
- Existing and prospective covenants (impact on future business decisions)
- Tax and regulatory issues
- Costs of issuance and maintaining the proposed program

If the funding is project or investment specific, the potential return on the investment must, at a minimum, exceed the cost of funds. The project analysis and valuation should include stress testing for various external and company contingencies. The tenor of the financing should match the approximate life of the asset, if possible.

Note that the apparent lowest cost of funds, while obviously very important, is usually not the single determinative factor in a company's funding choice. The cost of funds is not static and both planned and unplanned future events can impact the cost of a funding arrangement over time. A company may decide to incur slightly higher cost financing for a number of reasons, including to diversify funding sources, and in light of its capital structure and future strategic plans.



Management Analysis

In addition to the financial analysis of funding needs and options, a company seeking to issue bonds, particularly publicly traded bonds, should analyze its own internal resources available to manage debt issuance and maintain outstanding securities.

Debt management can be thought of as existing in two phases:

- Decisions made before incurring debt as to the type, terms and where to borrow to best meet the financial objectives
- Managerial decision made afterward—to properly maintain and minimize the cost of outstanding debt (this can include refunding debt as appropriate).

The process itself of issuing debt may require considerable management and staff time, as will be discussed more fully in Section III and IV.

GENERAL REQUIREMENTS

Debt issuance is a long-term commitment to the holders of bonds that the company will be able to meet its obligations to them for as long as the bond is outstanding. Good management and common sense dictate that the company should be able to devote adequate human capital to these responsibilities without compromising the ongoing operations and growth of the business; if not, bond financing is not an appropriate funding choice.

For the most part, the ongoing responsibilities of managing debt will fall to the treasury or finance department, which must have:

- the capacity to competently manage the company's cash flow to ensure timely servicing of debt payments, while maintaining funding to the company operations
- the ability to conduct the ongoing forecasting and analyses discussed above

The company may also need internal legal staff, who will need to work with the finance department to monitor and ensure compliance with debt terms and covenants.

Issuers of publicly traded debt are generally required to disclose information about the company, including financial information, to the public at the time of the issuance and at regular intervals thereafter and to periodically release any material information as events occur, as more fully discussed in Sections IV and VI. These responsibilities will also generally fall to a combination of legal and financial staff. Recent modifications have been made to the US and UK securities laws to ensure that the most senior levels of management are responsible for the accuracy of a company's financial disclosure, as corporate accounting practices have come under increased regulatory scrutiny in the wake of several high profile corporate scandals.

A company will also want to manage its outstanding debt so that its future financing and re-financing decisions maintain an optimal cost of capital, which involves monitoring and reacting, or even proactively planning, how to address changes in the financial markets, such as shifts in interest rates or the relative cost of various funding options.

DATA AND MIS REQUIREMENTS FOR CERTAIN STRUCTURES

Certain debt structures require enhanced data capture and management and MIS capacity that a company might not develop in the ordinary course of business. These structures include:

- Asset backed securities.
- Receivables finance



- Offshore borrowing
- Currency management and hedging strategies

The data needed to model and structure asset backed securities is usually not the same information that management needs for day-to-day operations or financial reporting. Mortgage backed securities, for example, require the ability to capture historical data about mortgage prepayments and defaults in order to predict future cash flows with a high degree of specificity. This historic information is not typically used in day-to-day management of a mortgage book, particularly in the early stages of product development, as is currently the case in Central and Eastern Europe. Information systems may need to be altered and data capture capacity developed in order to structure and issue and support payments once the issue is outstanding. This is likely to result in a longer lead time before issuance, will have pricing implications, and may require other measures to be taken. In these cases, management will need to consider how much it is willing and able to do to enable its systems to capture the necessary details and whether or not those actions are cost effective.

Selecting and Working with Advisors

Along with issuers, regulators and investors, a number of intermediaries—most significantly, bond underwriters and traders—are also participants in the bond market. In the US on large public offerings, investment banks generally (1) provide advice on corporate finance, funding strategy and alternatives, and structuring and developing the issue, (2) arrange for the registration and marketing of the issue, and (3) underwrite the issue. Large global banks and investment banks dominate the underwriting business; partly because, in any volume, underwriting requires a significant balance sheet, and partly because of the way the sales process works in the debt capital markets. Advisory and deal development work are expertise and relationship-based and may be provided by smaller firms who act as financial advisors and arrangers, particularly in specialized areas. Law firms and accounting firms also play important roles in the process of issuing bonds. The following outlines the roles played by these market participants who, with the exception of traders and underwriters counsel, are normally hired by the issuer. There is also a discussion of how to select and work with these advisors and how they get paid.

Advisors in Emerging Markets

The US debt market reached the level of \$22 trillion outstanding at the end of 2003. (See (Appendix I.) The size of this market results in depth, range and sophistication of intermediaries that is unlikely to be available or necessary in emerging markets that are in the early stages of developing a local bond markets. For large issuers, particularly those who are able to access the Eurobond markets, hiring an international investment banking firm is an option. Citigroup, for example, was at the top of the league tables (meaning it was lead manager in the most deals for 2003) in US debt and equity (securities issued in USD in the US), in Global bonds, (including all Eurobonds), and in Eurobond issues of Russian and CIS borrowers.

The banking sector in Emerging Europe is generally based on the “universal” bank model and, in many countries, is predominately owned by foreign banks. Many of these banks have investment banking capacity, at least at the parent level.

Many US and UK based-law firms have offices in transition economy countries, which can provide local counsel and access international expertise. The major accounting firms are also represented throughout the region.

Local banks, investment banks and law firms are developing capital markets expertise, and may be good options for straightforward local deals. Some local investment banks and commercial banks are managed by experienced international bankers. Others have participated in Eurobond syndicates, allowing them to develop expertise in international issuance standards and practices.



Underwritten offerings

Most corporate issuers in the US hire investment banks to act as underwriters of bond issues that are sold in the public capital markets. Some very large corporations that are frequent issuers sell directly to investors. The federal government and US agencies generally sell directly to the market using an auction system, as do some Central and Eastern European governments for local currency government bonds. Most US municipal issuers, which come to the markets less frequently than the federal government or agencies, use underwriters. Underwriters are also securities dealers that trade outstanding bonds in the secondary market and thus have superior access to market information and distribution channels, which generally makes it more cost effective for an issuer to sell securities through an investment bank. The same is true for Eurobond issues.

There are two types of underwriting: (1) firm (purchase and sale) and (2) best efforts (although the second type is not a true underwriting).

In a firm underwriting, the underwriter purchases the new bond issue and resells the bonds at a mark up agreed-upon with the issuer. This is accomplished with an underwriting agreement under which the underwriter purchases the securities from the issuer at a fixed price and agrees to offer them to investors at a specified price less a specified commission. Underwriting agreements are fairly standard contracts in the US and Eurobond markets. The securities dealer bears the risk that the issue may not be sold at the initial offering price. If it is not, the underwriter will sell the securities at the price the market will pay and bear the loss. Thus, the underwriters can be thought of as providing a form of insurance by guaranteeing the price to the issuer. The process of determining the price is more fully described in Section V.

In a syndicated public offering, a lead managing underwriter forms a group of underwriters, based on the marketing abilities of the securities dealers with respect to the particular issue, who will purchase the securities from the issuer and re-offer them to investors. The lead manager maintains a client relationship with the issuer on a given issue (although many large issuers use different investment banks from issue to issue) and also does the advisory and documentation work on the deal. An agreement among underwriters allocates the proportion of the issue that each firm undertakes to sell; provisions are also now fairly standard in the US market. Some deals are co-managed by two or more firms, in which case one manager acts as the bookrunner, which means, as the name implies, they run the order book and deal documentation.

In a best efforts underwriting, the investment bank undertakes to use its best efforts to market the bonds to investors but it does not commit to purchase the issue, thereby considerably reducing the risk to the bank. Most private placements are sold on a best-efforts basis, meaning the investment bank acts as an agent for the issuer (often called a placement agent) and helps negotiate the terms of the sale. In the US Rule 144A private placements, which are private placements that may be subsequently traded among qualified investors, may be underwritten.

Underwriting spreads

Underwriters are compensated by the gross underwriting spread, which is stated as a percentage of the issue price, and generally has three components:

- **Management Fee:** compensation to the managing underwriter for designing the issue, preparing the transaction documentation, forming the underwriting syndicate and managing the offering process. In the US market, management fees generally account for 15 to 20% of the spread.



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- **Underwriting Fee:** compensation to the underwriting group for the underwriting risk (the risk that the issue will not be sold into the market at the price the underwriter pays the issuer). In the US market, the underwriting fee is usually 15 to 20% of the spread.
 - **Selling Concession:** distributed among the syndicate members for the selling effort. In the US, the sales concession is generally 60 to 70% of the spread.

The proportion of the underwriting spread that is allocated to the selling concession is a good indication of the true nature of the business. Underwriting compensation represents a significant portion of the flotation expense of issuing securities.



Issuance Costs

Generally, a flotation of common stock has the highest underwriting costs and straight, non-convertible bonds the lowest, reflecting differences in underwriting risk and the higher commissions required to distribute stock, which is usually marketed more broadly and sold to individual investors.

Gross Underwriting Spread and Out of Pocket Expenses for US Registered Public Offerings, 1975-1999									
Issue Size	Common Stock			Preferred Stock			Bonds		
	Gross Underwriting Spread	Out-of-Pocket Expenses	Total	Gross Underwriting Spread	Out-of-Pocket Expenses	Total	Gross Underwriting Spread	Out-of-Pocket Expenses	Total
USD millions	(as percent of offering price)			(as percent of principal amount)			(as percent of principal amount)		
Under 10	8.64	5.94	14.58	4.73	1.75	6.48	1.57	0.11	1.68
10 to 25	6.47	2.65	9.12	2.90	0.86	3.76	0.97	0.06	1.03
25 to 50	5.88	1.59	7.47	2.22	0.46	2.68	0.78	0.04	0.82
50 to 100	5.39	1.03	6.42	2.03	0.31	2.34	0.71	0.06	0.77
100 to 200	4.99	0.72	5.71	2.74	0.25	2.99	0.74	0.08	0.82
200 to 500	4.62	0.56	5.18	2.73	0.15	2.88	0.76	0.09	0.82
500 to 1,000	4.22	0.58	4.80	2.81	0.14	2.95	0.82	0.06	0.85
over 1,000	3.28	0.78	4.06	2.88	0.27	3.15	0.83	0.07	0.88

Source: Thompson Financial; Debt Management, A Practitioner's Guide, John D. Finnerty, Douglas R. Emery

Out-of-pocket expenses include legal fees, accounting fees, SEC filing fees, state securities law fees and printing, mailing and miscellaneous expenses

The fees on publicly issued bonds are an excellent example of economies of scale as demonstrated by the table above showing gross underwriting spreads over a period of years and the table below showing first quarter 2004 spreads on US high grade debt (which is the cheapest to issue).

Gross Underwriting Spread, US High Grade Debt First Quarter 2004			
Issue Size (USD Millions)	Gross Underwriting Spread (USD Millions)	# of Issues	Average Fees (as % of Offering Price)
Below 100	21.4	30	.783
100 to 500	296.2	162	.608
Above 500	263.6	42	.481

Source: Thompson Financial

The level of effort required to prepare a bond issue for market (due diligence, document preparation, registration) is similar regardless of the size of the issue. Furthermore, for new or infrequent issuers marketing efforts for the issue is likely to be more extensive than for frequent issuers. If the issue is too small to support adequate float (bonds available for trading) in the secondary market, the issuer will likely pay a liquidity premium, on top of proportionally higher issuance costs.

While the minimum viable size of a bond issue is likely to be smaller in some emerging markets than in the US and Eurobond markets, there is a certain minimum level of effort required to properly document and market a bond issue. Over time, if the efforts of those who bring issues to market are not adequately compensated, their professionalism may not be of adequate quality to support a healthy market in the long run.

When an investment bank underwrites an issue they conduct due diligence and assist in the preparation of the prospectus (information memorandum) for investors, with the support of counsel to the issuer and their own counsel. This process requires that the company provide extensive information on practically all aspects of its financial and business conditions, including corporate statutes, financial statements, all major contracts and agreements, share ownership of officers and directors, employment agreements, pension plans. In secured or asset backed issues, general information may be more limited, with extensive information about the specific assets involved. The details and substance of the disclosure are



more fully discussed in Section IV. In a private placements, the buyer will normally conduct separate due diligence.

In addition to selling the issue, investment bankers typically advise clients about the type and terms of the security to be issued and the choice of market that is likely to provide the most attractive terms, organize document preparation and help see the issue through the registration process. They also design new securities—which can be thought of as an investment bank’s product line—to improve and broaden the range of options available to investors and issuers, generally with a view to reducing an issuer’s funding costs and increasing investors’ choices of investment product.

Historical Note

Historically in the US, there was a strict division between commercial banks, which could take deposits and make loans, and investment banks, which were underwriters and securities dealers. This division grew out of depression era legislation in reaction to bank failures were caused, in part, by speculative dealing in securities. This division blurred in recent years and was eliminated in 1999. The division did not exist in most European countries, although in the UK, merchant banks were traditionally comparable to US investment banks in business focus.

Investment banks were also historically partnerships. Now, as a result of mergers and the increasing global nature of the business, the industry is dominated by very large banks and investment banks, most of which are publicly traded corporations.

When a firm acts as a financial advisor or arranger in deals that are not underwritten, they generally charge an arranging fee, which is calculated as a percentage of the principal amount of the issue. Investment bankers and financial advisors may also ask for a retainer, which means the prospective issuer is asked to pay a small portion of the expected management or arranging fee at the beginning of the process of developing the issue to cover some of the expenses of the financial advisors in case the issue does not close. Retainers are deducted from the arranging fee at closing. Retainers are more likely to be required with new clients and/or types of issues that are new on the market, which have an extensive amount of preparation and a higher risk of not closing.

Hiring and working with bankers and financial advisors

Marketing is a significant component in the job description of today’s investment bankers, who often call on companies in search of clients. They are likely to prepare presentations outlining their experience and qualifications and proposed solutions for a prospective client’s financing needs. Sometimes a prospective issuer may hold a “beauty contest” to interview a number of firms before selecting an underwriter, on the basis of responsiveness or understanding of the needs of the company and the environment it operates in. A company may think that it can get a significant amount of free advice in this process, and while there is the potential to play the zero sum game of getting as much as possible without commitment, this is likely to be of limited real use.

Generally, financial advisory or potential arranging relationships begin with a confidentiality agreement (sometimes called an NDA, for non-disclosure agreement) which provides both sides with assurances that information may be exchanged without it becoming public knowledge. An advisor/arranger may ask for exclusivity for a period of time, which is not a commitment from the issuer to do the deal, but rather a commitment not to do the deal with another firm in a specified period of time. This provides some protection to the arranger from the risk that they will do all the preparation work and the client will execute the deal with another bank, which will take the fees.

Advice is only as good as the information used to develop it, so it is important that a company develop an open relationship with its advisors and provide them with full and accurate information. Complete and honest disclosure of financial matters to a company’s bankers should (assuming the bankers are competent) result in the best long term financing solutions for the company. There may be a short term



advantage in the non-disclosure of unfavorable information, but any issuer who wants to go back to the capital markets for financing should recognize there will be long term costs involved in deceiving the market, including regulatory enforcement actions and potential investor law suits. See Section IV and VI.

Depending upon the type of deal, bankers will need information from a variety of sources in the company, including finance or treasury, legal, and the business manager of the unit involved, particularly if there is project or asset specific financing. See Sections III and IV.

The senior management of the company will need to take an active role in a bond issuance. It may make sense to have one person designated point person for an issue who co-ordinates information exchanges, etc. The lead manager investment bank is likely to have several people of varying seniority working on a transaction and its own legal counsel, all of whom will need to interact with people at various levels of the company. See Section IV for a further description of this process.

Secondary Market Roles

Most bonds in the US trade in the over-the-counter (OTC) market maintained by national and regional securities dealers. Some US domestic bonds are listed on the New York Stock Exchange, often when companies want to encourage individual investors in certain issues. Many Eurobonds are listed in Luxembourg or London. Listing may make it easier for small or individual investors to track pricing; however, even among listed bonds in the US most trading takes place over the counter. Bond trading is very much an institutional game. Traders “make” markets by offering to buy or sell bonds. The difference between the bid and ask or offer price at which a bondholder can sell or buy a bond compensates the dealer.

The securities laws of many Central and Eastern European countries require securities to be listed on a domestic stock exchange if they are publicly traded, which, in theory, should aid in making information available to investors. NASDAQ-like exchanges with high technical standards provide a good trading forum and have been established in several transition countries. Electronic exchanges are also becoming more wide spread in the US and Europe, because they cut execution costs and time and help in information dissemination. (See the Bond Market Association web site listed in the Reference section for more information on electronic trading systems.)

EXTERNAL AUDITORS

Audited financials are typically required, both for registering an issue and listing the securities on the appropriate exchange. Most investors in private placements of debt will also expect to see audited financials. The rating agencies would like to review five years of financials in the credit rating assessment process. In Central and Eastern Europe, local securities laws or exchange listing requirements generally require [3] years of financial statements. [check audit level] Accounting firms may also be asked for certification of certain financial matters in certain structures, like asset-backed securities. Accounting firms are also a source of tax advice. The large international firms have the capacity to render both local and cross boarder advice. They generally charge a fixed set fee of an audit and a flat fee or hourly rates for consulting arrangements.

LEGAL

On US and Eurobond issues, a law firm usually acts as counsel to the issuer to advise on compliance with relevant laws, prepare legal documentation for the issue, assist with the preparation of disclosure materials and in the registration process, and advise on structuring issues. The firm may be asked to provide an opinion on the legality and due authorization of the issue and other matters, including tax issues, as discussed more fully in Section V.



Typically law firms charge hourly rates for the time of each lawyer that works on a transaction. The rates vary with experience and seniority. Generally a deal will be staffed by a partner who is in charge of the deal and one to several associates, depending upon the size, complexity and time sensitivity of the transaction. Firms typically bill in increments ranging from 5 to 15 minutes. They also charge for telephone, copying, translation and travel expenses. They provide detailed legal bills to their clients, which should be reviewed carefully and can often be negotiated. Sometimes a cap or maximum limit on total legal fees for a transaction can be negotiated in advance.

A company will probably want to designate one person who is primarily responsible for managing outside counsel, often an in-house lawyer or general counsel or a senior deal person within the company. A company will obtain better advice at a lower cost if its interactions with its attorneys are well managed and requests for advice well focused.

Often, an engagement letter between the firm and its client generally sets forth the terms of the engagement and usually includes the billing rates of the attorneys involved. Law firms also sometimes ask for a retainer, especially with new clients.

In the US most of the advice an attorney gives a client (within the scope of the client relationship) is subject to attorney-client privilege, meaning the attorney is ethically bound not to disclose confidential client matters. In the corporate context, the organization is the client and, while communications with the client's agent are generally privileged, the attorney's duty is to the organization and not its officers as individuals.

The underwriter or placement agent for a transaction generally also has separate counsel, who advises on deal structuring issues, disclosure and documentation. Other parties to a transaction, such as the trustee, also have counsel, although their role is more limited.



SECTION II — PREPARATION: UNDERSTANDING AND ANALYZING THE MARKET



Market Analysis

Bonds as Investments

- ✓ How do investors view the risks of investing in bonds?
- ✓ How do investors price those risks?
- ✓ How are credit ratings determined, and why are they important?

