Corporate Bonds

Debt securities issued by companies (issuers) to raise funds. In this contract, the Issuer undertakes payment obligations which it will have to discharge towards the Bondholder at a predetermined time. The detailed terms and conditions of the Bond and how it works are governed by the Final Terms issued in relation to it. Corporate bonds include a wide range of denominations, maturities and structures.

Important: the types of Corporate Bond detailed below may carry significantly different risks. When buying corporate bonds, you should always be aware of the specific terms and conditions of the given type and the additional risks involved.

1. To whom are corporate bonds recommended?

- Those who want to achieve **higher returns than government securities yields** and are therefore willing to take on additional risk.
- Those who **are confident about the future of a given company**, but prefer to invest in bonds rather than equities.
- Those who are concerned about the repayment of capital, as the face value of the bond will be repaid at maturity/until maturity. Of course, even then the Issuer's risk should be taken into account.
- Those who prefer bond-type investments but are looking for **more exotic** solutions. For them, the various floating rate/indexed bonds represent a suitable option.
- Those who **want to optimise their interest tax liabilities**, as corproate bonds can be purchased in either a long-term investment account (Long-Term Investment Account) or a pension savings account (NYESZ-R) subject to the legal conditions of the relevant account type.

2. Definitions

Issuer	A company (even a bank) that issues bonds to raise funds. It is important to note that individual Issuers may differ significantly by credit rating.
Credit rating of the issuer	Rating determined by independent debt rating agencies. The lower an Issuer's rating, the greater the risk of the Issuer's bankruptcy and partial or total loss of invested capital. The rating of the Issuer is set out in the Prospectus or Final Terms relating to the Bonds.
Nominal value/Capital	Determines the amount of the loan a purchaser of one Bond makes to the Issuer of the Bond. Typically, the Issuer will repay the Nominal Value to the Investor in one lump sum at the maturity of the Bond (but there are also bonds that repay the Nominal Value in several instalments over the life of the Bond)
Interest	The interest rate specified in the Final Terms of a given Bond, payable by the Issuer on the dates and subject to the fulfilment of the conditions specified in the Final Terms. The lower the rating of an Issuer, the higher the interest rate offered in the Final Terms.
Interest payment date	The dates on which the Issuer pays interest, as specified in the Final Terms of a given Bond. If the payment of interest is conditional, these are the dates on which the condition for the payment of interest is reviewed.
Maturity	The date on which the Issuer repays the Nominal Value of the Bond, as specified in the Final Terms of a given Bond. If the Bond repays the Nominal Value in several instalments during the term, the last instalment of the Nominal Value will be repaid at Maturity. There are special Bonds which are maturity free.
Expected return on the bond	The yield on the Bond may vary significantly from the Interest Rate. It is the value corresponding to the remaining life of the bond, reflecting the riskiness of the Issuer and the current market yield environment. The yield curve is used to determine the theoretical price of the Bonds.

3. Types of Corporate Bonds

a) Based on interest

Fixed Rate Bonds pay predetermined interest over their term according to the frequency specified in the Final Terms.

Discount Bonds do not pay interest, but may be subscribed for below the Nominal Value and repay the Nominal Value at maturity.

Variable Rate Bonds have an interest rate that is not predetermined, typically linked to a benchmark interest rate/index, e.g: 6-month BUBOR + 300 bp. In this case, +300 bp represents the premium over the reference rate.

Index-linked bonds have an interest rate not known in advance. The interest payout is conditional, the rate is a function of the performance of an underlying market instrument (equity, basket of shares, index, cross rate, etc.). Index-linked bonds typically provide exposure to the Underlying Product through derivative positions (e.g. options). In all cases, the rules for the payment of interest and the definition of the Underlying Product are set out in the Final Terms issued for the Bond.

b) In the order of satisfaction

In the event of a company's bankruptcy, bondholders receive a share of the company's post-liquidation value before shareholders. Within bondholders, there is an order in which bond liabilities are repaid:

Secured bond: in the event of the issuer's bankruptcy, predetermined security covers the repayment of the bond.

Unsecured, unsubordinated bond has no specific security assigned to it and is classified in the same way as other creditors in the event of bankruptcy.

