JOURNAL ARTICLE

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

John D. Finnerty

Financial Management
Vol. 12, No. 1 (Spring, 1983), pp. 5-10 (6 pages)
Published By: Wiley

https://doi.org/10.2307/3664831
https://www.jstor.org/stable/3664831

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

John D. Finnerty

John D. Finnerty is Vice President of Lazard Frères & Co., New York City.

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

The author would like to thank Andrew J. Kalotay and two anonymous referees for helpful comments on earlier drafts.

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...

Journal Information

Financial Management (FM) serves the profession by publishing significant new scholarly research in finance that is of the highest quality. The principal criteria for publishability are originality, rigor, timeliness, practical relevance and clarity. FM enjoys a broad circulation among academics and practitioners, and as such, links...

Publisher Information

Wiley is a global provider of content and content-enabled workflow solutions in areas of scientific, technical, medical, and scholarly research; professional development; and education. Our core businesses produce scientific, technical, medical, and scholarly journals, reference works, books, database services, and...