Local and International Bond Markets

- ✓ Which market is most appropriate for a company's bonds?
 - Local currency (domestic) bond market
 - Eurobond (international) market
- ✓ What are the characteristics of the target market?
- ✓ How does the market affect the bond issue?

Investors

- ✓ Who are the likely investors in a company's bonds?
 - Domestic institutional investors
 - International institutional investors
- ✓ What types of instruments do they buy?
- ✓ What factors are important to them?

Pricing and Risk Premium

- ✓ How is the price of a bond issue determined?
- ✓ What determines risk premium?
- ✓ What is yield?
- ✓ Foreign exchange rate risk and the impact of monetary policy



SECTION II. PREPARATION: UNDERSTANDING AND ANALYZING THE MARKET

After making a preliminary decision to issue bonds, a company and its advisors will determine which investors in which market are likely to be interested in buying its bonds and where it is likely to get the best price (lowest borrowing costs, often referred to as best execution). This market analysis is similar, in philosophy, to the analysis a company would undertake when seeking to introduce a new product or expand its market for an existing product line.

This section first examines bonds from the investor's viewpoint and discusses how investors assess and price the risks of debt instruments available in the US and Eurobond markets. It provides an overview of the local currency bond markets in emerging markets, and some of the issues prospective bond issuers and advisors will need to understand in those markets, and briefly describes international markets, primarily the Eurobond markets. It describes the types of institutional investors active in bond markets and some of the factors that influence their investment decisions in particular bond issues. It should be of interest to prospective issuers and advisors who wish to understand the potential markets for their securities, and policy makers and advisors who wish to gain an understanding of investor perspectives.

Bonds as Investments

RISKS OF INVESTING IN BONDS

Investing in bonds carries several types of risks that investors assess and analyze and normally price into the interest rate or return they require in order invest in a particular issue.

- *Credit risk or default risk* is the risk that a particular borrower will be unable (or unwilling) to make the principal and interest payments on its debts.
- *Interest rate risk* is the risk that interest rates may rise, eroding the value of the bond. Generally the longer the maturity of a bond, the greater the interest rate risk, which is the reason that, in a normal yield curve environment, interest rates become progressively higher the longer the maturity of a bond issue. The value of a bond (particularly a fixed rate bond) changes in the opposite direction of a change in interest rates, so as interest rates rise, the price of a bond falls.
- *Inflation risk* is related to interest rate risk—especially for a buy-and-hold investor—and is the risk that the value of the bond will be eroded by inflation because the interest rate will be exceeded by the inflation rate. Floating rate bonds have lower inflation risk, to the extent that the underlying benchmark fluctuates with inflation expectations (i.e. resetting based on 6 month LIBOR).
- *Liquidity risk or marketability risk* depends upon how easily investors can sell bonds at or near their intrinsic value in the secondary market. The spread between the bid and ask price is an indicator of liquidity risk—the wider the spread, the lower the liquidity. The financial intermediary (securities firm/bank) which makes a market in the issuer's bonds can be an important factor when analyzing liquidity risk, as sale of the bonds at a reasonable price might be hindered if the issue isn't supported by its arranging banks.

International investors, particularly in emerging market debt, face additional risks:

- *Country risk* refers to risks that a country will fail to honor its financial commitments—in particular, default on its sovereign debt for either political or macroeconomic reasons—which generally harms the performance of all other financial assets in that country. Country risk also includes the risk that a country will impose capital or currency exchange controls that would prevent a private debt issuer from making foreign currency payments, and thus render it unable to service its Eurobond obligations.



- *Currency risk or foreign exchange risk* are risks linked to a change in the value of the currency in which the bond is denominated relative to other currencies. The value of a local currency relative to the US dollar or the euro is particularly important in today's financial markets.

A borrower who borrows in a currency other than that in which its income is denominated faces a risk that its debt service payments may rise if its currency drops in value vis-a-vis the currency of a loan. For the lender, this potentially increases credit risk.

Interest rate, inflation, country and currency risks are sometimes referred to as systemic risks because they affect broad classes of assets. Although systemic events can increase credit risk, credit risk is particular to the specific investment. Certain other types of specific risks related to particular bond structures, such as call risk and prepayment risk, will be discussed in Section III.

THE IMPORTANCE OF CREDIT RATINGS

A credit rating is a formal assessment, based on established methodology, of an issuer's credit worthiness and its capacity to make scheduled payments on time. A credit rating can be viewed as a measure of the potential risk of default on a given bond issue.

In the US and increasingly in the Eurobond market, the credit rating on an issuer's debt provided by a major credit rating agency is a significant factor in determining the risk premium and the resulting interest rate of a bond issue and also the potential class of investors that may buy the issue. The following table shows the corporate bond rating systems for public and private debt of Moody's, Standard & Poor's and Fitch Ratings.

Credit Ratings for Long-Term Debt

Credit Risk	Moody's	Standard & Poor's	Fitch
Investment Grade			
Highest Quality	Aaa	AAA	AAA
High Quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not investment grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Lower grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	C	C
In default	C	D	D



Ratings for Short-Term Debt

Credit Risk	Moody's	Standard & Poor's	Fitch
Investment grade rating	P1	A1	F1+, F1
	P2	A2	F2
	B3	A3	F3
Speculative grade	Not Prime	B, C	

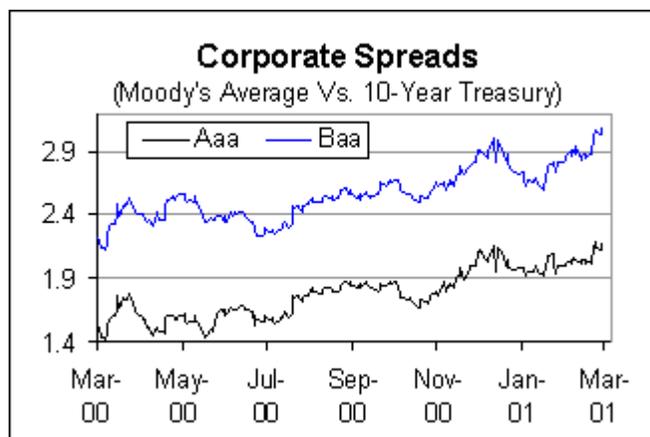
Rating Driven Market Segmentation: Investment Grade and High Yield Bonds

Investment grade bonds are bonds that are rated in one of the four highest categories by a major credit rating agency. They are issued by the most creditworthy corporations, which are usually the largest.

High yield bonds, also known less charitably as junk bonds, are bonds that do not have investment grade ratings. High yield bonds are issued by emerging companies, by companies whose credit ratings have been reduced or by highly leveraged companies in capital-intensive industries (cable, wireless). High yield bonds typically have shorter maturities than investment grade bonds, usually no more than 10 years. As the name implies, they have higher interest rate costs than investment grade bonds.

The delineation between investment grade (BBB or higher) and speculative grade is particularly important because the investment guidelines of many institutional investors restrict or prohibit holdings in debt that is not investment grade.

As the charts on the following pages show, the difference in yields and spreads on investment grade and high yield bonds is consistently pronounced, and in fact, in the US, these are two essentially different markets. The chart below shows the difference in spreads of US corporate debt rated AAA (the highest rating) and BBB (the lowest investment grade rating), over US Treasuries, the US dollar benchmark. The charts on the following pages include high yield debt and show spreads and yield to maturity for longer-term debt. They clearly show that the higher a bond issue's credit rating, the lower the market's perception of risk and thus required rate of return.

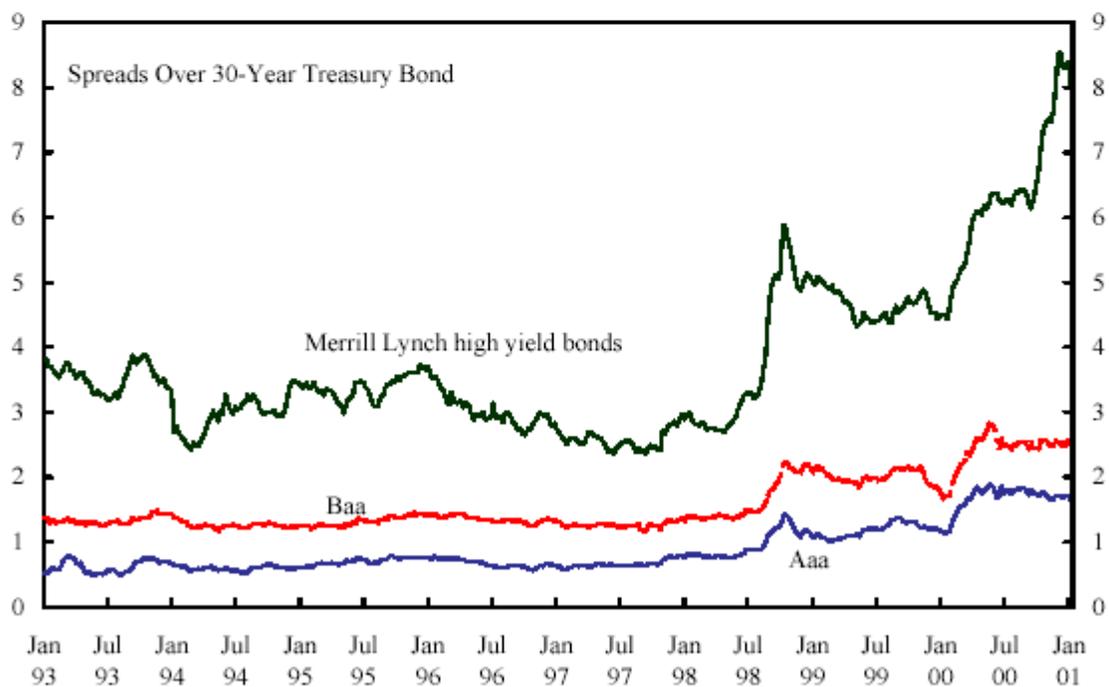
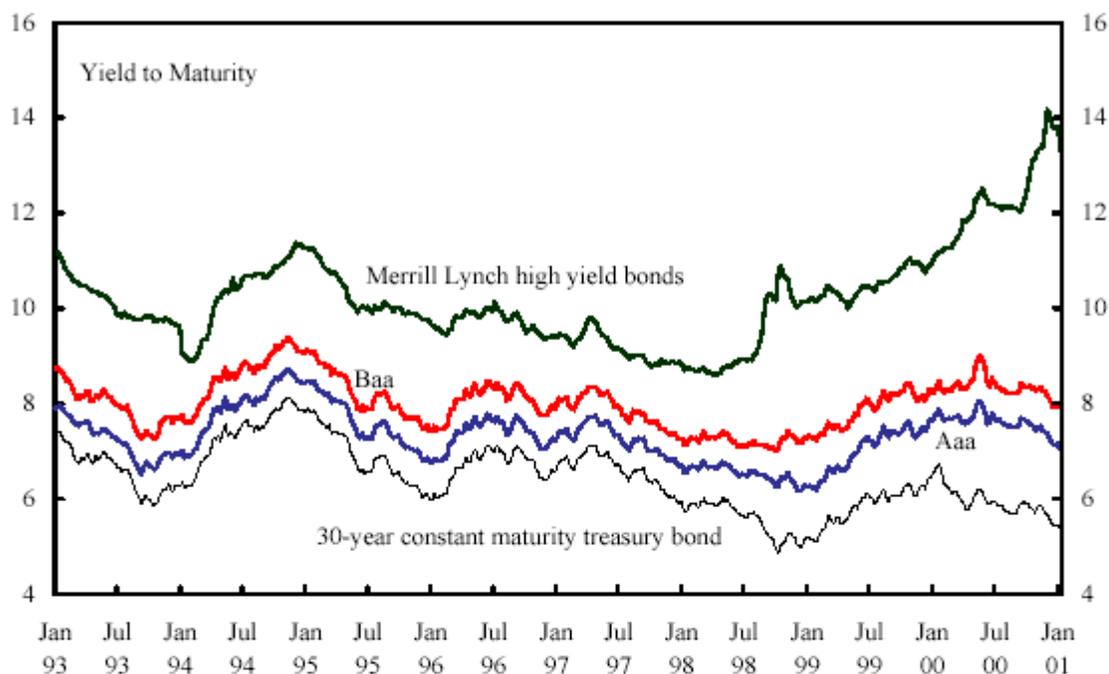


Source: www.bondtalk.com

High yield bonds may be of special interest to emerging market issuers, because emerging market Eurobonds often trade at prices similar to high yield bonds (although some event like projections of increases in US interest rates in the spring of 2004 hit emerging market debt much harder than US high yield.) Even emerging market companies that are 'blue chips' in their local markets are likely to be



regarded with caution by international investors because they do not have the track record or credit ratings of established investment grade issuers. The corresponding lack of depth in liquidity (fewer potential buyers) results in more volatile trading and wider prices in emerging market debt.



Sources: Federal Reserve; Merrill Lynch; and Bloomberg Financial Markets, L.P.

Source of tables: IMF



Summary of Fitch Ratings' Corporate Rating Methodology

Fitch's corporate rating methodology uses both qualitative and quantitative analyses to assess the business and financial risks of fixed income issues. A company analysis typically involves at least five years of operating history and financial statements, as well as company and Fitch forecasts of future performance. Fitch compares a company's performance with others in its peer group and performs a sensitivity analysis under several hypothetical scenarios to assess the company's ability to cope with changes in operating environment.

Qualitative Analysis

Industry Risk is higher when an industry is in decline, highly competitive, capital intensive, cyclical or volatile and lower when an industry has oligopolistic structures, high barriers to entry, national rather than international competition, and predictable demand levels.

Operating Environment includes social, demographic, regulatory and technological changes as well as the effects of geographical diversification, trends in industry expansion or consolidation, industry overcapacity and stage of the industry's life cycle.

Market Position gauges market share, product dominance and ability to influence price.

Management focuses on corporate strategy, risk tolerance and funding policy.

Accounting includes the degree to which accounting policies accurately reflect a company's financial performance and also looks at differences in national accounting standards and their effect on companies in the same industry but different countries.

Quantitative Factors

Cash Flow emphasizes cash flow measures of earnings, coverage and leverage.

Earnings and Cash Flow focuses on the stability and continuity of cash flows from major business lines.

Capital Structure analyzes a company's reliance on external funding and the credit implications of a company's leverage, within industry norms. A company's ability to meet cash interest payments from core business operating cash flows is analyzed

Financial Flexibility measures leverage, with more conservatively capitalized companies generally having greater flexibility.

Definitions

Earnings Measures:

- EBITDA: Earnings before interest, taxes, depreciation and amortization, an indication of a company's fundamental, unleveraged cash-generating capacity
- EBITDAR: EBITDA plus gross rental expense (if operating leases are material)
- After-Tax Cash Flow—residual cash remaining after payment of interest expense and cash tax payments
- Net Free Cash Flow: indicates funds available to repay debt, repurchase shares or make acquisitions without external funding

Coverage Ratios:

- EBITDA/Gross Interest Expense (cash and noncash plus capitalized interest)
- EBITDA/Cash Interest Expense
- EBITDA/Net Interest Expense (gross interest expense less interest income)

Leverage Measures:

- Debt and Net Debt
- Debt/EBITDA
- Net Debt/Equity or Gearing
- Total Debt/Total Capitalization

Profitability Ratios:

- Operating Income/Revenues
- EBITDA/Revenues
- Return on Equity

Source: Fitch Ratings "Corporate Rating Methodology," available at www.fitchratings.com



The Sovereign Ceiling

Generally a corporate issuer's debt will not be rated higher than the credit rating on the government foreign currency debt of its home country because of the government's ability to impose currency controls. This is sometimes referred to as the sovereign or country ceiling. Occasionally ratings are assigned above a country ceiling, in the case of corporate issuers with strong diversified foreign currency earnings or support from a foreign parent. Sometimes asset-backed issues can exceed the sovereign ceiling and the rating of the originator. Ratings on local currency obligations of strong corporate issuers above the sovereign's local currency ratings are more common, although not for banks.

Fitch has recently assigned country ceiling ratings to the 10 new members of the European Union that exceed the sovereign long term foreign currency ratings because of the view that membership in the EU reduces transfer and convertibility risks for the private sector, even in the event of a sovereign debt crisis.

The table on the following page shows the foreign and domestic currency ratings and country ceilings for a number of emerging market issuers.



Credit Ratings, Selected Emerging Market Countries, May/June 2004													
Country	Moody's					Standard & Poor's			Fitch				
	Government Bonds		Outlook	Country Ceilings for Foreign Currency		Government Bonds		Foreign Currency		Outlook	Local Currency	Country Ceiling	
	Foreign Currency	Domestic Currency		Long Term	Short Term	Foreign Currency	Domestic Currency	Long Term	Short Term		Long Term		
Argentina	Caa1	B3	STA	Caa1	NP	SD	SD	DDD	C			B-	
Azerbaijan								BB-	B	positive		BB-	
Bosnia Herzegovina	B3	B3	POS	B3	NP								
Brazil	B2	B2	STA	B2		B+/Positive	BB/Stable	B+	B	stable		B+	
Bulgaria	Ba2		STA	Ba2	NP	BB+/Stable	BBB-/Stable	BB+	B	positive		BBB-	
Chile	Baa1	A1	STA	Baa1	P-2	A/Stable	AA/Stable	A-	F1	positive/stable		A+	
China	A2		STA	A2	P-1	BBB+Positive	BBB+/Stable	A-	F1	positive/stable		A	
Croatia	Baa3	Baa1	STA	Baa3	P-3	BBB-/Stable	BBB+/Stable	BBB-	F3	positive		BBB+	
Czech	A1	A1	STA	A1	P-1	A-/Stable	A+/Stable	A-	F2	stable		A	A+
Egypt	Ba1	Baa1	STA	Ba1	NP	BB+/Negative	BBB-	BB+	B	stable/negative		BBB	
Estonia	A1	A1	STA	A1	P-1	A-/Positive	A-/Positive	A-	F1	positive/stable		A+	A+
Eurozone				Aaa	P-1								
Hungary	A1	A1	STA	A1	P-1	A-/Stable	A/Stable	A-	F2	negative		A+	A+
India	Baa3	Ba2	STA	Baa3	P-1	BB/Stable	BB+/Positive	BB+	B	stable		BB+	
Israel	A2	A2	STA	A2	P-1	A-/Negative	A+/Negative	A-	F1	stable/negative		A	
Kazakhstan	Baa3	Baa1	STA	Baa3	NP	BBB-/Stable	BBB/Stable	BB+	B	positive		BBB-	
Latvia	A2	A2	STA	A2	P-1	BBB+/Positive	A-/Stable	BBB+	F3	positive/stable		A	A
Lithuania	A3	A3	POS	A3	P-2	A-/Stable	A-/Stable	BBB+	F2	positive/stable		A	A
Mexico	Baa2	Baa1	POS	Baa2	P-2	BBB-/Stable	A-/Stable	BBB-	F3	stable		BBB	
Poland	A2	A2	STA	A2	P-1	BBB+/Negative	A-/Negative	BBB+	B	stable		A+	A
Romania	Ba3	Ba3	STA	Ba3	NP	BB/Positive	BB+/Positive	BB	B	stable		BB+	
Russia	Baa3	Baa3	STA	Baa3	NP	BB+/Stable	BBB-/Stable	BB+	B	stable		BB+	
Slovakia	A3	A3	STA	A3	P-2	BBB+/Positive	A-/Stable	BBB+	F2	positive/stable		A	A
Slovenia	Aa3	Aa2	STA	Aa3	P-1	AA-/Stable	AA/stable	A+	F1	positive/stable		AA	AA
South Korea	A3	A3	NEG	A3	P-2	A-/Stable	A+/Stable	A	F1	stable		AA-	
Turkey	B1	B3	STA	B1	NP	B+/Positive	BB-/Positive	B+	B	stable		B+	
Turkmenistan	B2	B2	STA	B2	NP			CCC-	C				
Ukraine	B1	B1	STA	B1	NP	B/Positive	B/Positive	B+	B	stable		B+	
France	Aaa	Aaa	STA	see Eurozone									
Germany	Aaa	Aaa	STA	see Eurozone									
Guernsey	—	—	—	Aaa	P-1								
Japan	Aaa	A2	STA	Aaa	P-1								
Jersey	—	—	—	Aaa	P-1								
Switzerland	Aaa	Aaa	STA	Aaa	P-1								
United Kingdom	NR	Aaa	STA	Aaa	P-1								
United States	Aaa	Aaa	STA	Aaa	P-1								

Sources: Moody's, Standard and Poor's and Fitch Ratings; see web sites for additional explanations and updates www.moodys.com; www.sandp.com; www.fitchratings.com



Domestic and International Bond Markets and the Euro Area Bond Market

Emerging and developed financial markets are increasingly integrated today in several ways that are potentially significant for emerging markets bond issuers. The character of foreign participation has expanded from primarily cross border lending by banks in the 1970s into broader and deeper participation by both banks and other financial institutions in emerging markets:

- Foreign financial institutions have increased their participation in domestic markets by buying local institutions. Foreign banks, mostly European and US, own large a significant portion of the banking industry in most of Emerging Europe. In emerging bond markets, banks may act as:
 - Issuers of bonds
 - Issuers of asset backed securities
 - Investors (both for themselves and as asset managers)
 - Intermediaries—market makers, underwriters, other service providers
 - Guarantors of other issuers' obligations
- The range of investors investing in emerging market bonds has widened, from primarily hedge funds in 1990s to include institutional investors that traditionally invested in highly rated developed market debt, such as pension funds and insurance companies.
- Emerging market investors have increased their participation in developed economies, with an increasing number of emerging market institutional investors with asset allocations that include foreign assets.

