

Chapter Review

Mini Case

Paul Duncan, financial manager of EduSoft Inc., is facing a dilemma. The firm was founded 5 years ago to provide educational software for the rapidly expanding primary and secondary school markets. Although EduSoft has done well, the firm's founder believes an industry shakeout is imminent. To survive, EduSoft must grab market share now, and this will require a large infusion of new capital.

Because he expects earnings to continue rising sharply and looks for the stock price to follow suit, Mr. Duncan does not think it would be wise to issue new common stock at this time. On the other hand, interest rates are currently high by historical standards, and the firm's B rating means that interest payments on a new debt issue would be prohibitive. Thus, he has narrowed his choice of financing alternatives to: (1) preferred stock, (2) bonds with warrants, or (3) convertible bonds.

As Duncan's assistant, you have been asked to help in the decision process by answering the following questions.

- a. How does preferred stock differ from both common equity and debt? Is preferred stock more risky than common stock? What is floating rate preferred stock?
- b. How can knowledge of call options help a financial manager to better understand warrants and convertibles?
- c. Mr. Duncan has decided to eliminate preferred stock as one of the alternatives and focus on the others. EduSoft's investment banker estimates that EduSoft could issue a bond-with-warrants package consisting of a 20-year bond and 27 warrants. Each warrant would have a strike price of \$25 and 10 years until expiration. It is estimated that each warrant, when detached and traded separately, would have a value of \$5. The coupon on a similar bond but without warrants would be 10%.
 1. What coupon rate should be set on the bond with warrants if the total package is to sell at par (\$1,000)?
 2. When would you expect the warrants to be exercised? What is a stepped-up exercise price?
 3. Will the warrants bring in additional capital when exercised? If EduSoft issues 100,000 bond-with-warrant packages, how much cash will EduSoft receive