Vanilla bond outline

Finance

Vanilla bond Outline The most basic version of a financial instrument is a vanilla bond. It usually includes options, bonds, swaps and futures. It has a simple expiration date, strike price with no additional features. Every bond issued by a company is different with different interest rates because of the difference in the company's credit ratings and nature of the bonds. In this thesis it has been observed that having better credit ratings not only lowers the interest costs for a company but it also provides financial flexibility to the company in case of future needs. For proving this observation first of all the vanilla bonds of Microsoft and Aon Corp were analyzed, with the focus being on determining the coupon rate, price and the present value of the bonds. Secondly it was observed that Microsoft has a better credit rating as compared to that of Aon Corp. And in the end it was observed that due to its highest credit rating in the country, Microsoft is considered to be a better investment option for the banks and the investors.

Discussion

The main reason for selecting Microsoft and Aon Corp is the difference between their credit ratings. Microsoft is rated at the highest level where as Aon Corp is suffering from a gradually deteriorating credit rating. These companies were selected so as to determine how the different credit ratings influence these companies.

Microsoft:

Outstanding debt of $11. 9 billion (Microsoft Financial Statements).

The current market price of the $100 bonds fall within the range of $100. 7 to $113. 6 depending on their maturity dates and interest rates (Morning Star, Microsoft Coupon Price).

Aon Corp:

Outstanding balance in long term debts of $ 2. 9 billion (Aon Financial Statements).

The current price for Aon Corp bonds fall within the range of $105 to $124. 8 depending on their respective interest rates and maturity dates (Morning Star, Aon Corp, Coupon Price).

Time Value of Money:

The concept of Time Value of Money implies that a particular amount of money, because of the interest factor, will value more in the present than in the future.

Present value of Long term debts of Microsoft is approximately $ 10 billion.

Present value of Long term debts of Aon Corp is approximately $ 1. 4 billion.

Credit Ratings:

Companies are rated on the basis of their financial results, their history of borrowing and repayments, and the extent of their assets and liabilities, so that their credit worthiness could be determined.

Microsoft’s Credit Rating:

Standard and Poor’s (Microsoft Investor Services)AAA

Moody’s (Moody’s Microsoft Ratings)Aaa

Aon Corp’s Credit Rating:

Standard and Poor’s (Aon Financial Statements)BBB+

Moody’s (Aon Financial Statements)Baa2

Credit ratings show that Microsoft has better credit ratings as compared to Aon Corp. Such higher credit ratings increase the company’s access to financial markets and also increase its financial flexibility.

Bank Interest Rates:

As evident from the loan portfolios of the two companies Microsoft enjoys a lower rate of interest for the same duration of loans as compared to Aon Corp because of its higher credit ratings.

Maturity Date Interest Rates

MicrosoftAon Corp

Year 20151. 625%3. 50%

Year 20203. 000%5. 00%

Year 20404. 500%6. 25%

As it can be seen, the bonds held by Aon Corp are generating higher yield to maturity than the bonds held by Microsoft Corp. Even though the time till maturity of the two companies is same for some bonds, still Aon Corp is charged with a higher rate of interest than Microsoft Corp because of their lower credit ratings. For the bonds that will mature till the years 2015, 2020 and 2040, the respective yields to maturity for Microsoft and Aon Corp. are 0. 64, 2. 27 & 3. 73 and 2. 07, 3. 37 & 4. 67 respectively. Thus it is obvious that the bonds issued to Aon Corp are receiving a better price than that of Microsoft Corp.

Conclusion:

Banks and Investors depend greatly on the credit ratings of the companies while making investment decisions. A company with a lower credit rating will imply that the probability of the company to face solvency issues, because of decreased access to capital markets, is more than that of the company with a higher credit rating. Thus banks and investors prefer investments in financially stronger companies. So if it will be a matter of investing in either Microsoft or Aon Corp, based on their credit ratings and their ability to access financial markets in order to ensure strong financial support for their operations, it is highly likely that investors and banks will prefer Microsoft

Corp.

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