

## Individual Assignment

### 1. Why do corporations sell bonds?

Corporations sell bonds to provide them with a way to raise capital without diluting the current shareholders' equity. With bonds, corporations can often borrow at a lower interest rate than the rate available in banks. By issuing bonds directly to the investors, corporations can eliminate the banks as middlemen in the transactions. Without the intermediaries, the borrowing process becomes more efficient and less expensive. By issuing bonds, corporations can often borrow money for a fixed rate for a longer term than it could at a bank. Most banks will not make fixed rate loans for longer than five years because they fear of losing money if their cost of funds rises to a higher rate than long-term loans. Most companies want to borrow money for long terms and so elect to issue bonds.

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

Bonds are debt instruments issued by governments and corporations. Corporate bonds can be secured or unsecured. A secured bond means that the issuer sets aside certain assets as collateral. In default, secured bondholders can lay claim to those assets to recover their investment. Unsecured bonds have no specific collateral backing. In default and bankruptcy, they are paid out of a corporation's general fund in an established order of priority.

Secured bonds have specific corporate assets pledged as collateral. The safest (and most popular) are bonds secured by real assets such as plants or buildings, called mortgage bonds. In default, bondholders can lay claim to those plants or buildings to recover their investment. Mortgage bonds may be further classified as first or second mortgage bonds, just like first and second residential mortgages.

Debentures do not have any specific collateral pledged and are backed by the general credit of a corporation – in effect, by a corporation's promise to pay. That is why corporate credit ratings that take into account credit history are so important in assessing a debenture's safety – they tell investors how likely a corporation is to fulfill its promise to pay.

If a corporation defaults and files for bankruptcy, its obligations are paid off in an established order of priority. Secured bondholders are paid first with the proceeds from the sale of collateral assets. A mortgage bond is considered very safe, therefore, especially if the real assets pledged as collateral have appreciated in value over time and more than covers the bond amount. All other bonds are paid out of the remaining general pool: senior bonds, debentures and junior debentures.

A subordinated debenture is a bond or debt obligation issued by a corporation that has junior priority status relative to other bondholders of the company in the event of a liquidation or dissolution. Since the claims of subordinated debentures are lower than those of other corporate creditors, they carry greater investment risk. Subordinated debentures are backed or secured only by the full faith and credit of the issuing corporation.

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

A convertible bondholder can trade the bond for equity and achieve potentially high dividends should the company be performing well at the time of trade. If the company is not performing as well as desired, the bondholder has the security of a bond and the option of cashing in the bond at the maturity date. The value of a convertible bond cannot fall any lower than the price at which the yield would be on par with that of a nonconvertible bond of the same period. Convertible bonds offer safety in a bear market and allow investors to convert to equity when the stock increases in value.

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

First, Issuing convertible bonds helps a corporation secure equity financing in a delayed manner, as it takes time for the bondholders to trade their bonds for stock. This process delays the common stock and earnings per share dilution.

Second, Corporations can sell bonds at a lower coupon rate than a standard bond because of the stock purchase option. The more the conversion feature is worth, the lower the yield it will need to sell the bond. Because convertible bondholders only receive a relatively small, fixed income, more operating income is available to the common stockholders until the bonds convert to stocks. This allows common stockholders to temporarily maintain voting control of the corporation while using the investment income from the convertible bondholders.

Third, Bond interest is a tax-deductible expense for the issuing company; for a corporation in the 35 percent tax bracket, the federal government effectively pays 35 percent of the interest charges on the debt through the deduction.

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

When corporations want to repay a bond they issued, they have two methods to use. The first method is sinking funds. The company requires to reserve some amount of funds in a saving account periodically to meet the amount that the company needs to repay the principal. The second method is serial bonds. The company issues bonds with different maturity at the same time to allow the company to repay principal back in different time with divided amounts.