In the long run these are positive developments for emerging bond issuers that will lead to a larger pool of funds available for investment and an increase in the range of financial services available to them. Integration also suggest that issuance standards are likely to converge, as emerging market investors, with increasing exposure to developed market instruments, begin to expect similar quality from their own markets. It may also lead to a tiering in the market, with countries that have well-managed economies and the perception of good growth prospects attracting the majority of investment over riskier countries, which may see a rise in the risk premium the market requires on their debt.

Integration may increase market volatility. As noted above, changes in emerging market bond spreads and US high yield spreads are more closely correlated today than ten years ago, indicating that price movements are increasingly explained by global market factors common to both emerging and developed markets, whiled the importance of unique local factors decreases. In some circumstances, the impact of the actions a country's regulatory authorities and policy makers on their own markets may be reduced.

Emerging market companies and their advisors need to have a good understanding of market options, as well as the impact that seemingly distant events may have on their financing plans, especially when contemplating relatively long term bond market funding.

DOMESTIC BOND MARKETS

The benefits of a local currency bond market as a policy matter and business matter for issuers—among them, avoiding the currency mismatches inherent in borrowing in foreign currency and providing alternatives in funding sources—are clear. Nevertheless, the degree of development of local currency bond markets varies not only in emerging markets, but among developed countries. Potential issuers and their advisors considering to bonds issuance in thier domestic market will need to understand the level of development of their local market to determine whether the domestic market will support the type of financing they are seeking. While the absence or underdevelopment of certain factors may not be fatal



to a local market, advisors should understand how the nature of these factors in the local market will influence a bond issue, both at the time of issuance and as the market develops.

By definition a market requires multiple participants and multiple transactions. In bond markets, liquidity is one of the most important determinates of good execution. The European Commission, has found that an effecient bond market requires size, breadth (number of issuers) and depth (size of issues) to create liquidity, which in turn determines the ease and cost of bond trading. In very illiquid markets, a single sizable transaction can move prices, which means the trade reflect the shallowness of the market as much as the risk of the instrument.

The relative significance of bond markets to an economy varies consderiably accross developed market. The US bond market is about 162% of GDP (2003) and European bond markets about 94% (2000). Although demographics are not the sole determining factor—in Denmark, a country of 5.4 million people, the bond market is 180% of GDP and is dominated by a fairly unique mortgage bond system—an economy probably needs to be of a fairly large size to be able to generate the liquidity necessary to achieve the full benefits of a debt capital market.

In addition to liquidity, size promotes both diversification of instruments and homogeneity within an asset class. Terms and documentation for US corporate issues are relatively standardized, within the framework of the issue type. This helps smooth the functioning of the market and further contributes to liquidity.

Furthermore some of the attributes of a smoothly functioning bond market require scale in order for service providers—for example, credit rating agencies—to function as viable commercial concerns. Because the US market is so large and well established a wealth of research, data, and sophisticated analysis exists about how the market and specific debt instruments perform in a wide range of circumstances. Regulators, academics, sophisticated institutional investors and professional money managers, investment bank research analysts, rating agency analysts and other third party service providers devote careers to studying the market and performance of bonds under various circumstances leading to a great deal of information on how the market works. See Resources.

Several other factors—in addition to the crucial factor of interested investors which will be discussed separately below--are important

- Macroeconomic Stability
- Rule of Law (and a solid legal and regulatory framework)
- Primary and Secondary Markets
- Benchmark Indices
- Credit Rating Agencies
- Interest Rate Derivative Markets

Macroeconomic Stability. While developed bond markets may be able to adapt and survive to high interest rate environments (US markets survived the inflationary 70s and high interest rate 80s), in transition economies macroeconomic stability, low or at least stable inflation rates and relatively low real domestic interest rates are significant factors that may help a corporate bond markets begin to develop.



Emerging Europe Inflation and Interest Rates

	Consumer Prices 2004e	Local Currency Spreads Banking 2003			Interest Rates Oct. 2004 Short term (% yr)	Domestic Gov. Bonds 2004						Oct. 20 Year YTM
		Avg Lending Rate	Avg Deposit Rate	Avg Spread		2 Year YTM	3 Year YTM	5 Year YTM	10 Year YTM	15 Year YTM		
Poland	3.8	9.60	2.90	6.70	6.90	7.02	7.08	6.81				6.53
Hungary	6.7			2.5	10.57		9.79	9.25	8.01	7.94		
Czech Republic	3.3	5.30	1.40%	3.90	2.66	2.95		3.88	4.75	5.07		
Slovakia	7.7	7.60	3.30	4.30		4.15		4.45	5.05			
Slovenia	4.0	9.30	4.80	4.50								
Estonia	2.8	3.40	2.20	3.20								
Latvia	4.0	7.20	4.20	2.90								
Lithuania	0.2			5.60								
Bulgaria	6.5			6.40								
Romania	12.0	25.40	10.80	14.60								
Croatia	2.4	11.50	1.70	9.80								
Bosnia & Herzegovina	0.9	10.30	2.60	7.70								
Serbia	9.0	14.80	2.70	12.10								
Albania ¹	2.4	13.90	6.20	7.70								
Kosovo ¹	0.1	14.20	2.60	11.60								
Russia	10.9	21.10	5.40	15.70	13.00	5.80	6.63	7.75				
Ukraine	7.0	17.50	6.80	10.70								
Belarus ¹	29.0	28.60	15.10	13.50								

¹2003

Source: RZB Group Research, The Economist

Rule of Law. A recent study by the Federal Reserve (the US central bank)¹ indicates high correlations between creditor friendly laws and creditor friendly policies—defined as low inflation rates and macroeconomic stability—and the level of a country’s bond market development. The study indicates that countries with better historical inflation performance, a well developed rule of law and better creditor rights have a deeper local bond market and rely less on foreign currency bond issues.

Furthermore the study suggest that well developed bond markets in countries with a strong rule of law and creditor friendly law and policy have a higher participation of foreign investors (as represented by US investors) in the local currency bond market, perhaps suggesting that local and international investors ultimately look for the same things in making investment decisions.

This is not to imply that creditor friendly countries will be free of default. In fact, historical defaults experienced by local bond issuers can be instructive on how a new bond issue may be received by the investor community. Default experience may highlight certain obstacles to future local and international bond issuance or it may demonstrate the smooth functioning of the rule of law.

The following table shows the level of local bond market development and the portion of local currency bonds in the local market for selected regions and countries at the end of 2001.

¹ Berger and Warnock, “Foreign Participation in Local-Currency Bond Markets,” Board of Governors of the Federal Reserve System International Finance Discussion Papers, Number 794, February 2004, available at www.federalreserve.gov/pubs/ifdp



	Total Bonds Outstanding			Local Currency Bonds Outstanding			
	USD billions	% of world bond portfolio	% of country's GDP	USD billions	% in world bond portfolio	% of country's GDP	% of country's total bonds
Developed Countries	28,973	93.1	122	27,047	86.9	114	93
Euro Area	6,840	22	112	6,055	19.5	99	89
Other Europe	2,049	6.6	92	1,548	5	70	76
Denmark	273	0.9	169	243	0.8	151	89
Switzerland	162	0.5	66	154	0.5	63	95
Great Britain	1,313	4.2	92	973	3.1	68	74
Other Developed	20,084	64.5	130	19,444	62.5	126	97
Australia	206	0.7	58	114	0.4	32	55
Canada	639	2.1	91	451	1.4	64	71
Japan	4,825	15.5	116	4,760	15.3	114	99
US	14,396	46.2	141	14,107	45.3	138	98
Emerging Markets	2,156	6.9	39	1,676	5.4	30	78
Latin America	544	1.7	31	262	0.8	15	48
Emerging Asia	1,198	3.8	42	1,087	3.5	39	91
Financial Centers	98	0.3	39	63	0.2	25	64
Emerging Europe	170	0.5	39	132	0.4	30	77
Czech	11	0	20	10	0	17	86
Hungary	26	0.1	50	16	0.1	31	61
Poland	42	0.1	24	35	0.1	20	84
Turkey	91	0.3	61	71	0.2	48	78
Other Emerging	146	0.5	56	132	0.4	51	90
World	31,129	100	106	28,723	92	98	92

Burger and Warnock, "Foreign Participation in Local-Currency Bond Markets"

Primary and Secondary Markets. The establishment of a government securities market has generally been the first step in creating a domestic bond market in emerging Europe. Governments are usually the first issuer with sufficient frequency of issuance to create liquidity, the ability to issue securities with longer terms as inflation declines, and variety among maturities to create a yield curve.

Success stories in Poland, Hungary and Czech Republic have attracted both local and international investors in their domestic government bond markets. Corporate issuance, however, is still small in all three countries.

Domestic Debt Securities: Emerging Europe
USD billions

	Governemnts			Financial Institutions			Corporates			All issuers		
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
Czech Republic	20.5	36.3	46.2	2.6	3.3	4.4	2.7	3.2	3.8	25.7	42.8	53.6
Hungary	18.5	29.3	38	0.4	0.6	3.1	0.8	0.9	1	19.7	30.8	42.1
Poland	44.2	55.3	65.8							44.2	55.3	65.8
Turkey	84.7	91.8	140.3							84.7	91.8	140.3
Denmark	73.5	90.7	105.4	160.1	203	262.5	14.1	15.7	19.5	247.8	309.5	387.4
UK	411.2	473.7	510.2	288.9	333.3	382.3	221.1	289.9	382	921.3	1096.9	1,274.50
US	4,199.90	4,540.60	5,021.40	8,623.40	9,290.60	10,133.70	2,441.60	2,422.60	2,489.70	15,241.90	16,253.90	17,644.80

Source: BIS

In Poland, because of high real interest rate, the corporate debt market has historically been dominated by commercial paper, which is now approximately 47% of the market but declining in share as investors gradually lengthened maturities in an environment of declining interest rates. According to Fitch Ratings at the end of the third quarter 2004, corporate bond issues outstanding with maturities over one year amounted to nearly two billion in USD and bank bonds stood at a little under 900 million. Much of Poland's non-corporate debt is privately placed and not actively traded.



Both Czech and Hungary have covered mortgage bond products that are reflected in the issuance figures for financial institutions.

Russia's local debt markets have begun to recover in the last few years after the financial crisis and default of 1998, with large corporate issuers taking the lead.

Russia		
USD billions, Sept. 2004		
Governments	Financial Insitutions	Corporate Issuers
163.4	1.3	5.6

Source: Cbonds "Russian Fixed Income Monthly, No. 10, October 7, 2004

Secondary market activity is an important manifestation of liquidity in a bond market, because it gives investors the ability to trade investments at a quoted and analyzable price. Institutional investors that make long-term investment in bonds are often required by law, regulations or investment guidelines to mark to market their portfolios (even when not actively trading) to reflect both performance and risk.

There is secondary market trading activity in the Russian corporate market. For example, domestic corporate market velocity (monthly turnover/amounts outstanding) was estimated at approximately 28% in August 2004.

In Russia, local investment banks and independent agencies provide price quotes, forward calendars, rating information and sophisticated market analytics. (See the resources section for examples.) Even some English language information is updated on a daily basis. A practice of rating domestic issuer seems to be developing, with S&P, Moody's and Fitch all active in rating Russian corporate issuers. Bank research departments in the region track Polish, Czech and Hungarian debt market fundamentals, although generally on a less frequent basis.

Privatization and corporate sector development. In emerging Europe, where most of the private sector did not exist prior to 1990, a certian amount of time is probably necessary for newly privatized enterprises to restructure, refocus and develop financial departments, before accessing public debt markets is practical. Both the market and internal, microeconomic infrastructure necessary to support bond markets have taken time to develop in most of emerging Europe.

Benchmarks. Government bonds are widely used as references for pricing corporate bonds for a number of reasons. Central governments in most of the developed countries are viewed as the most creditworthy borrowers which issue securities essentially free of default risk, which makes the government yield curve the best proxy for the nominal risk free rate. Governments have both large borrowing needs and a long life, so are able to offer a wider range of maturities than most other issuers. Furthermore the steady supply and fungible nature of government paper facilitates trading. Well-developed repo and derivatives markets enable market participants to take short and long positions to manage their view of future interest rate movements.

When government bonds are not available across the yield cure, it is difficult to establish a government benchmark yield curve to price corporate debt. But alternatives are coming into use in some markets.

European corporate debt issuers are increasingly using interest rate swaps as reference rates. Swap rates are especially useful for banks and other leveraged institutions that are interested in the spread on an asset relative to funding cost. Swap rates reflect expectations of future LIBOR and EURIBOR and because most European banks' liabilities are based on short-term interbank rates—either LIBOR or EURIBOR—they make attractive reference rates. Banks dominate the European fixed income markets to a greater



extent than in the US market, so issuer preference has facilitated the shift to the swap curve. The European swap market is highly liquid, with turnover of Euro swaps exceeding that of all interest rate products other than US Treasuries by 2001. Bid/ask spreads are comparable to German governments, although the market is not as deep. Swaps have the disadvantage of being vulnerable to the change in credit quality of banks and counterparty risk in the market. (Interestingly, no uniform government benchmark has emerged in the Euro area market, with German Bunds used as the 5 and 10-year benchmark, and shorter maturities using French securities.)

In theory, other non-government yield curves could serve as benchmarks, for example, an index of yields on similarly rated corporate bonds. Numerous corporate bond indices exist, including those focused on emerging market debt. Many asset managers benchmark their performance against such an index, which could be extended to interest rate risk pricing. In the US dollar market, interest rates in the general collateral repo market are used as benchmarks at short maturities, although US treasury securities usually serve as collateral for these transactions. Other instruments could potentially be used.

INTERNATIONAL BONDS AND OVERVIEW OF EUROBOND MARKET

A company may choose to issue bonds in its domestic market or may consider issuing bonds in the international market, depending on where the company can get the best execution and price for its debt.

Eurobonds are bonds issued outside the country in whose currency the issue is denominated. For example, a US firm may issue dollar denominated Eurobonds to investors in Europe, or a Russian company might issue euro denominated Eurobonds to those same European investors. Eurobonds can be issued in many currencies including the euro and, while the Eurobond market predates the development of the euro currency, the adoption of the euro has fostered increased integration in Western European domestic bond markets. The growing pan-European Euro area market is now second in size only to the US bond market. Because the Eurobond market reaches the widest investor base, even with the increase in Euro area market, most European corporate issuers still issue Euro denominated bonds off-shore (and list in London or Luxembourg), further blending markets.

Developments in the Euro area bond market are particularly important for new member states and accession countries, as they move toward adoption of the euro. The large Euro zone bond market gives bond issuers access to larger investor base and deeper, more liquid markets as the single currency has reduced some of the risks associated with a pan-European bond market. Benefits of the growing Euro zone market include:

- Lower transaction costs
- Wider risk diversification for investors
- Increased price transparency
- Financial innovation resulting from increased competition, which may lead to the creation of more tailored financial products

The European high yield market is still considerably smaller than that of the US, so innovation and increasing risk diversification that encourages this asset class could be especially significant for emerging Europe corporate issuers.

Foreign bonds refer to bonds issued by a foreign company or government in the country in whose currency it is denominated. For example, Yankee bonds are denominated in US dollars and issued by a non-US company in the US. Foreign bonds are subject to the securities law issuance and disclosure standards of the country in which they are issued, which may be more restrictive than for that country's domestic bonds.

Global bonds are structured so that they can be offered in both foreign and Eurobond markets.



US securities law requires that foreign private issuers of bonds in the US generally conform with US securities laws as they would apply to domestic issuers, so Yankee bonds may not be attractive options for any company that does not want to register its securities in the US. Yankee bonds or Eurodollar bonds might be an attractive option for companies that want to match dollar revenues/inflows with dollar financings to support that line of business (i.e., hedge its exposure to dollars).

For some large emerging market companies, choosing between a Eurobond and domestic issue in its own country is an option. In 2003, spurred by low interest rates in the US and other developed economies, investors' search for yield resulted in significant emerging market Eurobond issues, a trend that continued in 2004. Russian financial institutions and corporates and the Polish government were particularly significant issuers.

The Eurobond market is by far the most significant international bond market. Eurobond issues can be as varied as US domestic issues, and include straight high-grade bonds, high yield, mortgage-backed and asset-backed securities. There are some differences, such as Eurobonds pay interest annually, while US bonds pay interest semiannually.

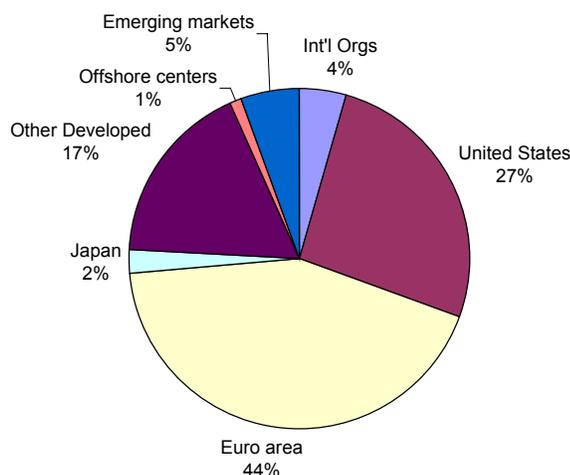
The Eurobond market is essentially unregulated; however, disclosure standards in the Eurobond market are investor driven and generally comparable to US standards, except for differences in accounting standards (IAS vs. GAAP). Documentation is standardized and extensive. Eurobonds were traditionally bearer bonds (meaning the issuer does not keep a register of the holders), which, among other things, makes it cumbersome to refund bonds prior to maturity. See Section III for a discussion of constraints on bearer bonds that apply to US issuers and investors.

