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THE EFFECT OF BOND REFUNDING ON SHAREHOLDER WEALTH

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THE BOND REFUNDING DECISION has, throughout the years, received considerable attention from both academicians and practitioners. Much of the academic literature has concentrated on two questions. First, researchers have considered whether, after a decline in interest rates,[1] refunding would have a positive effect on shareholder wealth. The second question involves a determination of the optimal "timing" of the refunding. Our paper is only concerned with the first of these questions.

Much of the previous research which has considered the effect of refunding on shareholder wealth has attempted to ascertain the appropriate rate to be employed for valuing the future interest saving from the refunding and whether pre-tax or after-tax interest saving should be discounted. The importance of the discount rate is expressed by Oswald Bowlin when he states,

> The most important question which will have to be answered concerns the rate that should be used in making time adjustment of cash flows resulting from the refunding operation [6, p. 55]

It is our feeling that much of the confusion over measuring the effect of refunding on shareholder wealth is due to the assumption that, in order to value the benefits from refunding, one *must* discount future cash flows. This confusion can be attributed, at least in part, to a failure to address the question of how much debt should be re-issued after the callable bond is refunded. As we demonstrate later in this paper, the effect of refunding on equity value can be easily evaluated when the firm issues that quantity of bonds that does not alter the future distribution of income available to equity holders. This is the same quantity of bonds that results in the firm taking all the net benefits in current cash flows. After we determine the amount of debt to be issued, it becomes quite simple to solve for the appropriate discount rate when, alternatively, the firm issues a smaller quantity of debt and takes the benefits as future interest saving.

The purpose of this paper is to present a static (single-period) analysis of the decision to refund a callable bond with a similar non-callable issue. We address this question by dividing the conventional refunding into a pure leverage and pure refunding operation. This dichotomy then allows us to isolate the effect on

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