FN281 Individual Assignment 2

1. Why do corporations sell bonds?

To raise capital to invest in new projects or other investment or operating activity without increasing the number of company's owner. The advantage of selling bonds is that the cost of debt (required rate of return on bonds) is lower than cost of equity.

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

The different between a mortgage bond and any debentures is that the mortgage bond is collateralized while there is no collateral associated with debentures. This makes debentures riskier than mortgage bond.

The different between a debenture and a subordinated debenture is their seniority of debt. The subordinated debenture is considered to be a junior debt which ranks below ordinary debentures meaning that in the case of firm's bankruptcy or default, ordinary debentures receive repayment first and then the subordinated ones.

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

A convertible bond is a bond in which conversion to common equity is allowed. An investor would prefer this kind of bonds if she expected that future of the company is promising because she can convert her bonds into common stocks and enjoy capital gain.

A high-yield bond is a bond rated as non-investment grade or speculative grade. This kind of bond associates with a higher probability of default or a higher risk. An investor who purchases this kind of bond is the one that can bare high risk and also requires high returns or for the sake of speculations.

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

(1) Convertible bonds can delay corporation's equity financing since it takes time for investors to use an option to convert because an immediate equity financing can create dilution effect.
(2) When company gives investors an option to convert, it is fair for investors that the company to lower coupon payments as a price of option.
(3) Even though convertible bond is a hybrid security, yet, the company still enjoys tax deduction from interest expense on bonds issued.

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

If bond is callable and a company happens to call the bonds back before maturity, the company may have to pay a premium attached to principal. In order to assure that a company is able to pay back there are two methods. First is **sinking funds**, a company is required to set aside funds in a saving account periodically to meet the amount that the company needs to repay the principal. Second is **serial bonds**, that is, a company issues bonds with different maturity at the same date in order that company can repay principal back in different time with divided amounts.