International Debt Securities Outstanding	
end 2003	
USD billions	
Money Market Instruments	
Commercial Paper	417.9
Total	569.5
Bonds and notes	
Floating rate	2,383.9
Straight Fixed rate	8,366.0
Equity-related (convertibles)	361.9
Total	11,111.8
Total Outstanding	11,681.3

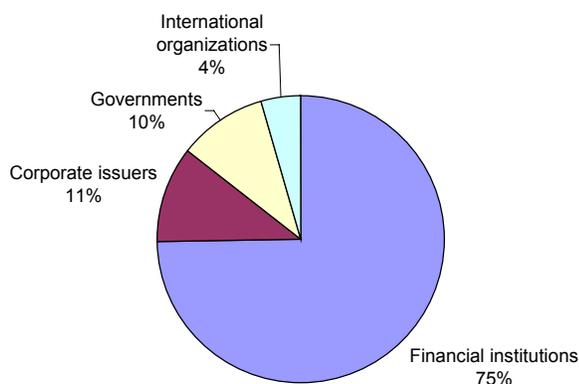
Source: BIS Quarterly Review, March 2004



International Debt by Nationality of Issuer, Outstanding 2003



International Debt Issuance in 2003 by Issuer Type



Historically, Eurobond investors owned assets denominated in several different currencies, so the relative attractiveness, and thus yields, depended on relative exchange rates. Traditionally, most Eurobond offerings were denominated in US dollars. Because of exchange rate sensitivity, Eurobond maturities have been shorter and issue sizes smaller than in the US market. Maturities range from 5 to 10 years, depending on market conditions. The advent of the European Monetary Union appears to be changing the character of the Eurobond market, increasing liquidity, deepening the investor base, and (not coincidentally) decreasing transaction costs. Issue sizes have now grown larger as investors are more comfortable with the pan European scope of the underlying assets producing the repayments. Euro area nationals are increasingly issuing Eurobonds denominated in euros, which eliminates the exchange rate risk of their international borrowing.

Central and Eastern European issuers raising funds in the Eurobond markets are usually able to access larger issue sizes and longer maturities than available in the domestic markets. For example, Gazprom, the Russian natural gas company, has issued three-year ruble paper in the domestic market, but in much smaller issue sizes than its Eurobond issues. In February 2004, it issued a three-year, 10 billion ruble note (about \$340 million) in the domestic market, which was something of a landmark. In the Eurobond market, Gazprom has both USD and euro obligations outstanding: three issues of over a billion in principal amount and one going out to 2034, albeit with a call option. Central and Eastern European corporate issuers in the Eurobond market are almost certain to fall into the high yield category, due to the lack of established issuance track record or investor following.



Emerging Europe International Debt Securities
(USD billions)

	Financial Institutions			Corporate Issuers		
	Amounts outstanding			Amounts outstanding		
	Dec 2002	Dec 2003	June 2004	Dec 2002	Dec 2003	June 2004
Croatia	0.1	0.2	0.5	0.2	0.3	0.4
Hungary	0.6	1.4	0.7	--	--	--
Poland	5.8	6.6	6.1	0.3	0.3	0.3
Russia	2.2	7.7	10.0	3.1	5.4	6.7
Slovakia	0.1	0.2	0.4	0.8	0.9	0.9
Turkey	2.2	1.4	1.7	0.4	0.4	0.4

Source: BIS Quarterly Review, September 2004

In 2003, while the US dollar remained the preferred currency for emerging market debt as a whole, for emerging Europe, issuance of US-dollar and euro-denominated international bonds was evenly split, with euro denominated issues likely to continue in favor with the new member states that are potential euro zone members.

Net Issuance of International Debt Securities by Currency and Nationality of Borrower in 2003					
USD, billions					
	USD	Euro	Yen	Other	Total
Brazil	18.2	-1.6	-2.3		14.3
Korea	4.5	1.3	1.4	0.6	7.8
Taiwan	6.9	0	0.2	0	7.1
Russia	5.4	0.4	0	0	5.8
Poland	0.9	4.5	0.2	0	5.6
Mexico	4.2	1.1	-0.3	0.4	5.4
Phillippines	4	0.3	-0.4	0	3.9
South Africa	2	0.8	0	-0.1	2.7
China	1.5	0.5	-0.3	0.6	2.3
Israel	2	0	0	0	2
Venezuela	2.7	-0.8	0	0	1.9

Source: BIS Quarterly Review, March 2004, (from dealogic, Euroclear, ISMA, Thomson Financial Securities Data, B

Potential Investors

A company considering a bond issue should have an understanding of who the likely buyers of the bonds might be: how they are likely to view the issuer and the issue, their investment guidelines and objectives, time horizon, and appetite for risk/return. These factors will determine, first, whether the potential investors will consider buying an issuer's debt and second, the price they may be willing to pay for it. The primary institutional investors in corporate bonds include:

- Banks
- Insurance Companies



- Pension Funds
- Investment Funds
- Other Corporations

Each has different investment profiles influenced by the nature of their businesses, and the nature of their investable funds. The section begins with a look at the US institutional investor market. The fundamental nature of the business of institutional investors is consistent across markets, although investment guidelines are partially dependant on local regulatory and market conditions. One important difference between institutional investors in the US and Europe is that banks are a less significant part of the financial sector in the US than in Western Europe. In emerging Europe, banks are playing a very important role, which is likely to evolve in ways that are perhaps different than in either the US or Western Europe.

The table below shows the main institutional investors in corporate bonds in the US.

Investors in Corporate and Foreign bonds Q4 2003			
USD, billions			
	Total Assets	Corporate & Foreign Bonds	
		Amount	% of Total Assets
Commercial Banks	7,812.2	506.4	6.48%
Savings Institutions	1,475.1	71.1	4.82%
Life Insurance Companies	3,832.4	1,597.1	41.67%
Other Insurance	1,043.3	219.1	21.00%
Public Pension Funds	3,243.9	365.9	11.28%
Private Pension Funds	4,194.0	340.7	8.12%
Investment Funds	7,046.6	803.4	11.40%
Total Corporate & Foreign Bonds	6,840.4	3,903.7	57.07%

Source: Federal Reserve

Insurance companies. Life insurance companies are the largest holders of private (unregistered) debt securities in the US, which under the regulations of the US SEC can be sold only to accredited or qualified investors (discussed further below).

Life insurance companies have a relatively predictable and steady annual cash flow, which means they can commit funds for relatively long periods of time, hence their investments in private debt, which lacks liquidity. Purchasers of private debt securities generally require shorter maturities than publicly issued bonds, in addition to security, and restrictive covenants, such as limitations on indebtedness, limitations on liens, limitations on cash distribution and net worth and working capital requirements. Also compensation or “make whole” provisions for prepayments are common.

Credit ratings on privately placed debt are important to US life insurance companies because of reserve requirements that are tied to an investment’s credit rating. Only about 10% of insurance company funds are invested in non-investment grade debt. Private placements, and thus insurance company investors, are



an important source of debt financing especially for smaller companies without access to the public debt market. Private placements are also often chosen for complex financings.

A special form of unregistered securities known as Rule 144A offerings can be underwritten and traded among qualified institutional investors (QIBs), and are considered quasi-public securities. Because they are more liquid, they have fewer restrictive covenants; however, because they are not registered, they can be arranged more quickly than public offerings. The maturities are longer and refunding provisions are generally more flexible than private placements.

Rule 144A placements are attractive to foreign issuers, non-investment grade or high yield US issuers in accessing the US debt markets. Again, insurance companies are the primary buyers.

Pension funds. Public pension funds, which consist primarily of state and local government employee retirement funds, are also large investors in debt securities. However, they have less ability to commit long term funds than life insurance companies because the flow of funds depends on current legislation, salary levels of state and municipal employees and sometimes the cash management needs of the sponsoring government entity. They also may have restrictions as to the geographic location of the bond issuer or be prohibited from buying foreign corporate debt. Some are required by statute to invest only in securities rated single A or higher. They also may have further qualifications for corporate issuers, such as minimum length of corporate existence or coverage minimums.

Private pension funds are mostly corporate pension funds managed either directly by the corporation or by investment management firms or the trust departments of commercial banks. These funds generally have more flexible investment policies than public pension funds and invest in a wide range of debt securities, with investment restrictions as to class.

Investment Funds. Mutual funds companies offer fixed income funds with a wide variety of investment profiles. Because mutual funds calculate their net investment value daily (generally requiring a daily price quotation) and because investors can redeem their shares on a daily basis, mutual funds primarily invest in publicly traded, liquid debt securities. They are, however, significant investors in high yield bonds.

Closed-end bond funds, which have fixed number of shares and trade on stock exchanges, are also investors in bonds.

Hedge funds, which are open only to qualified investors and have more flexible investment guidelines used to be the predominate investors in emerging market debt, accounting for 30% of all activity in the emerging market sovereign debt market in 1998. That share dropped to 10% in 2002, with “real money” investors such as pension funds and other institutional investors taking up 32% of the market.

LOCAL INVESTORS IN LOCAL BOND ISSUES

While the level of development of specific sectors varies from country to country, domestic institutional investors are likely to be the significant investors in domestic corporate bonds. An issuer investigating the potential to sell its bonds in the local market may be interested in the level of development of the ‘local buy side’ including assets under management, investment guidelines, and investment profiles.

As an example of local investors, the table below shows assets under management for the main domestic institutional investors in Poland.

Domestic Institutional Investors in Poland

Assets under management, end 2003



Investors	Assets \$US billions	% GDP
Pension Funds	12.3	5.9
Insurance Companies	13.0	6.2
Investment Funds	10.2	4.9
Banks	134.2	64.7

In Poland, as of August 2004, banks accounted for 42% of the investment in the non-governmental bond sector, followed by corporations at 36%, insurance companies at 4.24% and pension funds at 0.84%.

Banks are significant investors in local currency debt in developing economies and by far the largest potential investor group in terms of assets in Emerging Europe. The banking sector is also the most developed financial sector business in most of the transition economies. A company and its advisor seeking to issue local currency bonds will want to have a good understanding of its domestic banking sector. As previously noted, banks are likely to be significant participants in domestic bond markets in several roles:

- Investors and Asset Managers
- Issuers of corporate bonds and mortgage and asset backed securities
- Intermediaries: market makers, underwriters, arrangers,

Pension Funds. Many transition economy countries have recently enacted pension fund reform, which includes public and private pension fund systems. These pension funds are good potential sources of investors for domestic corporate bonds, although most are currently heavily invested in local treasury securities, which is not uncommon in developing markets. Their investment restrictions may require them to invest only in registered securities and generally contain substantial allocations for corporate debt.

Because of the lack of available alternatives and thin markets, transition economy pension funds may pursue a buy and hold strategy on debt.

Insurance companies. The insurance sector is beginning to develop in the region. Life insurance companies are likely to have cash flow streams similar to western insurance companies and therefore similar investment profiles. Non-life insurance investment horizons are shorter.

Investment Funds are also developing in some countries. They generally invest in publicly traded equities and government securities. Some have restricted redemption periods that may allow for investments in less liquid assets.



	Population	Nominal GDP	No. of Banks	State Owned Banks	Foreign Owned Banks	Banking Sector Total Assets	Total Credits	Credits to Private Enterprises	Classified Loans	Total Deposits	
	MM	EUR BN		% of Assets	% of Assets	% of GDP	% of GDP	% of GDP	% of Total Credits	% of GDP	% of Total Credits
Poland	38.2	185.3	60	25.8%	71.6%	64.7%	28.6%	13.3%	21.8%	35.7%	125.0%
Hungary	10.1	72.8	36		81.9%	78.1%	37.2%	22.8%	3.2%	78.1%	209.0%
Czech Republic	10.2	75.7	27	3.1%	95.9%	106.8%	35.8%	14.2%	11.1%	62.3%	173.8%
Slovakia	5.4	34	22	1.5%	96.3%	82.4%	33.6%	18.1%	17.7%	66.6%	198.1%
Slovenia	2	24.5	20	24.9%	23.1%	89.9%	44.4%	34.7%	13.6%	58.1%	130.8%
Estonia	1.4	8	7	0.0%	99.2%	85.1%	59.3%	20.1%	0.4%	46.6%	77.5%
Latvia	2.3	9.9	23	4.1%	53.9%	96.1%	43.3%	28.8%	1.4%	28.2%	65.2%
Lithuania	3.5	16.2	13	0.1%	88.7%	39.7%	24.7%	15.8%	2.6%	31.1%	125.5%
New EU Members	73.1					78.0%	34.0%				180.0%
Bulgaria	7.8	17.6	35	0.4%	82.2%	50.3%	26.2%	20.0%	7.3%	39.5%	150.8%
Romania	21.7	50.3	38	41.5%	50.7%	32.6%	16.0%	9.5%	33.1%	21.3%	139.2%
Croatia	4.4	25.5	41	3.0%	91.5%	107.7%	58.1%	21.7%	5.2%	64.8%	111.4%
SE Europe Accession	33.9					48.0%	29.0%				130.0%
Bosnia & Herzegovina	3.9	6.2	36	<5.0%	>75.0%	57.5%	34.1%	15.5%	21.2%	16.1%	126.5%
Serbia	7.5	16.8	46	46.5%	20.0%	36.3%	19.5%			19.7%	101.5%
Albania	3.1	5.4	14		45.0%	55.1%	13.6%		5.1%	46.4%	340.4%
Kosovo	1.9	1.3	7		63.2%	44.2%	17.7%		5.3%	39.2%	221.6%
SE Europe Other	23.2					45.0%	20.0%				150.0%
Russia	143.5	382.5	1612	31.7%	<4.0%	41.8%	21.7%	17.2%	5.0%	14.4%	66.1%
Ukraine	47.6	43.9	156	9.5%	75.0%	38.1%	25.8%	22.4%	3.7%	23.3%	90.5%
Belarus	9.8	15.3	30	78.3%	10.2%	28.2%	17.7%		3.3%	13.9%	78.3%
FS 2		57.5				35.0%	24.0%				89.0%
EU 15/Eurozone	379.5					201.0%	110.0%				81.0%

Source: RZB Group Research



INTERNATIONAL INVESTORS

As noted above, the hunt for yield in the bond markets in the recent low interest rate environment in the US and the developed economies has resulted in the successful entry into the eurobond markets on the part of a number of emerging market corporate issuers. International investors in emerging market debt include:

- Pension Funds
- Insurance Companies
- Banks
- Mutual Funds
- Strategic Investors
- Opportunity Funds
- Other institutional investors

Some of these investors may invest in local currency bonds in local markets, including multinationals that have local currency earnings, strategic investors and investment funds, especially hedge funds. In addition to the basic credit analysis of an issuer, these investors will have special considerations, including:

- Sovereign/Country risk, discussed above
- Currency risk: Foreign investors may explore hedging their currency exposure, and often discover the cost of doing so more expensive than the underlying bond economics. Hedging costs may make the overall return unattractive. For many investors in emerging market bonds, the investment is both a bond and a currency play.
- Withholding tax considerations depend on the tax treaties between the jurisdictions of the issuers and the investors. This issue must be understood in the context of the bond's cash flow to in order to determine actual cash flow received by a purchaser.

Institutional investors (including emerging or transition economy institutions) generally have allocation maximums or buckets that relate to specific asset classes, for example high yield bonds or emerging market bonds. They also have limits on that amount they can invest in the obligations of a single issuer. Whether or not they will be interested in a local currency bond issue will also depend on the status of their existing investments with respect to various bucket limitations.

Almost all institutional investors will want to be able to track the performance of their investment in emerging market bonds. Innovation since the mid-1990s, the development of various types of emerging bond indices allow institutional investors to benchmark their performance of their portfolios against an index. For example, JPMorgan offers several emerging market fixed income indices and has a web based tool that allows investors to customize indices, with country, regional and sector features and across credit quality and maturity buckets.

Pricing and Risk Premium

When a bond is first issued, the interest rate (plus the discount and minus any premium paid for the issue) reflects the risk premium over the benchmark or base rate that the market requires the bond issuer to pay in order to borrow the funds. In the US and for dollar denominated Eurobonds, the base rate is the yield on the most actively traded Treasury securities with the closest maturity to the targeted average life of new bond. Generally, all US dollar debt issues are priced off of the comparable US Treasury plus a



spread for the risk seen in the issue. Emerging markets international debt prices would also include a risk premium for country risk. Local currency bond issues are likely to use local government debt yields as the benchmark rates. See Section I and above.

In the US, corporate securities are sometimes referred to as trading at a spread over the applicable “on-the-run” Treasury securities (those that are most heavily traded). For example, if the yield on a five-year corporate note is 5.92% and the yield on the five-year Treasury note is 3.92%, the spread is 200 basis points. The yield on corporates (and all other non-Treasury securities) is expressed as the base rate plus spread or:

$$\text{base interest rate} + \text{risk premium}$$

International floating rate debt may be tied to LIBOR for US dollars or EURIBOR for euros.

Factors that affect the risk premium, and thus spread, include:

- Issuer type
- Market perception of the creditworthiness of the issuer
- Term to maturity of the security
- Embedded options (call provisions, convertibility, etc.) in the security
- Tax treatment of interest received by investors
- Liquidity or expected liquidity of the issue

The missing risk premium in the Russian Ruble Bond market:

Markets are not always rational. This spring local ruble bonds were trading at yields well below the Russian inflation rate of 10%. Most issues are either unrated or rated below investment grade, making what seems already to be an irrational investment decision more mysterious. Yields climbed over the summer after a couple of defaults by local banks on their bonds, but were still below the inflation rate, with one year governments yielding around 6% and Gazprom, a “blue chip” without an investment grade rating, at around 9%.

Although some investors may be sorry, the low yields are probably driven by a combination of few local investment alternatives and strong oil and gas export earnings that have left Russian banks with considerable cash in need of investment. Thus risk premium can sometimes be distorted by broader market factors that have little to do with the risk of the security.

See The Economist, “Ugh” May 27, 2004

Different classes of bonds have different levels of risk premium. In the US, the credit rating on the issue is a primary determinate of spread, with investment grade and some asset backed structures having a lower risk premium and high yield non-investment grade debt, the highest. See the discussion of credit ratings above.

Bond issuers may decide to purchase insurance or otherwise enhance the creditworthiness of an issue, in which case the bonds will carry the credit rating of the entity providing the credit enhancement.



The Basic Meaning of Yield

Yield is the rate of return on a bond. A bond's stated interest rate may be fixed (or float with reference to an index) but yield changes to reflect price movements of a bond caused by fluctuating interest rates or other factors, like deteriorating or improving credit quality, that affect the value of the bond.

