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FN281 Individual Assignment 2

1. Why do corporations sell bonds?

In order for company to raise capital to invest in new projects or other investment, bond is other way to obtain the capital. Bond is preferred due to it can raise capital for companies' operating activity without increasing the number of company's owner. Companies decide to issue bond because bond has advantage in cost of debt (required rate of return on bonds). The cost of debt is lower compared to the cost of equity.

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

The different between mortgage bond and debentures is that the mortgage bond is collateralized by things that have enough value in able to pay the bondholders when the company defaults or goes bankruptcy while, there is no collateral associated with debentures. Debentures bear more risk than mortgage bond.

The different between a debenture and a subordinated debenture is their seniority of debt. The subordinate debenture acts as a junior debt to the more senior debenture in case of insolvency. 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 high-yield bond is mostly issued by company with low rating or this bond can be junk bond. High-yield bond associates with a higher probability to 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 speculations.

A convertible bond is a bond that can be converted to common equity. Investors prefer this kind of bonds if they expect that future of the company is promising because they can gain benefit on conversion to common stocks so, the benefit capital gain is obtained.

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

1. A corporation would benefit from the agreement to lower coupon payments as a price of option.

2. 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

3. The company benefit by the tax deduction from interest expense on bonds issued.

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

In case that the bond is callable and needed to call back before maturity, the company usually pay a premium attached to principal. Two methods used to make sure that company will pay back are sinking funds and serial bond. Sinking funds work as a required set aside funds by a company in a saving account periodically to meet the amount that the company needs to repay the principal. Serial bonds work as an issued bond with different maturity at the same date in order that company can repay principal back in different time with divided amounts.