Case 7

The Board Looks to You

The financial department of Delphi Consolidated Industries (DCI) is just starting a 2-week retreat in the Canadian wilderness. The president of DCI has been approached by an investment banker who has acquired $1,000,000 in DCI bonds in one of his deals. He is offering to sell the bonds back to DCI for $900,000. The president thinks this seems like a good deal for DCI, but his background is in marketing, and he knows his limitations. DCI has had dealing with this investment banker before—his firm often underwrites DCI's bond issues. The president remembers that you seem to know your way around capital investments and has asked you to recommend a course of action by September 13th (later this week). The offer to sell at this price is good through this date.

The bonds consist of 100 bonds, each of which is identical. Each bond was issued 4.5 years ago and had a term of 10 years. The face value of each bond is $10,000, and it pays 14% in quarterly installments. The next payment will be made to the owner of record on September 20th (this is the 18th payment).

When the 100 bonds were sold 4.5 years ago, they brought in $920,000 ($950,000 less $30,000 in selling expenses).

The president and the board of directors have been talking about ways to use the unexpected profits from the sale of some land to the state for a right of way. One idea that was under consideration at the last meeting was to "call" (or pay off early) up to $1,500,000 of an older DCI bond issue.

The older bonds have a face value of $100,000 each and pay 18% in semi-annual installments. They have an early call provision for a 5% premium over face value. The bonds were sold 8 years ago and had a 12-year term. A payment (Number 16) was made last week. These bonds were sold at a premium ($110,000 less $2,500 in selling expenses) in part because of the early call premium.

The pre-tax MARR of DCI is 17.5%.

What do you tell the president to do?