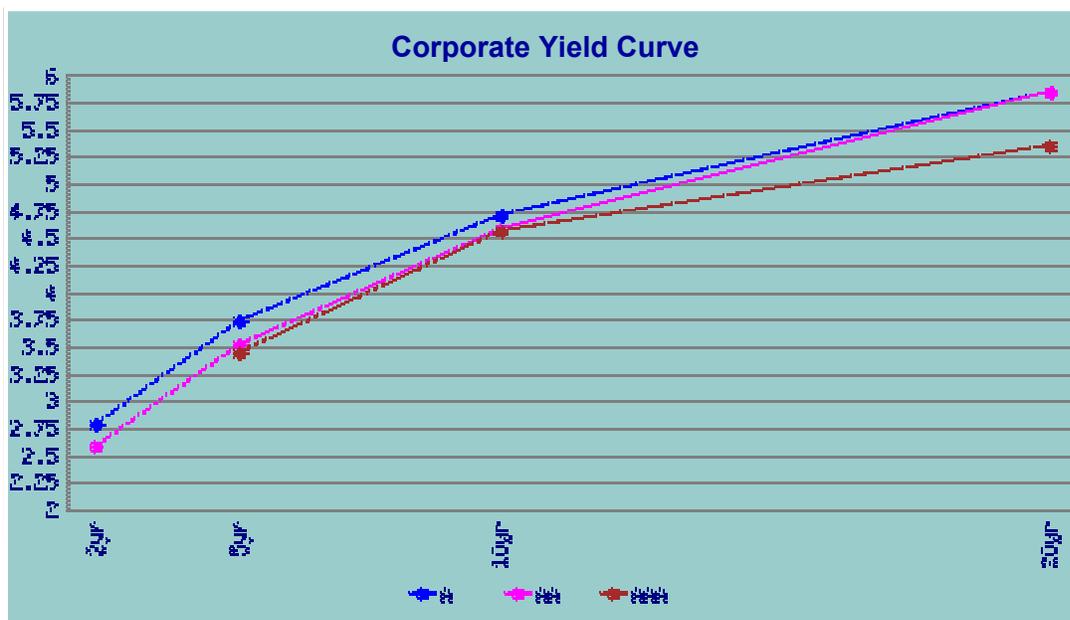
Current yield is the annual return on the amount paid for a bond, regardless of maturity. If the bond is purchased at par (100% of face value) and the stated interest rate is 5%, the current yield is 5%. If the bond is trading at a discount or premium, current yield will reflect the discount or premium. For example, if the price of a 5% bond with a \$1,000 face value is 105, its current yield is 4.76% ($1,000 \times .05 / 1,050$).

Yield to maturity is more meaningful because it takes into account the return on the bond if held to maturity. In the above example, if the bond matured in 5 years, its yield to maturity would be 3.9% (nominal interest + discount/years [or - premium/years] / (present value + maturity value)/2).

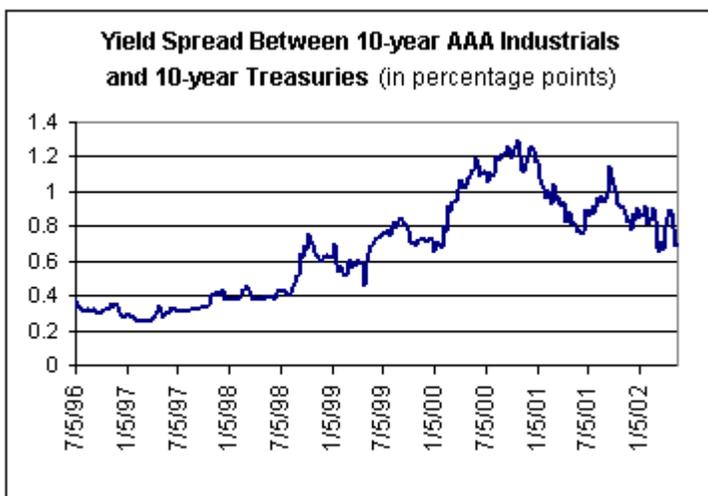
Yield curve is a series of data points representing individual bond issues that show yield over time. Yield curves are important for pricing debt.

A more in depth discussion of the factors that determine the risk premium on bonds is contained in Section III, in conjunction with a discussion of structuring and issue design because the two factors are intimately inter-related, and in Section V.

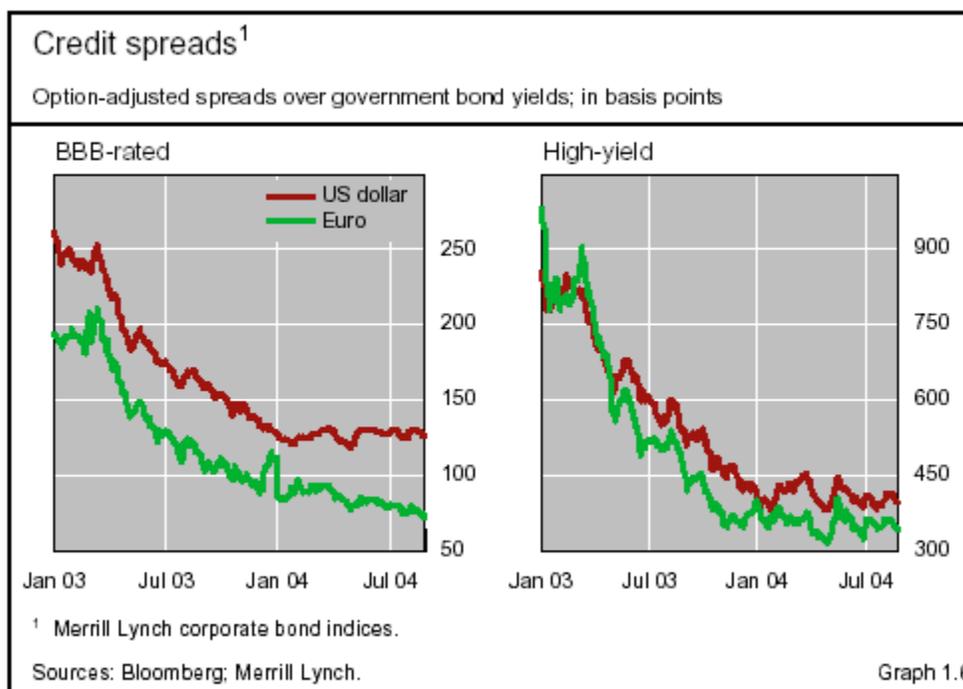
Yield curve on US high grade corporate bonds, as of October 15, 2004.



Source: www.bondtalk.com



Source: www.bondtalk.com



Source BIS Quarterly Review

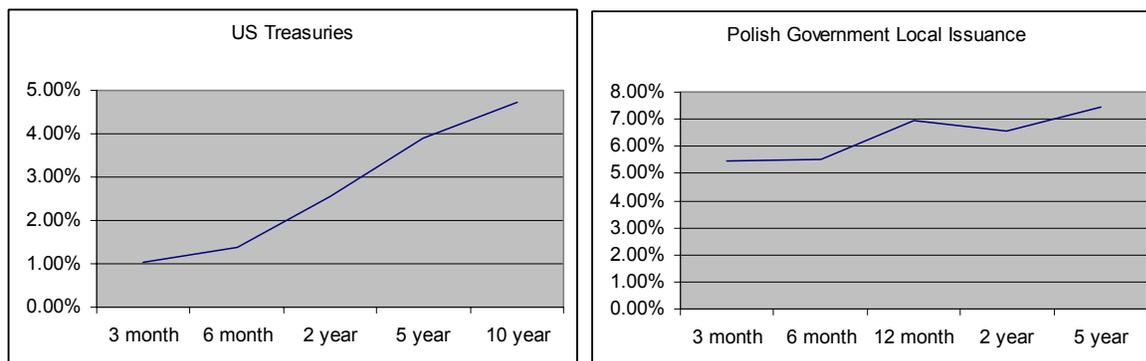


FOREIGN EXCHANGE RATE RISK AND LOCAL CURRENCY BOND ISSUANCE

Foreign exchange policy can impact rates on a local bond issuance. For example, according to the analysis of the National Bank of Poland², euro area membership will have the direct effects of eliminating transaction costs related to the zloty euro exchange rate and, more importantly, exchange rate risk, which will result in a decline in interest rates. The NBP estimates that the cost of capital reflected in long-term interest rates will be reduced by at least 150 to 200 basis points when Poland adopts the euro, which is the amount it calculates as the exchange risk premium. As of the end of May 2004, Polish local government bond rates were 441 to 358 basis points over comparable tenor US dollar treasury rates.

The NBP notes that the yield curve in the period preceding EU entry may be somewhat distorted. Short-term rates will still be used as instruments of monetary policy and may be raised to curb inflation. Long-term rates may be lower in anticipation of the decline in interest rates upon entry to the euro zone, depending on the markets' belief in the credibility of Poland's fiscal policies to achieve EMU entry targets. In the absence of a successful fiscal policy, the exchange rate may also continue to experience volatility and Poland could remain vulnerable to foreign exchange market risk premium fluctuations.

The following tables show the yield curves for US treasuries (which is a normal shape) and Polish government local zloty denominated bonds around the end of May 2004.



² National Bank of Poland (NBP), "A Report on the Costs and Benefits of Poland's Adoption of the Euro," March 2003 (available at www.nbp.pl). The report provides a thoughtful and informative analysis of the impact of entry into the euro zone on exchange rate risk and interest rates.



Maastricht Treaty criteria application in Poland, May 2004.

In order to adopt the Euro, Poland must meet the criteria set forth in the Maastricht Treaty:

Price Stability: The average rate of inflation rate may not exceed the average of the three best performing EU member states by more than 1.5%. In practice, this probably means that the inflation rate will need to be below 3%. Poland's monetary policy committee has set a permanent inflation target of 2.5% +/-1% and the NBP reports that the inflation criteria has been met since August 2002.

Fiscal Sustainability: The general government deficit must be below 3% of GDP and general government gross debt must be below 60% of GDP or on a declining trend. In order to meet these criteria, Poland must reform its public finances.

Interest Rates: The average nominal long term interest rate must not exceed the average long-term interest rate of the three EU member states with the lowest inflation by more than 2%. The benchmark for assessment of compliance with the interest rate has not been chosen yet; however, by the NBP's unofficial comparison of yields on 5 and 10-year treasuries, Poland has been meeting the interest rate convergence criterion since April 2003. Given recent increases in yields on Polish treasuries, this is probably no longer the case.

Exchange Rate Stability: To fulfill this criterion, the zloty must be introduced into the Exchange Rate Mechanism II, where the PLN/EUR market exchange rate can fluctuate against the central parity within a band of +/-15%. The zloty must stay within the normal fluctuation band for at least 2 years without 'severe tensions' on the exchange rate. The zloty exchange rate volatility over recent years has been considerable. The NBP concludes that a combination of disciplined fiscal policy and a moderately tight monetary policy will be required to ensure the zloty exchange rate stability within the ERM II for the necessary time period.

Source: NBP report and Standard and Poor's



SECTION III — TRANSACTION PREPARATION: DEAL STRUCTURE



Transaction Development and Structure

Basic Elements

- ✓ What should the bond terms be?
 - Principal amount
 - Par value
 - Term/Maturity
 - Coupon
 - Currency
 - Redemption provisions
 - Conversion provisions
 - Restrictive covenants
 - Events of default
 - Form

Types of Bonds and Security

- ✓ What type of security structure is appropriate?
 - Secured or Unsecured?
 - Senior or Subordinate?
 - Mortgage bonds?
 - Asset-backed?
 - Third party credit enhancement?

Local Legal Environment

- ✓ What is the local regulatory and legal environment?
 - Enforcement – regulatory and judicial
 - Structuring considerations



SECTION III. TRANSACTION PREPARATION: DEAL STRUCTURE

This section begins with the basic structural elements of bonds and the choices involved in the design of a bond issue. It describes how the market values certain features that may be included in bond issue design and what the potential consequences to the issuer may be. It provides an overview of the types of bonds that may be available to a potential issuer and certain aspects of security for debt. It is intended for potential bond issuers wishing to gain a greater understanding of the elements of bond design and for policy makers looking for a general overview of bond features.

Basic Elements of Bond Design

This section is based on the way bond terms and structures work in the US and Eurobond market. Potential issuers of bonds in their local markets should check with their legal and financial advisors to determine whether various provisions can be accomplished under local law and/or sold in the local market.

Bond terms are set forth in a contract with bondholders, which will be discussed along with other legal aspects of bond issuance in Section IV. This section discusses the mechanics and the financial and business consequences of bond terms. Most, if not all, of these factors can influence the price of the bonds. This section takes special note of high yield provisions in the US market because of trading/pricing similarities to emerging market debt.

SIZE OF ISSUE: PRINCIPAL AMOUNT

The process for determining the amount of funds that a company needs was discussed in Section I. The actual determination of issue size will involve a number of factors and sometimes is an iterative process of determining whether the issue size is feasible and cost effective based on market conditions and company capital structure.

The size of the issue will depend upon market conditions. In local markets that are not very deep, the issuer and its advisors will need to determine how much the market can absorb and at what price. Large issues may not be sellable in the local market. Conversely, if an issuer is considering a Eurobond issue, smaller sizes may not be cost effective because issuance costs as a percent of issue are higher for smaller issues. Furthermore, large markets generally prefer an issue of a size sufficient to generate liquidity—at least \$75 to 100 million, maybe more. This liquidity preference may result in a higher yield on smaller issues. See Section II.

Based on the estimated yield, a company should look at its projected debt service costs to determine if they are reasonable and sustainable. A simple debt service ratio can be calculated as follows:

$$\text{Debt Service Ratio} = \text{Periodic Free Cash Flow} / (\text{Coupon Payment} + \text{Principal Payments in that period})$$

Likely debt service payments should be analyzed in the context of other foreseeable and projected obligations and if they are not viable, the issue size may be reduced or restructured.

In most fixed rate issues in the US and Eurobond market, the cost of issuance and underwriters spread will be reflected in a discount from the issue price. The effect is that issuers pay for the cost of issuance over the life of the bonds, but also, obviously, that the proceeds are less than the total principal amount of



the issue. Discounts may also be used for other purposes, as discussed below. Discounts can have tax consequences and should be analyzed in the context of local jurisdiction tax laws.

PAR VALUE OR FACE AMOUNT

A single bond's par value or face amount is the amount to be repaid on the maturity date. Most US corporate bonds have a par value of \$1,000. Private placements may have much larger minimum denominations, as large as \$1,000,000 with multiples of \$100,000.

TERM / TENOR OR MATURITY

Bonds issued in the US have a stated maturity date, which is the date by which the borrower must repay the debt. Prior to maturity, a borrower is obligated to pay interest to the bondholder. A bond's original maturity is the length of its life as of the date it is issued. After issuance, remaining maturity is the amount of time until the maturity date. Maturity is used to calculate yield throughout the life of a bond and impacts the volatility of a bond's price—generally the longer the maturity, the greater the price volatility. Risks, such as credit risk and currency risk, are also greater the longer the maturity of a bond. See Section II.

In the US, debt securities with maturities of ten years or less are usually called notes, with bonds referring to debt that is issued for longer than ten to 12 years:

- Short-term notes—maturities of up to five years
- Medium-term notes or bonds—maturities of 5-12 years
- Long-term bonds—maturities greater than 12 years

Bonds with maturities up to thirty years are not unusual in the US, although bonds with longer maturities—up to a hundred years—have been issued. Until recently 30 years was the longest tenor of US Treasury securities. The US last auctioned 30-year treasuries in October 2001, but outstanding 30-year treasuries still provide an important long-term benchmark for yield calculations.

Ideally the term of the bond issue should relate to use of funds or relevant assets and the company should seek a maturity that aligns its total debt service stream with total operating cash flow stream. Because many markets do not support long-term issues, market conditions influence maturity decisions. Furthermore, for rapidly growing firms or firms operating in very volatile environments, short-maturity debt may be preferable because it allows for easier reconfiguration as circumstances change.

Pricing of a new issue by an underwriting syndicate in the US or Eurobond market would be based on average life or duration (which is a present value calculation of all principal and interest payments) rather than stated maturity.

COUPON / INTEREST CALCULATION

The coupon rate is the stated interest rate per year, unless otherwise indicated. In the US most bonds are *fixed rate*, meaning that the coupon rate is set at time of issuance. Floating rate notes are common and in past periods of high interest rates and inflation, floating rate bonds were not uncommon.

Floating or adjustable rate securities pay interest under a coupon rate that resets periodically according to the formula set forth in the bond contract. The base rate index is usually a financial benchmark, such as LIBOR or applicable treasury rates, but can be based on another index, such as a given commodity price. The terms for calculating the rate are set forth in the bond contract, are usually very specific, can include such detail as the specific source for a given index rate, and are generally calculated by a designated agent, often the trustee. As mentioned above, floating rate coupons are more common for notes than



bonds, except that banks and financial firms may find floating rate long-term debt attractive because their return on assets fluctuates with interest rate movements.

Zero coupon bonds do not make interim interest payments. They are sold at a discount to par value that is sufficient to provide the investor with a yield to maturity based on market rates (the difference between price and par value paid at maturity date is the bond's interest). Deep discount obligations are sold at a "deep" discount to par, but also have a current coupon. The coupon may be less than market rate, or it may be market rate, but the initial interest payment may be deferred until a specified date in the future. Deep discount bonds of this type might be used to finance a leveraged buyout when the company needs to conserve cash in the early years of a project but expects cash flows to pick up to enable it to pay a market interest rate in the future. Issuers should understand the tax consequences of issuing zero coupon or deep discount bonds.

Bonds in the US pay interest semiannually, generally calculated on the basis of a 360-day year (30 day month). Eurobonds pay annually. An issuer should check the law and custom of its jurisdiction.

Interest rates are market driven, as discussed further in Section II and V. Usually in the US, the coupon rate on fixed rate issues is set so that bonds will be worth close to their par value when issued (except for zeros or deep discount issues). Floating rate notes and bonds are almost always issued at par. The yield curve for similar debt with the same rating indicates the appropriate rate for a bond with that credit risk and average life. See Section II.

CHOICE OF CURRENCY

The choice of currency in which the bonds will be denominated is also market driven and determined by the company's capital structure and cash flow characteristics. Ideally, matched funding—funding that matches the term of the specific project for which it is raised—should be in the currency of the project being funded, which will provide the cash flow to service the debt. This reduces currency risk exposure to the issuer. However, not all markets are deep enough to support local currency financing. Spreads and tenor in the international markets may be attractive. The issuer and its financial advisors will need to assess the trade off between currency risk and size and tenor of the needed financing. Exchange rates in emerging markets tend to be volatile, so issuers should proceed with caution.



Summary Terms of 7.5% sinking fund debentures issued by [XYZ] company

Listed: New York Stock Exchange

Trustee: [Trust] Bank

Rights on: The trustee or 25% of the debentures outstanding may declare interest

Default: due and payable.

Indenture: Indenture may not be modified except as provided with the consent of

Modification: two-thirds of the debentures outstanding.

Registered: Fully registered

Denomination: \$1,000

To be issued: \$100 million

Issue date: June 15, 2004

Offered: Issued at a price of 98.25% (proceeds to the company 97.35) plus accrued interest through Investment Bank 1, Investment Bank 2, Investment Bank 3, and associates.

Interest: At a rate of 7.5% per annum payable June 1 and December 1 to holders registered on May 15 and November 15

Security: Not secured. Company will not permit any lien on its property or assets without equally and ratably securing the debentures.

Maturity: June 1, 2034

Sinking Fund: Annually between June 2, 2014 and June 2, 2033, sufficient to redeem not less than \$ 4.74 million principal amount, plus similar optional payments. Sinking fund is designed to redeem 90% of the debentures prior to maturity.

