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Evaluating the Economics of Refunding High-Coupon Sinking-Fund Debt

John D. Finnerty

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Introduction

The finance literature treats the bond refunding decision as an “all-or-nothing” decision. In the case of a high-coupon issue, the issuer must decide at each decision point either (i) to call the entire issue for immediate redemption or (ii) to call none of it immediately and wait until the next decision point to reconsider the call-all-or-call-none decision.¹ However, when a high-coupon issue provides for a sinking fund, a partial redemption may be more advantageous than calling the entire issue. It is therefore important for issuers to evaluate the economics of a partial redemption when analyzing a proposed refunding of high-coupon sinking-fund debt.²

Bond indentures typically provide that bonds can be

redeemed for sinking fund purposes at their par value whereas bonds can be called for optional redemption only at prices that represent premiums over the bonds’ par value (except in the last few years immediately prior to maturity when optional redemption at par may be possible). When a bond issue has a sinking fund and the optional redemption (or call) price exceeds the mandatory redemption (or sinking fund) price, it may be more profitable for the firm to call only a portion of the issue for immediate redemption and to wait to redeem the balance at the lower sinking fund price, rather than to call the entire issue immediately.³ Lewellen and Emery [6] and Riener [8] both overlooked this rather obvious point.

In a recent article in *Financial Management*, Kenneth Riener [8] develops a procedure for evaluating the economics of refunding high-coupon debt. His procedure involves constructing a single refunding issue the

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Abstract

In the finance literature, an issuer who is contemplating a bond refunding is typically assumed to have only two choices at each decision point: refund all of the issue or else none of it. However, this "all-or-nothing" assumption is not always warranted. In particular, when a high-coupon bond issue has a sinking fund and th...

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