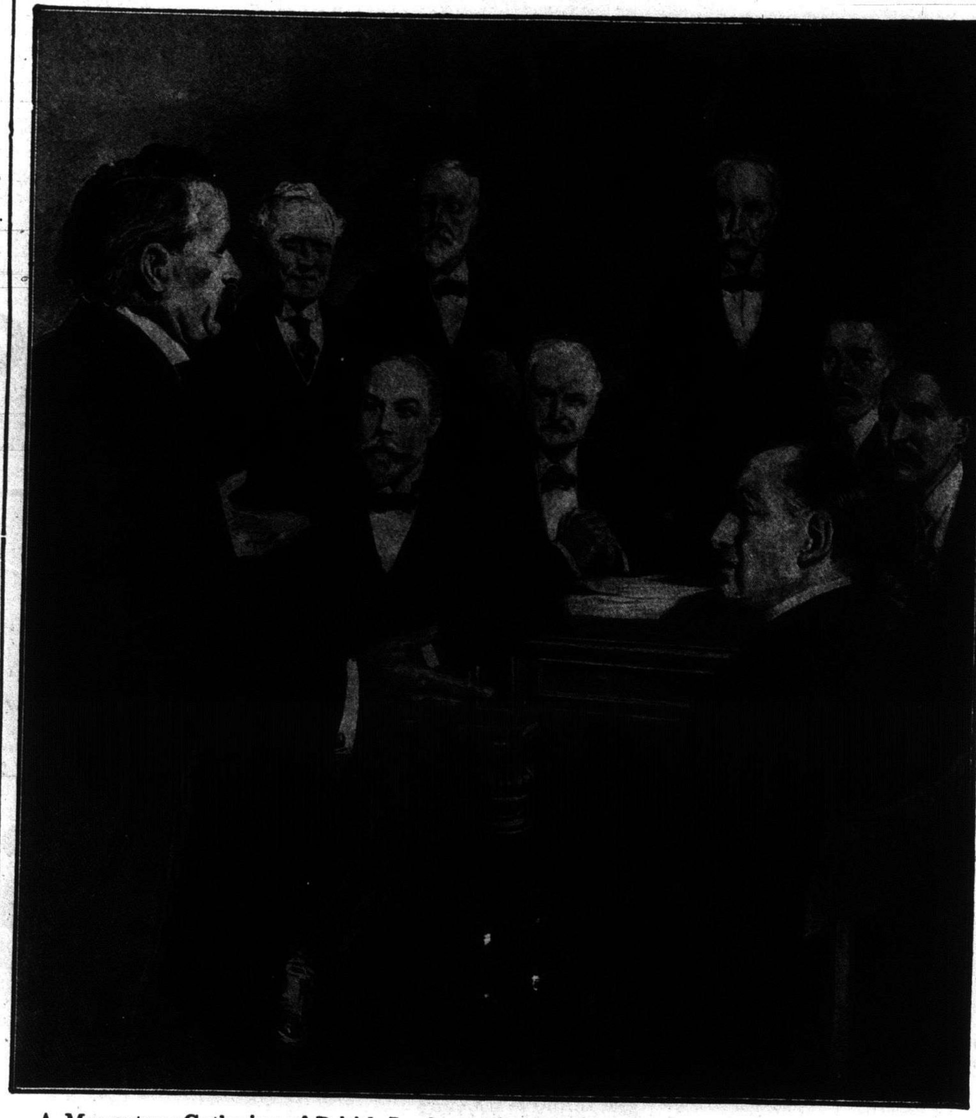
How Bonds are Issued

By A. C. Snivley

THE prospective purchaser had been asking a number of questions about the bonds offered him, some to the point, most so far afield that the salesman was hard put to find answers to satisfy him. Finally he remarked: "I suppose your house gets a pretty good commission for selling these securities." The reply surprised him and altered his attitude of tolerant suspicion to one of confidence at once. "Why, we own the whole issue," said the salesman; "we bought it from the company, in competition with other houses, and we paid the company for the bonds some time ago."



A Momentous Gathering of British Leaders at Buckingham Palace by Command of the King
The Prime Minister and Mr. Lloyd George represent the Government, Mr. Bonar Law and the Marquis of Lansdowne the Opposition, Sir Edward Carson and Captain Craig, Ulster, and Mr. John Redmond and Mr. John Dillon the Irish Nationalist Party. The Speaker of the House of Commons, who acts as Chairman, may be seen seated at the corner of the table in the foreground

"Why, I didn't know that bond houses owned the securities they advertise. I suppose if you fellows are sure enough of them to buy and pay for them they should be all right for me." And after some further information as to the details of the original purchase of the bonds, the investor bought with confidence a security which but a few minutes before he had looked on with considerable misgiving.

This is but one of many similar occurrences. The inexperienced investor confuses the position of the investment banking house with that of the stockbroker. The former is like a commercial house, buying in bulk and selling at retail, while the great bulk of the broker's business consists in buying and selling securities which he does not own for his clients and charging commission for filling their orders.