Callable: At whole or in part at any time at the option of the Company with at least 30, but not more than 60 days notice on each May 31 as follows:

<u>Year</u>	<u>Price</u>	<u>Year</u>	<u>Price</u>	<u>Year</u>	<u>Price</u>
2007	106.136	2013	104.091	2019	102.045
2008	105.795	2014	103.750	2020	101.705
2009	105.455	2015	103.409	2021	101.364
2010	105.114	2016	103.068	2022	101.023
2011	104.773	2017	102.727	2023	100.682
2012	104.432	2018	102.386	2024	100.341

REDEMPTION PROVISIONS

Many corporate bonds, particularly those with long maturities, are issued with early redemption provisions, including optional call provisions and sinking fund provisions.

Call Provisions

Call provisions allow an issuer the option to redeem all or part of a bond issue before maturity, at a specified date and price. Call provisions represent a cost to investors because they will be forced to reinvest, most likely at a lower rate. Issuers must pay for call provisions in the form of higher yields. Call provisions can be quite valuable to an issuer, because if interest rates decline before final maturity, the issuer may refinance at a lower rate. A high yield issuer may also refinance on better terms if its credit quality improves.



A typical call feature on a 10 year high yield bond is five years at par, plus one-half the coupon, which means that the call price of a bond with a 10 percent coupon is 105, five years after it is issued.

Straight (investment grade) long-term debt may have more elaborate call provisions. See the call provisions in the “Summary Terms of 7.5% sinking fund debentures of XYZ Company” in the box on the previous page under “Callable”. A non-callable bond cannot be redeemed. A non-refundable bond can be redeemed provided it is not redeemed using proceeds from a lower cost debt issue that ranks senior or equal to the refunded issue. Call provisions often contain a non-refundability clause up to a specified date. (In the XYZ company example, the call provision has a 10-year non-refundability provision and a three-year call protection feature.)

A make whole call provision, common in private placements, is an indexed bond call option, with a strike price based on comparable benchmark yields.

Call provisions generally allow an issuer to call bonds in whole (the entire issue) or in part. When a portion of the issue is called, the bond contract specifies the method that will be used to choose the bond. Publicly traded bonds generally specify that bonds to be called be chosen randomly, usually by the trustee. Private issues usually require pro rata redemption.

Sinking Funds

Bond contracts sometimes provide for mandatory repayment provisions of bonds in multiple installments, usually annually, known as sinking funds. Sinking fund payments generally begin ten years or so into the life of long-term bonds and frequently provide both for mandatory and optional annual payments. Issuers generally have the option to pay cash, or, if their bonds are trading at a discount, buy bonds in the market and pay them into the sinking fund.

Sinking fund payments have fallen out of favor in the US market. They may be attractive to investors in emerging market debt because they provide added discipline on the issuer to ensure principal repayment and may be seen as reducing default risk. An issuer should keep in mind that sinking funds reduce the effective maturity of a bond issue. For bond issues with sinking funds, average life is a better measure of the time an issue will be outstanding than stated maturity for purposes of a capital structuring analysis.

Other Redemption Provisions

Extraordinary redemption provisions allow the issuer to redeem bonds in case of an extraordinary event, for example, the destruction of the asset financed with the bond proceeds.

Puts allow a bond to be redeemed at the option of the bond holder on designated dates for face value plus accrued interest. Bondholders generally pay for puts in the form of lower yields.

CONVERTIBLE BONDS

Convertible bonds have a conversion provision that gives the bondholder the right to convert the bond into a predetermined number of shares of the issuer’s common stock. Convertible bonds are callable by the issuer. Convertible bonds should reflect the value of two “embedded options” in the bond—the call option on the stock that the investor has purchased from the bond issuer and the call option on the bond that the investor has sold to the bond issuer.

RESTRICTIVE OR PROTECTIVE COVENANTS

Covenants are provisions in the bond contract that protect the interests of the bondholders by restricting the issuer from taking certain actions or obligating it to undertake others. Typical restrictive covenants may include:



- Debt limits—restrictions on taking on more debt
- Dividend payments—limitations on payment of dividends or retiring equity
- Limitation on liens or negative pledge (the issuer will not pledge assets to another lender, creating a class of creditor that ranks above the bondholders in the hierarchy of creditors)
- Limitations on borrowing by subsidiary entities
- Limitation on asset dispositions
- Limitations on merger, consolidation or sale
- Limitations on sales of stock in subsidiaries
- Limitations on transactions with affiliates
- Limitations on investments other than in the ordinary course of business
- Limitations on leasing and sale-lease-back transactions

Summary of Typical High Yield Bond Covenants

High yield covenants are typically based on incurrence, meaning a bond issuer is prohibited from taking certain actions unless the tests are met.

Debt Incurrence: Restrictions on incurring additional debt are usually stated in one of two ways:

Maximum Leverage: Total Debt/EBITDA (i.e., “no additional borrowings may be drawn if the pro forma Debt/EBITDA for the latest twelve months reported period is [x] times or less.”)

Minimum interest coverage: EBITDA/Interest Expense

This covenant may also contain “carve outs” when additional debt does not have to meet the tests, which depend on the industry, but may include existing bank lines, receivables financing, debt used to refinance existing debt, and working capital lines.

Restricted Payments: Limitations on the ability to pay dividends, retire equity or junior debt except if the proceeds come from an equity offering and if certain terms are met, usually stated as a formula (i.e. 50 % of net income) or tied to ability to debt incurrence covenant.

Change of Control: The issuer is typically required to make an offer to purchase bonds at 101% of principal (face) amount if the controlling ownership structure changes. Ownership definitions vary. Ratings downgrades or changes in net worth may also the trigger purchase.

Asset Sales: Limits on the issuer’s sale of assets or the manner in which the proceeds may be applied, such as a requirement that proceeds be invested in certain cash-flow generating assets.

Strong covenants can increase an issue's credit rating resulting in lower borrowing costs, but may result in the loss of some business flexibility. Research has shown that strong covenants increase a bondholder’s chances of being repaid in leveraged buy-outs and restructuring financings.

EVENTS OF DEFAULT

Events of default include a borrower’s failure to pay interest or repay principal on time, default on another debt issue and failure to meet covenants. Upon the occurrence of an event of default, the bondholders have the right to demand immediate repayment of the debt (for covenant defaults, usually after a cure period.) This essentially enables bondholders to force a firm into bankruptcy.

Forced liquidation is an expensive and time-consuming process for creditors, so negotiation is the traditional first response. For example, under the US bankruptcy code, creditors have a choice between seeking to force a defaulting borrower into liquidation (Chapter 7) or court-administered reorganization (Chapter 11). The ultimate possibility of bankruptcy and liquidation is a crucial discipline for well



functioning debt markets. See Sections I and VI for a further discussion of why the option of bankruptcy is important.

FORM (CERTIFICATE OR BOOK ENTRY)

Bearer bonds are issued in a form that contains no identification of the owner. A bearer bond is therefore presumed to be owned by the person who holds it. US companies have not been legally permitted to issue bearer bonds since 1982. Originally this prohibition was designed to combat tax evasion; now money-laundering concerns also weigh against bearer bonds. Bearer bonds are traditional in the Eurobond markets; however, this is becoming less uniform because of registration requirements for US issuers of Eurodollar bonds and for issuers that would like to sell securities to US investors.

The ownership of *registered bonds* is registered with the issuer or an agent. Ownership of *book-entry or dematerialized securities* is recorded electronically and physical certificates are not issued to the owner. Usually a global or master certificate is held by a depository. In the US the depository is most often the Depository Trust Company; for Eurobonds, Euroclear or Clearstream.

Some [many] securities laws in Central and Eastern Europe require that only securities issued in dematerialized form may be admitted for public trading (Croatia, Slovenia) or that securities must be deposited with a brokerage or the national depository and registered with the national depository in order to be admitted to public trading (in effect dematerializing certificates) (Poland).

Overview of Types of Bonds, Security and Collateral

SECURED VS. UNSECURED BONDS

Most straight corporate bonds in the US are unsecured (sometimes called debentures), meaning that they are issued against the general credit of the corporation rather than a specific asset.

Secured bonds have a claim on particular specified assets, which may be evidenced by a mortgage or a pledge. If the issuer defaults, the bondholder has a first claim on the mortgaged or pledged asset. Debenture holders have a general claim on unmortgaged assets but a junior claim on mortgaged assets. (Bond secured by this type of mortgage should not to be confused with mortgage bonds issued by mortgage banks in Europe or mortgage-backed securities in the US, discussed below).

To effect a security interest, a pledge or mortgage evidencing the bondholders' lien on the collateral must be registered under the applicable local laws. For the security interest to be meaningful, the pledged assets must be excluded under local bankruptcy law from the bankruptcy estate of the issuer or the pledge holder's claim must place first (or in a determinable position) in the priority of payments from the liquidation of the bankruptcy estate.

Note that secured debt may be secured with a lien that is ranked above or below other claims on that asset (i.e., first, prior, overlying, junior, second, third, etc.) Furthermore, within an issue of secured debt, different tranches can have different priorities of claims on an asset or pool of assets. Finally under some bankruptcy laws, statutory liens, such as tax liens, may be given priority.

Collateral trust bonds are secured with securities, such the issuer' common stock or the stock of one of its subsidiaries, often deposited with a trustee. *Equipment trust certificates* and *conditional sales contracts*, which are sometimes used to finance aircraft or railroad cars, allow title to pass to the borrower only after the debt is fully paid. In most Central and Eastern European countries, trust procedures are not well established, but a similar result may sometimes be accomplished with an escrow or blocked account.



SENIOR VS. SUBORDINATED DEBT

Senior debt has a claim prior to junior or subordinated debt and equity on a corporation's assets in the event of bankruptcy and liquidation. In US practice, unless bonds are expressly defined as subordinate it can generally be assumed that they have a senior claim. Subordinated debt is junior in its claim on assets to other debt, meaning that it is repayable only after debt with a higher claim has been paid, but it is still senior to equity. There can be tiers of subordinated debt, meaning some subordinated debt has a lower claim on assets than other subordinated debt. See Section I.

Senior debt is less expensive to the issuer than subordinated debt because it is less risky and therefore has a lower yield. There is generally a very definite cost spread in the market between senior and subordinate debt. The following table shows the priority of debt types and demonstrates investors' rationality in pricing secured and senior debt lower than subordinated issues.

Average Loss Severity for various debt classes
(relative to historic loss severity on the same issuer's senior unsecured bonds)

Secured Bonds	-30%
Senior Unsecured Bonds	N/A
Subordinate Bonds	40%
Junior subordinate Bonds	52%
Preferred Stock	62%
Common Stock	85%

Source: Moody's

Subordinated debt may be an attractive option when debt covenants limit an issuer's ability to issue senior debt.

MORTGAGE BONDS

Some central European countries have enacted mortgage bond legislation based on the German pfandbriefe and other European mortgage bank models. In some cases the legislation provides for specially licensed separate institutions, for example in Poland. In other cases mortgage bonds can be issued under additional licenses granted to universal banks, as in the Czech Republic.

Covered bonds are secured by a distinct pool of mortgages. Generally, bondholders also have a claim on the other assets of the bank equal to other unsecured creditors, should the pool collateral prove insufficient.

MORTGAGE BACKED AND ASSET BACKED SECURITIES

Asset backed securities (ABS) are securities that are secured by a pool of assets, usually financial assets, and paid from the cash flow generated by that asset pool. Mortgage backed securities (MBS) are securities backed by pools of mortgage loans (usually residential mortgage loans), while asset-backed securities refer to securities backed by other types of assets or cash flows. Cash flows from the asset pool may be passed through to bondholders, or different classes or tranches of the same issue may have different priorities of claims on the right to receive payments.

Assets that have been securitized include most types of mortgage loans (first lien residential mortgage loans, multifamily mortgage loans, commercial mortgage loans), automobile installment loans, equipment loans, installment loans, credit card receivables, commercial bank loans, consumer loans and royalties. While mortgage securitization and other types of asset-backed structures are increasing internationally, the US is by far the largest generator of asset-backed securities.



Asset backed structures can be used as funding and /or risk transfer techniques. The originator or owner of assets sells and transfers the assets to a special purpose company or special purpose vehicle (SPV), which is independent from the originator, bankruptcy remote and set up for the sole purpose of the securitization transaction. The SPV issues securities to investors and uses the proceeds to purchase the assets from the originator. The cash flow from the assets pays the principal and interest on the securities. The SPV contracts with the originator of the assets or third party servicer to service the assets—collect cash flows and transmit them to the SPV, and handle any delinquencies and defaults. SPVs in the US and other common law jurisdictions are generally set up as trusts. In civil code countries, asset-backed structures generally require specific legislation.

The timing of payment of principal on ABS is generally dependant upon the timing of collections of cash flow on the underlying assets. Thus ABS often carry a prepayment risk—the risk that the underlying asset will pay earlier than predicted and therefore the securities will pay earlier than expected—that is in contrast to most other types of fixed income securities. They also carry a servicer risk—and the quality of the servicer as well as the quality of the asset pool is a factor in the rating agencies assessment of an asset-backed issue.

The following contrasts two typical structures for mortgage backed securities:

PAY-THROUGH VS. PASS-THROUGH

Pay-Through MBS:

- Cash flow of eligible mortgages will be used to pay the tranches of the bonds as structured
- Assumptions regarding delinquency, prepayment, reinvestment
- Interest generally paid quarterly, semi-annually or annually, principal at maturity of tranche
- Credit enhancements include: 1) guaranty 2) monoline insurance 3) reserve fund 4) senior/sub structure

Pass-through MBS:

- Investors receive pro-rata share of all cash flow received (scheduled and unscheduled principal and scheduled interest)
- Generally agency paper (i.e. Fannie Mae, Freddie Mac, Ginnie Mae, HKMC)
- Pricing based on prepayment assumptions – borrower has call option to prepay at any time
- Cash flow generally paid monthly
- Credit enhancement usually, a guaranty

Source: IFC, Pamela Lamoreux, presentation, November 2001

Asset backed credit ratings depend upon the quality of pool assets and the quality of the servicer. Risk premiums can be quite low on highly rated mortgage and asset-backed issues depending on the quality of pooled assets, but the attendant information needed to achieve the detail necessary to structure and support an issue that an issuer must supply can result in costs that outweigh the lower interest coupon.

THIRD PARTY CREDIT ENHANCEMENT

Third party credit enhancement may lower the yield on a bond issuer by enhancing the security (and therefore decreasing the risk to investors) of an issue. An issuer considering using a form of credit



enhancement should analyze, with their bankers whether the enhancement is cost-effective, that is whether the savings in the form of lower yields is greater than the cost of the enhancement.

Guarantors / Guarantees

A parent company, commercial bank, or international financial institution may provide a guarantee on all or a portion of the principal amount of a bond or note issue, for which the issuer must pay a fee.

Bond Insurance

In the US and developed markets, monoline bond insurers may provide insurance as to the payment of principal and / or interest on an issue or part of an issue. Most monolines are reluctant to insure non-convertible local currency debt, although they may consider future flow transactions with off shore capture of cash flow.

Asset portfolio/pool insurance

Mortgage insurance on mortgages with high loan to value ratios is an important component in the US mortgage backed securities market. Mortgage insurers may provide insurance on individual pool assets (i.e., mortgage insurance) or at a pool level.

Local Regulatory and Legal Environment

Potential bond issuers will need to become aware of the legal and regulatory provisions in their domestic market that may affect their ability to issue bonds or use certain types of structures, including:

- Securities Laws (the process for registering a bond offering will be discussed further in Section V and IV)
- Industry specific requirements, i.e., bank capital adequacy requirements
- Companies law, i.e., debt limits and other possible restrictions

Statutory Debt Limits

Some countries have provisions in their corporate or company law that place limits on the amount of debt (bonds) that can be issued as a percent of nominal or authorized capital, for example, Romania (75%) and Ukraine (25%). Authorized capital is not an indicative financial measure, has little to do with actual shareholder equity and demonstrates neither financial health nor the ability to service debt. Prospective issuers should check the company law in their jurisdiction. Both Ukrainian and Romanian companies have issued Eurobonds, indicating that structural solutions can be developed for this limitation in the international market.

ENFORCEMENT—REGULATORY AND JUDICIAL

Creditor friendly laws are important to the development of a local bond market. See Section II. In the case of secured bonds, clear and efficient pledge or mortgage registration systems, strong protection of security interests and the ability to foreclose and collect on collateral are crucial. For unsecured bonds, default remedies, including effective bankruptcy procedures and processes and mechanisms for managing defaults are imperative.

[Most/All] countries in Central and Eastern Europe have enacted bankruptcy laws, but in some cases the lien and bankruptcy laws conflict [Kazakhstan]. In many cases, foreclosure and collection procedures are



untested. Both the political will and judicial capacity may need to develop to carry out the process of significant bankruptcy proceedings.

Asset backed structures—mortgage backed securities in particular—may be constrained by lack of foreclosure practice. Offshore transactions may be able to be structured around certain restrictions like limitations on senior/subordinate debt, but will generally be subject to local bankruptcy law and procedures regarding assets.

STRUCTURING ISSUES

Potential bond issuers and counsel will want to be aware of local law issues that may restrict flexibility in structuring debt. In some jurisdictions it is difficult or not possible to issue senior and subordinated debt or multiple tranches of debt. The concept of non-recourse debt is not well developed in some jurisdictions.

In most cases, specific legislation will be required for local domestic issuance of asset backed and mortgage backed securities, addressing, among other things:

- Segregation of pool assets
- Bankruptcy remote structures
- Tax pass through

To be effective, these structures also require well functioning foreclosure procedures, the ability to re-register and transfer pledges or mortgages, with full survival of all rights to the underlying collateral, in a timely and cost-effective manner.



SECTION IV — TRANSACTION PREPARATION: LEGAL DOCUMENTS AND SECURITIES LAW COMPLIANCE



Legal Documentation and Securities Law Disclosure

Documentation Process

- ✓ How is the documentation of a bond issue prepared
- ✓ What are the applicable securities regulation requirements?
 - Enforcement – regulatory and judicial
 - Structuring considerations

Legal Documentation

- ✓ What legal documentation will be needed?
 - Corporate documents
 - Bond contract / indenture
 - Agreements related to structure
 - Issue prospectus
 - Underwriting agreement

Financial Statements

- ✓ Which financial statements and for how many years will be needed?

Due Diligence

- ✓ What is the purpose and who is responsible for due diligence
- ✓ What matters should be covered in a due diligence review?
 - Integrity of management
 - Industry review
 - Corporate documents
 - Accounting matters
 - Site visit
 - Interviews of management
 - Legal review
 - Officer & Director information
- ✓ Is management responsible for inaccurate information in its offering documents?



SECTION IV. TRANSACTION PREPARATION: LEGAL DOCUMENTS AND SECURITIES LAW COMPLIANCE

This section will outline the process of documenting a transaction and summarize the substantive provisions of the significant documents in a US or Eurobond issue. It should be of interest to potential bond issuers wishing to gain a better understanding of the process of bond issuance, their obligations to bondholders under a bond contract and their disclosure obligations under securities laws. It may also be of interest to policy makers interested in US and European practice.

Issuance Documentation Process

Deals are heavily documented in the US and Eurobond market, whether privately placed or publicly offered, with closing document binders consisting of 50 or more documents and running to hundreds of pages. The process of documentation takes place in parallel with deal structuring and is not incidental, as holders of defaulted bonds or participants in securities litigation will testify.

