Chapter 17  Corporate Bonds

Types

(1) Debenture - Unsecured bonds
(2) Mort gage Bonds - Bonds secured by real property of the firm
(3) Collateral Trust Bonds - Debt secured with financial collateral (e.g., Student loans, Auto's etc)
(4) Equipment - debt that is issued by a trustee who owns ownership of the collateral

Bonds INDENTURE - Description of the contractual terms of a new bond issue.

Seniority - Bonds are ranked by which gets priority of payment if a firm goes bankrupt. Usually first issued is the most senior. Newer bonds are "subordinated to older bonds.

Negative Pledge Clause - Bond indenture statement that prevents new debt from having a higher seniority than old debt.
Call Provision - Allows a bond to be refunded prior to its maturity date. Restrictions typically include:

1. "Lock out" period during which the bond cannot be called

2. A premium must be paid over face value (Call Premium)

3. Some restrictions to prevent calling simply because interest rates have declined

Put Provisions - are the opposite of call provisions.
- allows the bond to be redeemed early.

Note: Other things equal we would expect higher coupon rates on callable bonds, and lower coupons on put bonds.

Convertible Bonds - Bonds that can be exchanged common stocks, according to a pre-specified ratio.
You will only convert if the stock price rises to where the stock value is higher than the bond value.
Conversion = \# of stocks acquired in conversion

\[
\text{Conversion} = \frac{\text{Bond Face Value}}{\text{Price}} \times \text{Conversion Ratio}
\]

(This is the stock price at which conversion may be appropriate)

\[
\text{Conversion} = \text{Price of the stock times the conversion ratio}
\]

(This is the value you receive if you convert)

Convertible bonds are typically callable to force conversion if the stock price rises above the conversion price. This prevents the bond holders from holding onto the bonds and earning a higher yield from the bond, which is higher than the dividend yield the stock holders are earning.

Sinking Fund: A provision for the orderly payoff of the bonds. It may require an investor to accept early redemption.
Bond Covenants - Restrictions in indenture to protect bondholders.

Negative Covenants Examples Include:
- No excess dividend payments
- Negative pledge clause
- Rules on refunding

Positive Covenants Include:
- Sale of assets must be used to reduce debt.
- May require bond redemption if there is a merger or spinoff.

Preferred Stock - A type of stock with a stated dividend. Because the dividend is stated like a bond coupon, they are seen as more like bonds than as stock.
- They have a higher dividend priority than common stock.
- They are typically "cumulative," which means any missed dividends will be made up at a later date.
- They have few ownership rights, such as choosing the board of directors.
- They are often convertible to common stock.
Bond Trading

- Bonds are often purchased with a "buy and hold" strategy.
- Some trading is done on the stock exchange.
- Most trading is done through bond dealers (i.e. OTC).
- Trading has historically been for liquidity.
- Some major financial firms trade bonds to try and "beat the market".

The following IQ questions won't be on quizzes or exams.

3, 5, 6, 8-13, 21, 25