In the event of the bankruptcy of a company, **subordinated debt** is repaid after all other creditors in this category have been paid. The subordinated debt can be further broken down by seniority: in the event of bankruptcy, the claims of senior bondholders are satisfied before those of junior bondholders, after the payment of other creditors. As subordinated debt carries a higher risk for the lender, it is typically issued at a higher interest rate. In many cases, subordinated debt is issued without maturity and with embedded options (call options, redemption options), which significantly increase the volatility and risk of the bond. As a consequence of these factors, a bond may trade deeply below its nominal value.

c) Based on the rights sold with the bond

Callable Bond: gives the Issuer the right (but not the obligation) to call its issued and outstanding Bonds (or part thereof) at predetermined dates/periods. The Issuer will then repay the Bondholder the Nominal Value or the value specified in the Final Terms and the bonds will be cancelled. Because the bond gives the Issuer extra rights, it is typically issued at a higher interest value than bonds without a call option. The exact terms of the call options are set out in the Final Terms.

Redeemable Bond: gives the Bondholder the right (but not the obligation) to redeem the Bonds held by him/her at predetermined dates/periods. The Issuer will have to repay the Bondholder the Nominal Value or the value specified in the Final Terms at that time and the bonds will then be cancelled. Because the bond grants bondholder extra rights, it is typically issued at a lower interest value than bonds without a redemption option. The exact terms of redemptions are set out in the Final Terms.

Convertible bonds: give the bondholder an extra right to exchange the bonds of the company for shares in the company at a predetermined proportion and at a predetermined time before the maturity of the Bond (there are also convertible bonds where the Issuers of bonds and shares are different). Because the bond grants bondholder extra rights, it is typically issued at a lower interest value than bonds without conversion options. The exact terms of the conversion options are set out in the Final Terms.

4. Factors affecting the price of bonds

At the time of issuance, the Issuer typically sets the subscription/market price. In the subsequent period, the price of the bonds is influenced by a number of factors, both jointly and separately.

Determination of the gross price

Gross price = $$\sum_{i=1}^{n} \frac{CF_i}{(1+r)^i},$$

Net price = Gross price - accrued interest

n= number of interest payment periods until maturity of the bond

CF_i = cash flow value associated with a given interest payment period. In determining its value, the interest payments, principal repayments and the value of any embedded options in the period must be taken into account.

r= the yield to maturity of the bond

accrued interest = value of interest accrued and not yet paid since the last interest payment.

Market quotes for corporate bonds are typically quoted at the Net Price, but in all cases the Customer buys or sells at the Gross Price.

- **market yield environment**: all else being considered unchanged, as market yields rise, the bond price falls.
- with a deterioration in **the issuer's rating**, the expected yield on the Bonds increases, i.e. the price of the Bonds decreases.
- **rights embedded in the bond**: price movements of bonds with call, redemption and conversion options behave differently from their counterparts without options. The price of Callable Bonds rises much more slowly in the event of a fall in the market yield environment than their counterparts without call options. If the call and redemption options have value to their holders, the price of a Callable Bond will be lower and the price of a Redeemable Bond will be higher than its counterpart without embedded rights.
- In the case of **Variable Rate/Indexed Bonds**, market movements in the Underlying Instrument will significantly affect the price of the bond. There may be market movements that completely devalue the derivative positions in the bond, in which case the Variable Rate/Indexed Bond will behave in the same way as a bond without a derivative position (e.g. fixed rate).
- **supply and demand**: the bond is always quoted at a Net Price, the value of which is significantly influenced by changes in the supply and demand.