KICK-OFF MEETING

In the US, after an issuer makes a decision to go forward with a first time bond issue and hires an investment bank (see Section I), an organizational meeting is generally held between the issuer's principal officers, representatives of its accounting firm and the law firm that will act as its counsel on the transaction, and the managing underwriter and the underwriters' counsel. The underwriters will prepare a timetable for bringing the issue to market, which will be reviewed and the responsibility for various documents will be allocated. Typically, the issuer's counsel will draft the bond indenture and the registration statement and prospectus (or offering circular) and company officers will be responsible for gathering relevant factual information. Financial statements will be prepared by the company's chief financial officer, with the assistance of the issuer's accounting staff and external independent public accountants. Underwriters' counsel will prepare the underwriting documents (the underwriting agreement with the issuer and the agreement among underwriters).

A variety of substantive and procedural issues may be discussed at the initial meeting. The participants may select the trustee for the bond issue, along with other necessary third party service providers. At this meeting or shortly thereafter, the underwriter will provide the issuer with a list of documents that it and its counsel will need to review as part of the due diligence process, discussed below.

REGISTRATION PROCESS AND TIMING

As facts and information are gathered and the structuring and development of the issue progresses, documents will be drafted by the responsible parties and circulated among the working group for comments.

In the US, the securities law requires that all securities offered to the public be registered with the US Securities and Exchange Commission (SEC) and that accurate and complete information relating to the company and the issuer be filed with the SEC and distributed to investors in a prospectus, which is prepared according to SEC regulations. The SEC reviews the registration statement for adequacy and accuracy of disclosure in compliance with its regulatory requirements, but does not approve or disapprove of the substance of the securities offered. Unless specifically exempted from the registration requirement, no securities may be publicly offered in the US before a registration statement is filed with the SEC and no securities may be sold until the registration becomes effective, upon approval by the SEC.



Many Central and Eastern European securities laws follow this basic philosophy in their requirements for the registration of securities prior to public offering, but prospective issuers should discuss the details of their local securities laws with their attorneys.

In the US, the process of drafting documents and readying an bond issue for market can take as little as a few weeks or as long as several months. For large public companies that frequently issue securities and already have most of the required information on file with the SEC and are bringing relatively straightforward issues to the market, the process might be quite short. For first time issuers, even of “plain vanilla” structures, an issue will take longer and for complex issues, such as asset backed securities, the process might take six to nine months or more.

History and Philosophy of US Securities law

The US securities laws and regulatory system emphasize full and accurate disclosure of information relevant to securities being offered to the public. The US regulatory regime has its origins in the government’s response to the 1929 stock market crash, which was believed to be partially the result of dishonest and fraudulent practices in the sales of securities. Franklin Roosevelt called for “letting in of the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public” in his acceptance speech of his party’s Presidential nomination in 1932—the same speech where he also laid out his vision for a “new deal”.* Accurate disclosure in the securities market was considered an important issue at the time and is still the cornerstone of US securities regulation.

The 1933 Securities Act requires issuers to file a detailed registration statement with the SEC prior to the offer and sale of securities (unless the securities are included in one of the exceptions to the registration requirement). The requirements of the registration statement are very specific. See Form S-1 and/or S-3 available at www.sec.gov, for details.

The 1934 Securities and Exchange Act set up the US Securities and Exchange Commission and imposed periodic reporting requirements to the SEC on issuers of publicly traded securities. It also contains certain anti-fraud provisions.

Neither the 33 nor 34 Act regulates the substance, business fairness or terms of securities. They are designed to ensure that investors have sufficient, accurate information to make an informed decision about whether or not to buy a securities offering.

The Trust Indenture Act of 1939 does contain substantive requirements, including a requirement that debt securities be issued under a trust indenture that conforms to the Act, which requires an independent trustee—as defined in the Act—to enforce the rights of the bondholders for the life of the bond issue.

**Quoted in Charles J. Johnson, Jr. and Joseph McLaughlin, Corporation Finance and the Securities Laws, second edition (Aspen Law & Business 1987), p. 2-3.*

Legal Documentation

Documentation for a transaction will include documents to meet the application requirements of the securities commission of the country in which the bonds are issue and listing requirements of any exchange where the company intends to list its bond issue. Some [many] countries may require that certain institutional investors, especially pension funds, invest only in securities admitted to public trading. Public trading may include listing on an exchange or other regulated market, like an organized over the counter market. Eurobonds are often listed in Luxembourg or London. As noted in Section I, in the US most bonds trade over-the-counter and are not listed. The disclosure documentation required by the securities laws for publicly traded issues and by investors for private placements would include or reference the documents described in this section, which would be gathered for the transaction, and filed with trustee and various parties to the transaction.

CORPORATE DOCUMENTS

Securities commissions, stock exchanges and contractual closing conditions may require copies (often certified) of some or all of the following

- Charter/Articles/Memorandum of Incorporation
- By-laws



-
- Certificate of registration (in the US this would be a certificate of formation or incorporation, typically augmented by a certificate of good standing from the applicable state secretary of state)
 - Authorizing resolution of the board of directors or shareholders relating to the issue

INDENTURE

In the US, the contract with bondholders that sets forth the terms of the bonds is called a trust indenture. By statute, the indenture must be administered by a trustee, which assumes fiduciary obligations as a representative of the bondholders. Eurodollar obligations (Eurobond denominated in dollars issued) may be issued under an indenture with a trustee, like a US offering, but straight Eurobonds more often are issued under a fiscal agency agreement, in which case the fiscal agent acts as an agent of the issuer to make principal and interest payments, publish notices, etc., but does not assume a fiduciary obligation to the bondholders. The terms of a fiscal agent agreement and a trust indenture can be generally the same. Asset backed and structured Eurobond issues are likely to require a trustee.

The trust indenture sets forth the conditions of the bond issue, including the terms, such as maturity, interest rate, callability and negative covenants, described in Section III. US trust indentures also include affirmative covenants (an issuer's obligations to take certain actions rather than refraining from specified actions) such as:

- To continue to conduct business activities along the same lines as currently conducted
- To maintain the corporate existence of the issuer and its material subsidiaries, pay taxes, maintain insurance, and maintain properties necessary to conduct the issuers business
- To comply with applicable law and regulations
- To provide the trustee and investors with certain information, including:
 - Financial results prepared in accordance with generally accepted accounting principals and audited annually
 - Quarterly statements and evidence of bond covenant compliance
 - Notification if the issuer violates any of the bond covenants

FOR SECURED AND SENIOR/SUBORDINATED STRUCTURES

The security arrangements for secured issues will be reflected in a Security Agreement and or a Pledge Agreement . Arrangements and undertakings will be made to ensure lien registration. Senior/subordinate structures, will require an Inter-creditor Agreement.

PROSPECTUS

Securities laws generally require that the issuer of publicly traded securities file or register a prospectus with the securities commission prior to offering securities to the public. The contents of the prospectus are outlined either in the law or regulations promulgated by the securities commission.

The prospectus is both a legal and a marketing document. Securities laws are generally intended to ensure that the prospectus provides potential purchasers with full and accurate information about the issue so that an informed decision can be made about whether the securities are an appropriate investment. In US private placements, the private placement memorandum or offering circular fills this role and generally contains the same level of information as a prospectus for registered securities. The prospectus usually includes:

- A description of the securities, including



-
- Security/collateral, if secured
 - Payment of principal and interest
 - Interest rates or manner of determining interest rates
 - Price
 - How offered
 - Mandatory redemption provisions
 - Optional redemption provisions
 - Covenants
 - Rating
 - Tax status
 - A description of the issuer
 - Major contracts
 - Management
 - Description of issuer's business and industry specific information
 - Any legal or regulatory enforcement actions relating to the issuer
 - A description of any third party agents, guarantors, insurance on the issue, etc.
 - Use of proceeds
 - Issuer's financials
 - A description of the risks of the securities

Copies of other documents, including the trust indenture, significant contracts and corporate authorization described in the prospectus, are available from the trustee upon request of a bondholder.

Underwriting Agreement and Syndicate Agreement

The underwriting or purchase agreement is the contract that governs the underwriters' purchase of securities from the issuer in a firm commitments underwriting. In addition to the price for the securities (which is usually the public offering price less the agreed upon underwriting discount), the underwriting agreement contains certain representations and warranties from the issuer to the underwriters, covenants, conditions, indemnification provisions and other terms governing the relationship between the issuer and the underwriters. The underwriting agreement generally lists conditions of closing that usually include certain legal opinions and a "bring down" certificate from officers of the issuer that the representations in the underwriting agreement are true and correct as if made at the time of closing.

An agreement among underwriters is made among syndicate members and sets forth allocation procedures, provisions relating to the underwriting spread and matters relating to delivery of the securities.

Financial Statements

Securities commissions and exchanges generally require at least three years of financial statements of the issuer. [Audit standards vary in emerging Europe.] Credit rating agencies generally require five years of audited financials.



Financial Information Required US Public Offerings		
Annual Financial Statements	Interim Financial Statements	Other Financial Information
Audited balance sheets as of the end of the two most recent fiscal years	Unaudited balance sheets as of the end of the most recently ended fiscal quarter	Selected income statement and balance sheet data for each of the last five fiscal years and any subsequent interim period
Audited income statements, cash flow statements and statements of stockholders' equity for each of the three most recent fiscal years	Unaudited income statements, cash flow statements and statements of stockholders' equity for: The three-, six-, or nine-month period since the latest fiscal year end, and The corresponding three-, six-, or nine-month period of the prior year	Supplementary income statement data for each full quarter within the two most recent fiscal years and any subsequent interim period For debt securities, coverage ratios for each of the last five fiscal years and for any interim periods presented

Source: Latham & Watkins and KPMG, "An Overview of the Financial Statement Requirements for US Securities Offerings" August 2003.

Financial statement disclosure issues in the US received increased scrutiny after the Enron scandal and other corporate excesses of the 1990s. Recent legislation (known as Sarbanes Oxley for the US Senator and Congressman who sponsored the act) focuses on the accuracy of financial disclosure and imposes new liabilities on corporate officers and directors for inaccuracies in the company's financial statements. The company's CEO and CFO are now required to certify as to the accuracy of accounting statements.

Due Diligence

Traditionally, the managing underwriter performs a process known in the US as "due diligence" to assess and ensure the accuracy of the prospectus and registration statement. The due diligence process is motivated primarily by three factors:

- To avoid statutory liability and fear of litigation under the US securities laws
- To maintain the underwriter's good reputation
- To maintain good relationships with clients who buy the issuer's securities

Changes in securities practice in the US (an increase in continuous disclosure and a practice known as shelf registration) have attenuated the traditional model but it still pertains in IPOs and high yield issues and has a great deal of merit when new issuers are bringing securities to market.

Due diligence is to a certain extent an exercise in imagining what could go wrong with an issue in the future. The emphasis and process will depend both on the issuer and the type of securities to be issued.



Liability under the US Securities Laws

US securities laws impose liabilities on various parties to a securities transaction to insure that information provided to investors is accurate. For example, Section 11(a) of the 33 Act provides that a person acquiring a security covered by a registration statement may recover damages from the issuer, the directors, and officers who sign its registration statement, and every underwriter with respect to the security if "any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Section 12 (a)(2) of the 33 Act imposes liability on any person (whether or not the underwriter) who offers or sells a security by a prospectus or oral communication "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." A court decision exempts private placements from Section 12(a)(2).

Rule 10b-5 of the 34 Act is an anti-fraud provision that has generally been applied to all transactions in securities and is not limited to a class of defendants. However, it requires proof of intent, which is more difficult to prove than the negligence based claims under Section 11(a) or 12 (a)(2).

Due Diligence procedures

The following summarizes certain aspects of the due diligence process.

Integrity of Management

A securities firm is likely to want to become comfortable with the integrity of a company's management before it establishes an investment banking relationship with a prospective client. Due diligence cannot ensure the accuracy of a registration statement and prospectus if company management is prepared to intentionally withhold or misstate information. Some investment banks have formal procedures for approving participation in securities offerings, especially if they act as managing underwriter. These procedures generally include written reports to a commitment committee by those in the bank that are advocating the establishment of an investment banking relationship with an issuer.

Does Reputation matter?

A study of the impact of the managing underwriter's reputation on underwriter spreads, offering yields and other expenses indicates that underwriter reputation may act to certify the value of a debt offering to investors. The study found that offering yields were lower and offering prices higher (meaning lower costs for the issuer) on issues brought to market by prestigious underwriters. The study analyzed data on 2,449 issues of nonconvertible industrial debt in the US in 1990-1997, approximately 70% of which were investment grade.

Source: Livingston and Miller, "Investment Banking Reputation and the Underwriting of Nonconvertible Debt", *Financial Management*, Summer 2000, Vol.29, No. 2.

Review of the Industry

The managing underwriter and its legal counsel may begin by becoming familiar with the industry of the issuer, if they aren't already; a process that might include a review of securities commission filings, prospectuses and annual reports of other companies in the industry. Some investment banks and law firms have expertise in certain industries. For industries subject to a special system of regulation, like banking, insurance, communications or transportation, bankers, with the assistance of counsel, need to make sure they are up to date on current regulatory developments. Advisors may review relevant trade publications to identify industry trends and the investment bank's research analysts may be asked to provide current information on the industry and its future prospects.



Preliminary Review of Basic Documents

After an investment bank decides to proceed with an issue, its counsel will usually send the issuer a request for basic documents regarding the issuer, which will likely include:

- Articles of incorporation
- By-laws
- Loan agreements
- All SEC filings for the past five years or since the issuer began to report to the SEC, whichever is shorter. These will include registration statements relating to the sale of other securities as well as proxy statement relating to annual meetings and SEC periodic reporting forms (in the US quarterly, annual and material events). Bankers will also want to review any private placement memorandum or written rating agency presentation.
- All reports and other communications sent to shareholders during that period. These will include annual reports, quarterly reports, reports on annual meetings and shareholder letters and press releases.

The bankers, and in some cases underwriters counsel, will review all the requested documents. An electronic database or internet search might be undertaken to check product announcements, litigation developments, regulatory proceedings, key personnel changes and so on. Underwriters counsel will review all indentures and loan agreements to which the issuer or its subsidiaries are a party to analyze the impact restrictive covenants may have on the company's operations and the prospective issue.

Preliminary analysis and list of questions

Once the industry and preliminary document review is complete, the bankers will prepare an analysis of the company with respect to other companies in its industry. They will compare the company to the industry standards in terms of basic financial ratios and may then prepare a written memorandum of questions to ask the issuer's management and identifying areas to be explored in greater detail.

Review of Registration Statement/prospectus

During the due diligence process by the underwriters, the issuer and its counsel will prepare the registration statement/prospectus and will circulate a draft among the parties to the transaction. The underwriters and their counsel will read the draft and compare it to information gathered in the due diligence process. They will then meet with the issuer's management, accountants, corporate counsel and counsel to the issuer to go through the registration statement line-by-line (literally). During this review process, the information in the registration statement will be discussed by the participants and revised to improve disclosure, clarity and accuracy. This give and take process can last several days or weeks. The exchange of views and perspectives is important in developing an accurate disclosure statement.

Once the team has completed a draft prospectus that they consider relatively complete, it will be circulated to all of the company's directors and key officers. The investment banker should be satisfied that the company has an adequate process for collecting, evaluating and incorporating the comments of these individuals.

Accounting Matters

Under the US securities laws, audited financial statements are subject to an expert opinion—that of the company's independent auditors—and are considered “expertized” therefore are not expressly covered by the reasonable investigation requirement that governs an investment bank's due diligence obligations.



However, the investment bank is still required to show it had no reasonable ground to believe the material was false or misleading. As part of its due diligence an investment bank should consider how the issuer's accounting policies compare with other companies in the same industry, whether there have been accounting failures in the industry or industry-specific criticism from the SEC or other regulator, whether the issuer has made any recent significant changes in accounting policy, and whether, even if the financial statements meet the relevant GAAP standards, there are other SEC issues that should be considered. Recent legislation has greatly increased scrutiny of accounting and financial statements disclosure in the US. See *Financial Statements* above.

Due diligence procedures should extend to an issuer's use of derivatives and off-balance sheet items.

Visits to Principal Facilities

Due diligence often includes site visits to an issuer's principal plants or facilities. The level of detail and inspection will depend on the circumstances of the offering.

Meetings with Principal Officers

The investment bank and its counsel usually interview the principal officers of the company after receiving the first draft of the registration statement, but prior to the line-by-line drafting session. These meetings are held so that the bankers and counsel will have an opportunity to obtain a better understanding of the company's business and prospects, as well as to identify any potential future problems. It is generally considered good practice to ask the same list of questions of different officers in order to evaluate the answers and obtain a broader perspective on the business and potential problems.

Legal Review

Counsel to the underwriters will conduct a legal review of the corporation to enable them to give legal opinions required by the underwriting agreement, such as due incorporation and the validity of the issuance of the company's securities.

In addition to a review of the company's basic documents (described above), underwriters counsel will also request and review litigation letters from the company's counsel that were furnished to the auditors in connection with the company's most recent audit and will also need to determine whether any material legal or administrative proceedings have been filed since the date of the litigation letters. Counsel will review the pleadings of any material litigation and may meet with the attorneys handling the litigation for the issuer. Counsel to the underwriters will evaluate the determination of issuer's counsel as to whether material litigation is sufficiently described in the registration statement.

Underwriters counsel will also review the company's stock option plans, pension and profit sharing plans, employment contracts, leases, license agreements, supply and sales agreements and any other documents described in the registration statement and notes to the financial statements and assess the accuracy of the description of these documents in the registration statement.

Underwriters counsel also will read the minutes of meetings of the company's shareholders, board of directors and executive committee, typically for the past five years, as well as the minutes for the company's major subsidiaries. The level of review will depend upon the type of securities being offered. Items uncovered in the minutes sometimes lead to a determination that additional disclosure is required.

Officers and Directors Questionnaire

In the US, certain levels of registration statements include information on officers and directors, their compensation, employee benefits and any material transactions with the corporation. Issuer's counsel



generally prepares a questionnaire on these matters for completion by the company's officers and directors, which is reviewed by underwriters counsel.

Review of Other Documents

Preparation of the registration statement generally involves one or several working sessions at the issuer's headquarters. The underwriter and its counsel may review sensitive documents on site when the issuer does not want copies taken from its offices. These documents might include budgets, financial forecasts, multi-year plans, periodic reports by operating units to senior management or the board of directors, and management letters prepared by the auditors in connection with the most recent audit. Bulky internal documents such as operating manuals, might also be reviewed on site.

MANAGEMENT LIABILITY FOR MATERIAL MISSTATEMENTS

Management's liability for material misstatements or inaccuracies in its registration statements and periodic securities commission filings is generally stronger than for underwriters, so full disclosure and openness is in the interest of all parties to a transaction.

The securities laws of [many/most] Central and Eastern European countries impose liability for inaccurate information in registration and offering documents of public securities on the issuer, underwriters and other agents of the issuer.



SECTION V — MARKETING AND PLACEMENT



Marketing and Placement

Private Placement or Registration and Listing

- ✓ Should the bonds be publicly or privately placed?
 - Costs of issuance
- ✓ What is the registration process?
- ✓ What are the exchange listing requirements?

Marketing Process

- ✓ What is a road show and what does it accomplish?

