

## Individual Assignment FN281

### 1. Why do corporations sell bonds?

- In order to understand the reasons why corporations sell bonds, we should compare the benefits of issuing bonds over other types of raising cash.
- **Bonds VS Bank Loan**
  - Issuing bonds is cheaper than borrowing from the bank. As interest rate on bonds is often lower than the rate on a bank loan.
  - There are fewer restrictions on bonds compared to bank loans. Since companies are required to follow several limitations, for example, companies are prohibited from issuing more debt or making acquisitions.
  - Normally, issuing bonds offers a fixed rate for a longer period relative to bank loans. Because most banks are afraid of losing money in the case that their cost of sources of funds increases to be higher than interest rate on long-term loan.
- **Bonds VS Stock**
  - The issuance of new bonds does not have dilution effect on the current shareholders' equity. Due to the fact that stock issuance increases the number of shares causing EPS to decrease and the ownership to be spread across a larger number of shareholders.

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

- The differences among these types of bonds are collateral and ranking claim.
- **Collateral**
  - **Debenture**: unsecured bond that is not backed by collateral due to inadequate assets in a company to serve as collateral, so it is backed by reputation of the issuing company. Thus a company with high credit rating can perceive issuing debenture bonds as an easy way to raise funds.
  - **Mortgage Bond**: secured bond that is backed by collateral which is usually real estate.
  - **Subordinated Debenture**: unsecured bond that is not backed by collateral and it pays higher interest rate with higher risk.
- **Ranking Claim**
  - If a company liquidates, a mortgage bond is ranked as the first one to receive the proceeds of liquidation of the company's asset and followed by a debenture and a subordinated debenture respectively.

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

- **Convertible bond** can be converted into shares of common stock of the issuer. It combines characteristics of debt and equity. Thus, due to the features of debt instrument, investors find it attractive because it has lower volatility, higher level of safety, and higher priority claim than stock. Moreover, if a company's stock price increases as a result of good performance, the bondholders can decide to trade their bonds for the stocks and become stockholders.

- **High-yield bond** gives investors higher return in form of interest than higher grade bond but also higher default risk.

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

- A corporation can enjoy a lower coupon rate on convertible bonds relative to traditional corporate bonds because of the conversion feature.
- The amount of convertible bonds issued is not recorded as a debt in company's balance sheet. Therefore, interest payments are tax deductible which helps company reduce its cost of capital.
- Convertible bonds can delay the dilution effect of common stock.

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

- **Call Provision:** A bond issuer can use a call feature on callable bonds to repurchase the outstanding bonds from current bondholders before the maturity date. The issuing company usually pay a premium or pay a little bit more than the face value on the bonds when it buys back the bonds early.
- **A Sinking Fund:** A fund set aside annually by issuing company to save up money to pay back the bonds at maturity.