Methods

The method of the bond house in its dealings is interesting and quite outside the experience of the average man. The buying of large issues of securities is surrounded by so many pitfalls that the majority even of investors do not realize that preliminary investigations have been undertaken by the investment banker before he feels that he is justified in offering them to the public.

The first thing, of course, is to get the bonds. As a rule the company which finds it advisable to raise money by mortgaging its assets goes to some financial house of repute and lays the situation before the members thereof. The house usually considers it an important step, before going farther, to inquire as to the type of men at the head of the business and their methods. Unless both meet with their approval the issue is declined. Then, after going into the details of the business to the fullest extent, the house, if this examination proves satisfactory, enters into negotiations as to price. As a matter of fact, few prospective bond issues get past this preliminary stage. One bond man stated recently that this house turned down at least nine out of ten propositions put before it. The price is often a matter of prolonged negotiations. The managers of every company issuing bonds are convinced that they should get considerably more than the bond house knows it can pay. They generally overlook the fact that the difference between the price paid and that at which the public buys is not all profit by a great deal. The bond house has the expenses of a large selling staff, in addition to other overhead office charges to consider, and when these expenses are taken into account the net profit on an issue of average amount shrinks to a very modest sum. As a matter of fact, the gross profits on bond issues is by no means large, often not so great as the commission paid real-estate agents in handling large transactions. The price once agreed upon, there are several other stumbling blocks to be avoided. The question of the length of time the bonds have to run, the arrangements for providing an adequate sinking fund, and the many other details which experience teaches the house investors desire in a certain manner to be arranged. The borrowing company usually considers these items unimportant or vexations, and perhaps merely so much red tape. All this takes time, patience, and diplomacy.

Then comes the real examination. If the issuing company is a traction or other public-service corporation, engineers of the highest standing are employed to make a thorough physical examination of the plant and equipment, and, disregarding the company's figures, estimate exhaustively the actual value of the company's properties as well as the cost of rebuilding the whole out of new materials —that is what is known as "replacement value." In the case of industrial companies, appraisers of known ability and experience are employed to valuate the plant or plants. In this case also the company's own valuation, as shown on their books, is not considered. The real estate is valued independently by real-estate valuators. At the same time—and this is done in the case of all companies, rail-road, public utility, or industrial—accountants are turned into the company offices to make an independent audit of the books. In this way the issuing house knows absolutely the value of the company's assets, just what their earnings are—and these are always examined over a period of at least three years—and, in short, they seldom take anybody's unsupported word for anything. In employing auditors and valuators the investment houses always invariably employ those of international reputation, as their figures must have weight on both sides of the Atlantic. Nothing is left to chance.

Then the banker's lawyers go into the question of the legality of the issue, to see that all proper, legal safeguards have been taken, and the form of mortgage is drawn up and executed. This is then turned over to the trustee, practically always a trust company, which issues the bonds after they have been signed by the borrowing company's officers, and vouches for the fact that they have been issued in accordance with the mortgage—part of which is printed on the bonds.

Then and then only are the bonds delivered to the public, although most houses sell the issues they purchase before the bonds are printed, which takes some time (one or two months) to do, delivering the purchasers in the meantime "interim certificates," which are exchanged later for the "definitive" bonds themselves.

All these preliminaries run into a whole lot of money, and very often as much as three or four or more months are occupied in the physical, financial, and legal examinations. When, however, this work is completed, to the satisfaction of the investment house, they offer the bonds to their clients without misgivings.

Business Requirements

The ultimate success of a bond house depends altogether on its ability to find and purchase issues that merit investment and on their obtaining and keeping a clientele that has faith in it and its business judgment. In short, a bond house, to be successful, requires a long and growing list of satisfied clients. To satisfy clients it is necessary that they have no cause for uneasiness over the securities in which they have invested—hence the ultraconservative care with which the better houses investigate prospective purchases. Moreover, such houses feel a sort of moral responsibility in seeing their clients' interests are properly safeguarded. They do not feel, as they might, that their duty is over when—after conscientious examination—they have sold the bonds. Some houses take pride in maintaining an active market—except perhaps in times of panic, when it may be impossible to raise enough money to satisfy everybody—for securities they have issued, and are always prepared to repurchase from investors, at a fair market price, securities which they have sold. This, of course, does not in effect guarantee that the bonds will never sell below the issue price. That, of course, would be an attempt to negative the law that supply and demand rule prices. It does mean, however, that the market is not subject to violent fluctuations and that one can realize on one's purchase if circumstances make such a course advisable.

The manner in which municipal loans are purchased is somewhat different. Generally the proposed debentures are advertised by the municipality, and in competition with the other houses the issue is purchased by the highest bidder, "subject to legality." Of course before bidding, the bond houses examine into the physical and financial condition of the issuing, municipality and base their bids on the probable price at which investors will buy the bonds. The accuracy with which this can be figured in normal times makes the bidding very close. In more than one instance that I have noticed recently three of four bids for blocks of bonds up in the hundreds of thousands have been within a few dollars of each other. Once purchased, the by-laws authorizing the issue and notarial statements as to all the essen-