Pricing

- ✓ What factors determine the price of a bond issue?
- ✓ Credit rating
- ✓ Seniority of debt
- ✓ Term / maturity
- ✓ Other bond terms
- ✓ Current market conditions

Securities Issuance

- ✓ What happens at the time the bonds are issued?



SECTION V. MARKETING AND PLACEMENT

This section briefly describes the process of final registration, marketing, pricing and closing of an issue. These matters, or their primary determinants, have been discussed in greater detail earlier in the Tool Kit. This section is designed to give a more chronological review of marketing and placement, for potential issuers interested in process.

Private or Public Placement, Registration and Listing

An issuer and its financial advisors will want to evaluate the merits of placing its securities in the public markets or offering them privately to a limited number of investors. Most securities laws set forth the requirements an issuer must meet to be exempt from the registration requirements for publicly traded securities and/or define private placements.

As noted above, in the US, private placements may have higher yields because of lack of liquidity but lower issuance costs because they do not have to meet registration requirements. Due diligence and disclosure standards on Rule 144A type debt issuances very closely resemble public offerings. In domestic emerging bond markets, if the issue size is small or the market not very liquid or if investors hold rather than trade bonds, secondary trading is likely to be limited even if the issue is publicly placed, so issuers may not get better execution in a public traded issue.

The marketing process of publicly offered securities is described below. Private placements might be negotiated with small number of purchasers who would expect greater input into terms. While bond indenture terms are standardized in public and Rule 144A offerings, covenants are often negotiated in more limited private placements.

COST OF ISSUANCE

Regardless of whether an issue is publicly or privately placed, it will involve certain costs of issuance in addition to the underwriting spread, including some or all of the following:

- Legal fees
- Accounting fees
- Regulatory filing fees
- Trustee and paying agent fees
- Depository fees
- Prospectus printing costs
- Rating agency fees

The importance of credit ratings was discussed in Section II. The decision to seek a rating occurs fairly early on in the issuance process and involves working with the rating agency during the process of developing the issue to ensure that the issue will achieve the desired rating. Although rating of privately placed debt is common in the US market, it is less established in the Eurobond and Euro area markets. In some emerging markets where credit rating agencies are not present or the practice well established, obtaining a rating, especially for a private placement, may not be practical or cost effective. The issuer will want to assess whether a credit rating will reduce the cost of borrowing enough to justify the process and cost of obtaining it.



REGISTRATION PROCESS

The process of registering an offering of securities to the public depends on local securities law. In the US, the process can be thought of as occurring in three stages. Prior to the point at which a registration statement is filed with the SEC, no offers of any kind can be made with respect to the securities. After a registration statement is filed with the SEC, the underwriters may begin to market the issue with a preliminary prospectus (sometimes referred to as a red herring because certain language required by SEC rules to appear on the cover page is printed in red ink). The offering the securities may be offered for sale, but no sale or contract to sell may be made during this period. The SEC will review the registration statement and may provide comments that will require changes to the prospectus, which must be made before the securities can be sold. The third stage—actual selling—occurs after the SEC declares the registration statement effective. See Marketing below.

Some securities laws require that the prospectus be approved by the securities commission before it is published or distributed to prospective investors. See Section IV. Issuers should consult with their attorneys as to the requirements of their jurisdiction.

EXCHANGE LISTING REQUIREMENTS

If bonds are exchange traded, listing requirements may include:

- Corporate legal documentation
- Indenture
- Offering memorandum
- Some number of years of audited financial statements

Exchanges may categorize issuers by specific financial and other requirements including:

- Minimum capital requirements
- Minimum Profit History
- Financial Agent (Financial Advisor, Broker-Dealer, Market Maker)

Again, an issuer should check the specific requirements of the exchange where it intends to list its securities.

Marketing

Road shows are a series of meetings that the managing underwriter arranges for the company's management to make presentations to groups of institutional investors, money managers and securities salespeople. In the US the road show begins after the registration statement is filed but before it becomes final—a period in which no written offers may be made to sell securities under the US regulatory regime—and thus, the only written document that can be distributed at the road show presentations is the preliminary prospectus.

As a result of the road show, negotiations determine:

- Quantity: how much of the issue a given investor will buy. The subscription rate is an indicator of how investors will receive the issue. A low subscription rate may indicate modifications to the terms of the issue are required.
- Price: how much investors are willing to pay. Typically coupon is stated in registration documents and actual pricing occurs on date of sale through premium or discount to par, which will reflect market conditions on the day of sale.



Depending on the size and complexity of the deal and the investors the underwriters think are likely to be interested in the issue, a road show can go to many different investors in different cities and countries.

Pricing

By the time an issue is priced, the deal has been structured and marketed. Absent a significant market event or unexpected event at the issuer, in most cases neither the issuer or its bankers should be too surprised by the price the market is willing to pay for the issue.

Traditionally in the US, an issue was priced after the close of the market on the day before the registration statement was expected to become effective. The underwriting agreement was signed and held in escrow until the following morning just before the pricing amendment—the amendment to the registration statement that states the pricing terms of the issue—was filed with the SEC. Now rule changes allow the registration statement to become effective without pricing information, as long as a supplemental prospectus is filed with the pricing information, generally two days after the price is determined. Issuers should check with their legal counsel regarding the requirements of their local securities laws.

Price of an issue is based both on the characteristics of the security and the market at the time it is sold. Refer to Sections II and III for a discussion of some of the elements that determine risk premiums and spread.

Analysis of the determinants of spreads on new high yield bond offerings in the US indicates that the most significant factors were rating, zero coupon status, intramarket spread curve, seniority, callability, term, first-time issuer status, underwriter type and interest rate change. However, the studies have shown that no more than 50 to 60% of the yield on a new issue of high yield debt in the US can be explained by objective factors—comforting statistics for those who make a living orchestrating road shows.

Issuance

FORM AND MECHANICS

Many Central and Eastern European securities laws require that publicly traded securities to be issued in dematerialized form or that securities be deposited with a national depository, effectively dematerializing them. Issuers should check the requirements of their jurisdiction with their bankers and attorneys. Local securities laws will govern issuance requirements.

In the US today, securities are generally issued in the form of a global certificate that is deposited the Depository Trust Company and beneficial ownership is recorded in book-entry form. The underwriting agreement will set forth the date and place of closing. The standard settlement cycle in the US is T+3 or in some cases T+4. Depository Trust Company (the depository) now provides the capacity for same-day funds settlement, although traditionally payment was made in “next day” clearing house funds.



Pricing Determinates

Research on high yield bonds¹ has identified many variables that affect the price of an issue, including such company and issue specific factors as:

- Credit Rating of the company and the issue
- Seniority of the debt (senior or subordinate)
- Term
- Callability
- Float
- First Time issuer
- Underwriter reputation
- Zeros (higher default rates)
- Rule 144A status

Market determinates of spread include:

- Market wide spread over treasuries
- Changes in intramarket spread curves (variations among quality tiers in the same rating category)
- Treasury yield curve
- Default rate—spreads are likely to widen when defaults rates go up and the market perceives higher credit risk
- IPO volume—high equity valuations may indicate overall optimism in the market that will result in lower spreads on high yield issues
- Forward Calendar—announced but not yet completed issues (a large volume of supply may result in wider spreads)
- Mutual fund flows—cash inflows to high yield mutual funds may indicate increased demand
- Mutual fund cash positions (may indicated discomfort with the market because mutual fund managers hold cash rather than buy assets)
- Interest rate change
- High yield return (risks premiums may drop when an asset has provided strong returns in the recent past)

Freidson, Garman and Wu "Determinants of Spreads on New High Yield Bond Offerings" reprinted in High Yield Bonds (McGraw Hill 1999).

CLEARING AND CUSTODY

Some securities laws have established a national depository and prescribe mechanisms for clearing, custody and making payments of principal and interest. Again, issuers should check the requirements and availability of facilities in their jurisdiction.

Many jurisdictions require the publication of sales results. (In the US, this is known as a tombstone.)

SECONDARY MARKET INFRASTRUCTURE AND ISSUES

Most securities laws regulate the activities of broker/dealers and trading in the secondary market of securities. Issuers may wish to gain an understanding of the operation of the secondary market for their securities from their banker.



SECTION VI — POST-ISSUANCE REQUIREMENTS



Post Issuance Requirements

Debt Service and Corporate Governance

- ✓ Has the company properly prepared to meet its ongoing debt service requirements?
 - Managing and forecasting cash flow
 - Contingency arrangements
- ✓ Does the issuer have the ability to monitor compliance with the terms of the bond issuance documents and covenants?

Ongoing Disclosure and Communications

- ✓ What are the ongoing disclosure requirements for the bonds?
 - Regulatory or required by an exchange
 - Bond covenants
- ✓ Is there a rating maintenance requirement?

Default

- ✓ What happens if a bond issuer defaults?
- ✓ What do regulators do?
- ✓ What does the judicial system do?



SECTION VI. POST-ISSUANCE REQUIREMENTS

This section provides a review of post-issuance requirements that bond issuers must follow to service their debt and comply with the terms of securities laws and the bond contract. It is largely a review of matters discussed earlier in the Tool Kit, but should serve as a short list of items that issuer's should monitor following bond issuance.

Debt service and Bond Documentation Compliance

Perhaps the most important post issuance requirement is that a bond issuer must make timely payments of interest and principal as required in the bond contract. In order to ensure that a company can meet these obligations it must have the ability to manage and forecast cash flow. See Section I.

CORPORATE GOVERNANCE: BOND DOCUMENTATION COMPLIANCE

A strong, sound corporate governance atmosphere is important to engender investor confidence in a country's capital markets, and is likely to ultimately be reflected in investor interest and price. Bondholders are not owners of a company, however, so corporate governance issues for holders of debt securities are different than for shareholders, and largely questions of compliance with the terms of the issuance documents, primarily the bond contract and any security agreements relating to the issue, and ongoing disclosure in accordance with applicable securities laws and listing rules. See Sections II and III for a description of bond covenants and obligations of the bond contract and security documents. Specifically, an issuer should carefully monitor:

- Ratio reporting and maintenance
- Collateral coverage reporting and maintenance
- Lien re-registration and pledge maintenance
- Maintenance of other bond contract covenants

Asset backed securities generally have asset performance information requirements, as do some secured and structured finance issues.

Ongoing Disclosure and Communication requirements

DISCLOSURE

Bonds that are publicly traded are priced after the initial issuance in the secondary market based on information available at the time of the trade. Therefore, ongoing disclosure is important for the integrity of the secondary market and to protect bondholders who buy after the initial issuance.

Most Central and Eastern European securities laws require ongoing periodic reporting for issuers of publicly securities. Issuers should keep up to date as to ongoing:

- Legal and regulatory requirements under the securities and other applicable laws
- Exchange and listing requirements

As noted above and in Section III and IV, the bond contract is likely to contain requirements of periodic reports to bondholders.

If there is a question of misleading information in the prospectus or subsequent disclosure filings, a number of actions may be taken against the issuer:



-
- Regulatory enforcement actions
 - Exchange suspension of trading
 - Legal actions by shareholders and bondholders

RATING MAINTENANCE

Rating agencies will review the credit rating annually, a service for which they generally charge a rating maintenance fee. Bond contracts generally require that any change in rating be communicated to bondholders.

Default

A crucial component of bondholder protection is the legal and regulatory regime in place for handling defaults in payment of principal and interest and covenant provisions in the bond contract. The system should facilitate:

- Contractual enforcement –negotiation and rescheduling
- Reorganization
- Liquidation

Without these remedies it is not possible for bondholders' rights to be fully protected, because they will have little recourse or leverage if defaults do not have consequences for the bond issuer. See Sections I, III and IV for discussions of the terms of events of default and the importance of bankruptcy remedies to a well developed bond market.

Although it may seem paradoxical, a few defaults—provided they are handled in an orderly, transparent manner by the legal system and conducted in accordance with the rule of law—may actually strengthen a developing bond market in the long run. Precedent thus established will remove an additional element of uncertainty for prospective bond holders.



RESOURCES

List of Sources

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Batchvarov, Alexander, Collins, Jenna, De Pauw, Xavier, Spencer Jeffrey, Davies, William, Hani, Chinatsu, *Merrill Lynch Guide to International Mortgage Markets and Mortgage –Backed Securities*, London, Merrill Lynch, 2003

Battan, Jonathan A., Fetherston, Thomas A., and Szilagyi, Peter G., *European Fixed Income Markets: Money, Bond, and Interest Rate Derivatives*, Chichester, West Sussex, John J. Wiley & Sons Ltd, 2004.

Brealey, Richard A. and Myers, Stewart C., *Principles of Corporate Finance*, Sixth Edition, Boston, Massachusetts, Irwin/McGraw Hill 2000

Coyle, Brian, *Capital Structuring*, New York, AMACOM, American Management Association, 2000.

Fabozzi, Frank J. and Modigliani, Franco, *Capital Markets: Institutions and Instruments*, Second Edition, Upper Saddle River, NJ, Prentice Hall, 1996.

Finnerty, John D., and Emery, Douglas R., *Debt Management, A Practitioner's Guide*, Boston, Harvard Business School Press, 2001.

Johnson, Charles J. and McLaughlin, Joseph, *Corporate Finance and the Securities Laws*, Second Edition, New York, Aspen Law & Business, 1997.

Melnik, and Nissim, “Liquidity and Issue Costs in the Eurobond Market: The Effects of Market Integration”, International Centre for Economic Research, Working Paper No. 3 / 2004.

Narayanan, M.P., Vikram, K.Nanda, *Finance for Strategic Decision Making, What Non-Financial Managers Need to Know*, San Francisco, California, Jossey-Bass, a Wiley Imprint, 2004

Van Horne, James C. *Financial Management and Policy*, 11th Edition, Upper Saddle River, NJ, Prentice Hall, 1998

Woodridge, Paul, Domanski, Dietrich, and Cobau, Anna, “Changing links between mature and emerging financial markets”, BIS Quarterly Review, September 2003.

Internet Resources

[Description] www.debtmarkets.org

Trade Associations:

- *The Bond Market Association*, www.bondmarkets.com, has information and research, including a report on electronic fixed income trading systems that is periodically updated.
- Securities Dealers Association

Rates and market trading information

- www.Bloomberg.com (extensive information available for subscription)
- www.rencap.com (Russia)
- www.troikadialog.ru (Russia)
- www.cbonds.info.ru (Russia and Ukraine)



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- www.rzb.at (region wide debt market research)

Rating Agency web sites are good sources of information about rating agency criteria, research in the credit markets and recent ratings and analysis of new issues and occasional special reports. For example, Fitch publishes a free quarterly analysis of the Polish non-governmental bond market and has done special reports on securitization in Russia and Poland.

- Standard and Poor's; www.sandp.com
- Moody's: www.moody's.co,
- Fitch Ratings www.fitchratings.com

International Organizations:

- Bank for International Settlements: www.bis.org. BIS papers 11 is a series of studies on bond market.
- World Bank: www.worldbank.org
- IFC: www.ifc.org
- EBRD: www.ebrd.org
- IMF: www.imf.org
- OECD: www.oecd.org
- European Union: www.europa.eu.int

Regulators and self-regulatory organizations:

- US Securities and Exchange Commission: www.sec.gov
- NASD: www.nasd.org
- Federal Reserve: www.federalreserve.gov

Local market interest rates may be found at central bank web sites, securities exchange web sites, ministry of finance and local banks, investment banks and broker dealers. The BIS website has a list of all national bank web sites.

General bond information

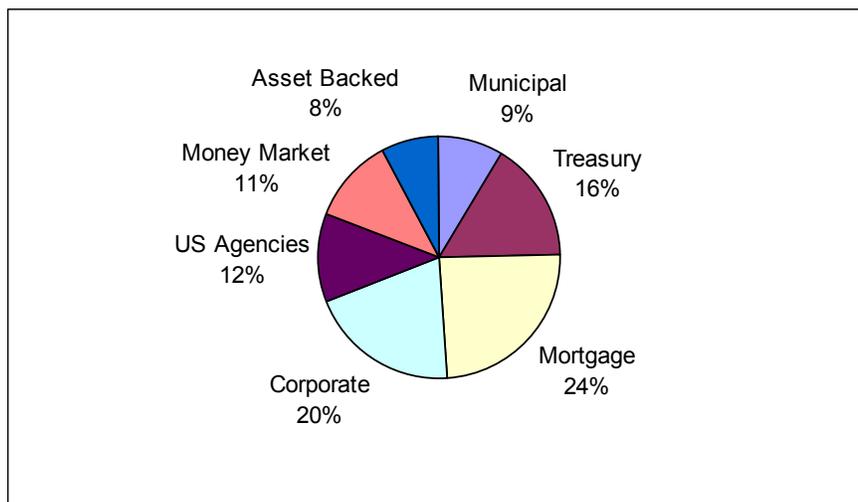
- <http://www.investinginbonds.com/loab/>
- <http://www.bondsonline.com/asp/research/faqcorp.asp>
- www.bondtalk.com

Law Firms and accounting firms can be good sources of legal and regulatory information about a local market. They often prepare client memos and publications on topics related to changing legal and regulatory matters.



APPENDIX I: THE US BOND MARKET

Total outstanding public and private debt stood at \$22 trillion at the end of 2003. The size and nature of the capital markets in the US has allowed for considerable segmentation in the debt markets. The following chart shows outstanding public and private debt securities in the US at the end of 2003, segmented according to issuer and type.



Source: The bond market association

US Outstanding Public and Private Debt End 2003	
	\$ Billions
Municipal	\$1,899.4
US Treasury (interest bearing marketable debt)	\$3,574.9
Mortgage (includes GNMA, FNMA and FHLMC mortgage-backed securities, CMOs and private-label MBS/CMOs)	\$5,309.1
US Corporate	\$4,455.2
Federal Agencies	\$2,636.7
Money Market (includes commercial paper, bankers' acceptances, and large time deposits)	\$2,517.7
Asset Backed (includes public and private placements)	\$1,693.7
Total	\$22,086.7

Source: The Bond Market Association



The following table shows US publicly traded and Rule 144A corporate securities issued in 2002 and 2003

US Underwriting of Corporate Securities						
	2003			2002		
	Proceeds	No. of Issues	Avg. Deal Size	Proceeds	No. of Issues	Avg. Deal Size
	USD millions		USD millions	USD millions		USD millions
Debt						
LT Investment Grade	641,681.1	1,815	353.5	538,946.1	1,377	391.4
LT High Yield	130,328.2	449	290.3	57,229.0	228	251.0
ST non-cvt debt	422,684.4	3,906	108.2	387,900.4	3,446	112.6
Mortgage Backed	906,000.3	1,217	744.5	805,746.3	1,024	786.9
Asset Backed	603,211.0	1,162	519.1	401,423.3	987	476.6
Convertible	88,521.8	254	348.5	36,595.6	97	377.3
Total Debt	2,792,426.8	8,803	317.2	2,227,840.7	7,159	311.1
Common stock						
IPOs	16,337.1	89	183.6	26,520.6	97	273.4
Non-IPOs	74,773.2	501	149.2	77,488.3	448	173.0
Total Common	91,110.3	590	154.4	104,008.9	545	190.8
Preferred stock						
Straight	36,016.2	199	181.0	18,335.4	126	145.5
Convertible	7,841.1	25	313.6	22,877.5	38	602.0
Total Preferred	43,857.3	224	195.8	41,212.9	164	251.3

Source: Investment Dealers Digest; January 19, 2004 Data includes public and Rule 144A deals, but not private placements