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Write-Down Bonds and Capital and Debt Structures[☆]

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Abstract

We analyze a defaultable firm's optimal capital and debt structures when its debt includes senior straight and Write-Down (WD) bonds. Credit events and premature or terminal bankruptcy are triggered if the firm's asset value hits specific barriers. The optimal capital structure and the optimal straight/WD debt mix are jointly determined along with the optimal level of debt reduction. The firm increases its leverage by swapping both equity and straight debt for WD bonds. The credit spread on the straight debt is shown to be considerably lower when the firm's capital structure also includes WD bonds, for a given global leverage.

Keywords: Capital structure; Debt structure; Write-down debt; Credit event; Credit spread.

JEL code: G13; G32; G33.

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