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FN281 Individual Assignment 2

1. Why do corporations sell bonds?

When companies need to raise money, issuing bonds is one way to do it. A bond functions like a loan between an investor and a corporation. The investor agrees to give the corporation a specific amount of money for a specific period of time in exchange for periodic interest payments at designated intervals. When the loan reaches its maturity date, the investor's loan is repaid.

The decision to issue bonds instead of selecting other methods of raising money can be driven by many factors. Comparing the features and benefits of bonds versus other common methods of raising cash provides some insight into why companies often look to bond issuance when they need to raise cash to fund corporate activities.

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

The main difference between mortgage bonds and debenture bonds is collateral. The mortgage bond is collateralized by something that has value and can be sold to pay the bondholders if the company defaults on payment of that bond or goes through bankruptcy. Debentures have no such collateralization. They are unsecured debt, backed only by the full faith and credit of the issuing company. If investors receive only the issuer's promise to pay, they typically require a higher interest rate than they would require buying a collateral-backed bond.

A subordinated debenture is similar in character as a debenture however in this case they are paid as a subordinate issue. This leaves the subordinate debenture acting as a junior debt to the more senior debenture in case of insolvency. As you might imagine these issues, although linked to the debentures, pay a higher interest rate.

In the case that the corporation does become insolvent, the more subordinated a note is the more risky it would be. Imagine a series of issues with senior debt and junior debt this flow of funds from the corporation to the bond investors happens like a funnel.

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

The reason why investor will purchase a high-yield bond or convertible bond, because this kind of bond is mostly issued by company with low rating or this bond can be junk bond. The company has opportunity to issue such a bond to attract the investor. Because the investor hope that if the price of their stocks rise and has value more than the value of the issued bond, so, the investor is willing to convert the bond to stock to gain more benefit than what it should be.

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

Firstly, Companies with poor credit ratings often issue convertibles in order to lower the yield necessary to sell their debt securities.

Secondly, there are also corporations with weak credit ratings that also have great potential for growth. Such companies will be able to sell convertible debt issues at a near-normal cost, not because of the quality of the bond but because of the attractiveness of the conversion feature for this growth stock.

Thirdly, most issuers hope that if the price of their stocks rise, the bonds will be converted to common stock at a price that is higher than the current common stock price. By this logic, the convertible bond allows the issuer to sell common stock indirectly at a price higher than the current price. From the buyer's perspective, the convertible bond is attractive because it offers the opportunity to obtain the potentially large return associated with stocks, but with the safety of a bond.

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

In case of callable bond is called before its maturity, the company has to attach some compensation, which is premium. There are two methods to make sure that company has capability to pay back the debt. Sinking fund is a method that company is required to set aside the funds in a savings account periodically to meet the amount that the company needs to repay the principal. Another method is a serial bond, which a company issues bonds with different maturity at the same time in order that company can repay principal back in different time with divided amounts.