5. Risk factors:

- **Issuer risk**: refers to the risk that the Issuer may not be able to meet its payment obligations undertaken in the Final Terms.
- **Repayment risk**: the risk of how much of the invested capital the Bondholder will receive back in the event of the Issuer's bankruptcy. In the event of bankruptcy, the subordinated / unsubordinated nature of the bonds will determine where the Bondholder stands in the creditor ranking. Subordinated bonds are much riskier than their unsubordinated counterparts because they are at the bottom of the order of satisfaction of bondholders. In the event of the Issuer's bankruptcy, the Bondholder may not recover the capital invested (this also applies to unsubordinated bondholders).
- **The risk of downgrading an issuer:** if the issuer's rating is downgraded, the expected return on the bond increases and its market price decreases.
- **Risk of volatility**: volatility has a major impact on the price of any bond that contains an option. For example, as interest rate volatility increases, the price of callable bonds decreases but the price of redeemable bonds increases. The price of some index-linked bonds can also change significantly in response to changes in the volatility of the Underlying Product, but the direction of this change is always determined by the embedded derivative products.
- **Reinvestment risk**: the risk that, in a declining yield/interest rate environment, individual interest payments or potential principal repayments can only be reinvested at a lower yield. This risk is particularly relevant for callable bonds as the Issuer calls its bonds in a low yield environment, i.e. when the interest rate environment allows it to finance its funding needs by issuing bonds with a lower interest rate than the interest rate on the bonds called.
- **Interest risk:** the price of bonds moves in the opposite direction to the change in the yield environment. That is, if the expected return on the bond rises, the bond price falls. Importantly, bonds with longer maturities (average maturity) are more sensitive to changes in yields, i.e. a rise in yields will cause the price of bonds with longer maturities to fall more sharply than those with shorter maturities.
- **Inflation risk** for many bonds, the future payments (interest, capital) are predetermined and their real value decreases with rising inflation.
- In the case of **Index-linked Bonds**, the structure of the Bond may contain a limit on the pay-out of the Underlying Product. In such a case, the full performance of the Underlying Product will not be paid, but only the maximum/limit set out in the Final Terms.
- **Liquidity risk** in many corporate bond markets, liquidity is very low, which means that a sale before maturity can only take place at a price much lower than the theoretical price.
- **Currency risk** if a bondholder wishes to convert the bond payments into a different currency, he/she must also be aware of the risk arising from the volatility of exchange rates.

6. Important information

Corporate bonds are very varied and the risks they carry can vary widely, so you are advised to read the Final Terms of each corporate bond carefully before buying.

7. Tax information

The interest earned on bonds and the income earned on redemption or transfer is **interest income** within the meaning of Article 65 of the Personal Income Tax Act. In Hungary, from 1 January 2016 interest income earned is subject to a 15% tax rate, while interest income earned up to 31 December 2015 continues to be subject to 16% tax. If the sale, income or interest payment is arranged through a statutory paying agent, the tax is assessed, deducted and paid by the paying agent on a transaction-by-transaction basis and does not have to be reported by the individual in his/her tax return.

From 1 January 2017, Section 3/A of Act LXVI of 1998 on Health Care Contributions will be repealed. Under the change, the 6 percent health care contribution on interest income will be abolished, so that the 6 percent health care contribution will not be deducted from interest income credited after 31.12.2016.

The above rules also apply to **non-resident individual** investors, with the difference that in possession of a certificate of residence issued by the foreign state in which the individual is resident for tax purposes, the paying agent determines the tax deduction liability and the tax rate on the basis of double taxation treaty, or, failing this, in accordance with the provisions of the Personal Income Tax Act. In addition, in the case of a foreign individual whose state of residence does not have a double taxation treaty with Hungary, the organisation that is deemed to be the paying agent under the law must deduct 15% tax on the interest income.

In the case of an investment under a long-term investment contract with an investment service provider pursuant to the provisions of the Personal Income Tax Act in effect at the time of the preparation of this Product Information, the investor may apply the preferential tax rules provided for by the Act under the conditions set out in the Personal Income Tax Act. In addition, it is also possible, subject to compliance with the conditions laid down by law, to place the bonds in a pension savings account.

For more information on the pension savings account scheme, its advantages and tax features, please visit our website (http://ersteinvestment.hu/hu/erste_nyugdijelotakarekossagi_szamla.html).

Corporate Bonds can also be bought in a Long-Term Investment Account. For more information on the Long-Term Investment Account, its advantages and tax features, please visit our website (http://ersteinvestment.hu/hu/erste_tbsz.html).

The tax information is not exhaustive. Before making your decision, please check out the information in detail on the legal conditions for interest income, long-term investment accounts (TBSZ) and other taxation issues (including the case where the transaction is not concluded through an investment service provider) and consult your tax advisor as the tax conditions and the choice of a scheme for the Long-Term Investment Account can only be weighed on the basis of the investor's individual circumstances. Tax laws and their interpretation may change and Erste Befektetési Zrt. cannot be held liable for the consequences thereof.

8. Further Conditions

The information contained in this document is not exhaustive and Erste Befektetési Zrt. reserves the right to make changes.

The content of this document does not constitute an investment offer, an invitation or solicitation to make an offer, investment advice or tax advice. It is intended solely to provide investors with certain specific information about the Investment Loan to assist them in obtaining sufficient information about this form of investment prior to entering into a transaction. Further information on the Investment Loan is also contained in our **Terms and Conditions of Business** and our notices, which are available on the website of Erste Befektetési Zrt. (www.ersteinvestment.hu).

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