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Sung Nam

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Zero Coupon Bonds

In his 1989 Annual Investor letter, the legendary Warren Buffett, explains his issuance of zero coupon, convertible bonds and the abusive usage of the proceeds by other zero coupon issuers during the 80s, which was marked by large LBO deals and a period of high inflation. On a side note, man.... his investor letters are really eye opening and a must read for all avid investors and students of finance.

Details: Issued $902.6MM in 15 year, semi-annualized zero coupon bonds at 44.31% of face value, which resulted in proceeds to Berkshire Hathaway of $400MM. The formula in excel is 44.31*(1.0275)^30. The annualized implied return is 5.5%.

The $10,000 bonds could be converted into .4515 shares of Berkshire Hathaway, or to capture 1 share, it would be require 1 divided by .4515=2.21 bonds x 4,431 (at 44.31% of face value), or $9,815/share, which was a 15% premium over the market at the time of issuance.

Zero coupon bonds eliminated reinvestment risk, which is where the investor would need to find a security to park the coupon payments until maturity at a rate equal to or in excess of the coupon rate.

Thus, investment banks during this period would strip the coupon payments from the government bonds, and sell the bonds as if they were zero coupon bonds, which would appease investors hunger for the reinvestment risk free securities.

He hates the notion of EBITDA, and prefers to work with FCF, which is operating earnings plus depreciation and amortization minus capital expenditures. EBITDA neglects the cost of equipment aging, which is crucial for heavy capital expenditure business models. During this age of frenzy buying, by eliminating the cash outflow for interest expense, buyers who were strapped on earnings growth, could now finance these amortized interest expense deals at a more leveraged structure.