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FN281 Personal Finance

Individual Assignment

1. Why do corporations sell bonds?

Issuing bond is one of the best ways for funding business. Bond is a loan between investor and corporation that investor will give specific amount of money with specific period of time in exchange with specific periodic interest payment in determined intervals. Investors will get back their money when loan reaches its maturity date. Moreover, corporation can not only issue callable bond that corporation has a right to buy bond back whenever it want even before maturity date, but also use interest payment as a tax deduction because bond works like other types of corporate debt.

Why corporations don’t borrow from bank or issue stock. In term of borrowing from bank, first point, issuing bond is more attractive proportion because interest rate required paying to bank is more than interest rate required paying to investor so that company can deduct this proportion of expense. Another point, issuing bond provides less restriction for operating. Borrowing from bank requires variety of limitations, for example company can’t generate more debt or make corporate acquisition until whole of its loan are repaid. These limitations will be an obstacle for company to invest and expand its business. For bond, company can borrow large amount of money with very low interest rate and also less restriction; therefore issuing bond offers more ability to invest in growth, infrastructure and other projects. Furthermore when interest rate is extremely low, even company that doesn’t seem to need money usually issue bond. In term of issuing stock, it is a popular way to funding business, however owner needs to grant proportional ownership in business to investors for exchanging of money meaning that the more additional number of stock issued, the more amount of earning shared to investors. This fact leads to reducing in earning per share (EPS) to the owner and lower in ESP is generally not performed as a favorable development.

Hence, issuing bond offers more advantage in term of ownership protection, Interest rate deduction, Fixed maturity date and Callable feature.

2. What are the differences among a debenture, a mortgage bond, and a subordinated debenture?

A debenture is one type of debt instruments, which is not secured by assets or collateral, but it is backed by credit and reputation of issuer.

A mortgage bond is a bond, which is secured by a mortgage on at least one asset such as house and land. In case of default, mortgage bondholders have a right on underlying asset and can sell it as compensation.

A subordinated debenture is one type, which is classified to be lower than more senior debt in case of default, so holder of more senior security will be paid first before holder of subordinated debenture leading to higher risk of nonpaying back. However this bond is compensated by paying high interest rate.

3. Why would an investor purchase a convertible bond or a high-yield bond?

Convertible bond issued by corporations provides alternative to bondholder to trade for shares in the corporations that issued it and offers fixed-income with coupon payment. In addition it gives potential of benefit from increasing in company's share price. Pros for investor, bondholder can trade bond for equity (stock) and receive potentially high dividends whenever company performs well. On the other hands, bondholder can keep bond and get money back when bond reach its maturity date, if company doesn't perform well as desired. Moreover convertible bond's value will not fall lower than par like other bonds. Therefore it provides safety and alternatives for investor.

High-yield bond is a high paying bond given lower credit rating than investment-grade bond like Corporate bond, Treasury bond and Municipal bond. The higher risk it takes, the higher payment of yield it offers. Pro for investor, high-yield bond offers higher payout compared to ordinary investment-grade bond and if company improve it credit rating, the bond will appreciate leading to higher return.

4. Describe three reasons a corporation would sell convertible bonds.

Firstly, issuing convertible bond helps to secure equity financing in a delayed manner due to taking time in trading bond for stock. This process delays the dilution, which is a reduction of ownership percentage's share of sock caused by issuance of new stock.

Secondly, company has ability to sell bond with lower coupon payment rate than the other normal bonds due to the alternative of trading for stock. The more convertible bond is worth, the lower yield company is able sell bond

Lastly, bond interest payment can used as a tax deduction leading to cost of capital. For the company, it can use to deduct at most at 35 percentages.

5. Explain the methods that corporations can use to repay a bond issue.

The method that company can use to repay a bond issue is Call option, which is able to use with callable bond. A callable bond is a bond, which can be bought back by the issuer and cease the interest payment before its maturity. It is very attractive to both issuer and investor because it offers a chance of interest rate reduction in the future for issuer and gives higher interest rate payment than the standard bond for investor.

Furthermore it provides an essential propose to financial market through generating opportunities for both parties to act upon its interest rate expectation.