WorldCom Case

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Timing of Bond Issuance

- MCI Merger boosted investor interest and awareness in the company.
- Credit rating expected to be elevated post MCI merger.
- Due to Asian crisis investors’ interest had moved from equities to corporate bonds and Treasuries.
Timing of Bond Issuance (Contd.)

- MCI merger would elevate WorldCom from the 4th largest player in the market to 2nd.

- The Merger would amplify revenues

Vinnie Q1
Disadvantages

- Corporate yield spreads over Treasuries had increased.

- Numerous issues were in the pipeline for the year. The large supply coming to market was putting pressure on corporate bonds, therefore increasing pricing.

- Uncertainty in the market by analysts about the future of the economy and the fixed-income market caused by the turmoil in Asia.
Risk

1, Corporate Risk

- Increase Debt Weight
- Increase Interest Burden
- Reduce earning & liquidity

The covenants restrict future mergers, consolidations and sales of assets.

2, Industrial Risk

1997 – 1999: Telecom Boom
2000: Telecom Bubble Burst
WorldCom failed to merge with Sprint


A heavy calendar of debt issues
$40 billion debt issued in the same week

Peter Q2
Market Response

Very Positive Response from Investors

Telecom Boom

1. High growth
2. High profitability
3. Financial crisis impact

Promising Prospect

1. Become 2nd largest telecom company
2. High growth in growth and revenue

Credit Rating Improvement

1. Improved from BBB- to BBB+
2. Forecast further improvement to A area

Geoffrey Coley: the success of the sale (WorldCom Paper) might help turn around the corporate bond market, which has been spooked by the recent plunge in the stock market.

Peter Q2
Small Issues Preferred

Why issue large debt - Motivation

- Needs of capital for future acquisitions
- Opportunism: raise more debt in favorable time

Small Issues Preferred

- Deteriorating capital structure
- Opportunism sometimes results in bad names
- “Term out” bank loan reduces bank credit

It is usually risky to raise long term debt to finance short term capital needs
Financing with Corporate Bonds or Bank Loans

- Corporate debt instruments
  - Used for liquidity needs to fund expansions, projects, PP&E, or working capital needs
  - Investment grade firms and below investment grade firms
  - Corporate rating importance and structure
  - Prepayment risk on bank loans
  - Market conditions, bond term structures, coupon payments, and principal repayments

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<th>S&amp;P</th>
<th>Fitch</th>
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<td>AAA</td>
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Types of Corporate Bonds

- 5 major types:
  - Debentures
    - Pledge no collateral
    - Riskier than other corporate bonds
  - Senior secured bonds
    - Mortgage bonds, collateral trust, equipment trust certificates
  - Subordinated bonds
    - Are paid the two above mentioned
    - 3 types: senior subordinated, subordinated, and junior subordinated
  - Income Bonds
    - Pays interest only if high enough earnings
    - Defers interest expense to holders
  - Convertible bonds
    - Option to convert into common stock at owners discretion
    - Based on predetermined exchange ratio
**Bank Loans 101**

- **2 types**
  - Investment-grade loans (IGLs)
  - Leveraged Loans (LLs)

- **Primary differences**
  - IGLs are provided to borrowers considered to have “investment grade ratings”
  - LLs are provided to borrowers considered to have “below investment grade ratings”
Leveraged Loans

- Credit rating affects higher borrowing rates
- Are similar to high yield bond financing
- Financing options, floating rates and amortized principal payments
- Callability options

Exhibit 5: Comparison of Leveraged Loans and High Yield Bonds

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<tr>
<th></th>
<th>Leveraged Loans</th>
<th>High Yield Bonds</th>
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</thead>
<tbody>
<tr>
<td>Interest Rate/Coupon</td>
<td>Floating Rate</td>
<td>Fixed rate</td>
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<tr>
<td>Security</td>
<td>Senior Secured</td>
<td>Generally unsecured</td>
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<tr>
<td>Priority</td>
<td>Senior</td>
<td>Generally subordinate, but sometimes senior</td>
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<tr>
<td>Amortization</td>
<td>Required quarterly principal payments</td>
<td>Bullet payment at maturity</td>
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<tr>
<td>Callability</td>
<td>Prepayable at par without penalty</td>
<td>Call protected</td>
</tr>
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Investment Grade Loans

- Qualified firms have vast funding options to them
- Revolving lines of credit
  - Prepayment risk
  - Not sold to institutional investors by originating bank
  - Maximum set amount
- Syndicated loan
  - Seeking large funding
  - Provided by a group of banks
    - Distribution of risk exposures
    - Issuance
      - Assignment
      - Participation out
What are Securities

- In the financial market, securities are tradable assets
- They are broadly categorized as debt securities (such as banknotes, bonds and debentures), equity securities (common stocks) and derivatives contracts (forward, future, swaps and options)
Who is the SEC?

- Securities and Exchange Commission (SEC)

- An agency of the United States Federal government
  - Holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets in the United States

- SEC makes the companies’ reports public via an online database called EDGAR (the Electronic Data Gathering Analysis)
Violations at WorldCom

- At WorldCom, the managers looked over the uncertainties and disadvantages of issuing large scales of bonds
  - Bankruptcy

- Accounting irregularities spotted in MCT’s books

- SEC was suspicious about the total revenue and earnings in last year

- SEC found out some un-matching numbers and WorldCom cannot provide and documents to support the capital expenditures
Uncertainties of Issuing Corporate Bonds

- Surprisingly voluminous structure of the proposed issuance and the macro-economic climate
- Timing (appropriate or not)
- Company’s choice of structure (analyzed or not)
- Economic fluctuations
- Government issues