



J.C. Penney's Deep Discount Debt*

Exhibit 1 is an announcement (sometimes called a tombstone) that appeared in major business journals in late April 1981. It announced two long-term debt instruments: zero coupon notes due in 1989 and 6% coupon bonds maturing in 2006. While issuing deep discount bonds was consistent with a recent trend, the zero coupon notes were new and received considerable attention in the media. It is not difficult to understand why a borrower would like to avoid paying interest, but who would want to invest in these notes?

Questions:

1. “A bond with no interest sounds like a car with no motor.” (*Forbes*, May 25, 1981) Why would J.C. Penney be interested in issuing zero (or 6%) coupon notes (bonds) when prevailing interest rates in 1981 were 12% or higher?
2. What type of lender would want to purchase zero coupon notes?
3. What is the effective yield-to-maturity of the zero coupon notes and the 6% coupon bonds? Assume the notes mature on April 30, 1989 and the bonds mature on April 30, 2006. Further assume that interest is compounded semi-annually. Do you think the yields-to-maturity that you calculate should be above or below prevailing market rates for coupon bonds issued at par?
4. Prepare a journal entry to record the issuance of these notes and bonds on April 30, 1981.
5. Prepare the remaining journal entries that J.C. Penney had to record later in 1981 related to these notes and bonds? [Hint: assume the company typically records interest accruals semi-annually.]
6. What are likely to be the characteristics of J.C. Penney and other companies that issue zero coupon notes?

* This is a revision of a case by Professors Robert M. Bowen and Glenn Pfeiffer. It was prepared from publicly available data for class discussion purposes only. Revised September 2003.

EXHIBIT 1

This advertisement is neither an offer to sell nor a solicitation of offers to buy any of these securities. The offering is made only by the Prospectus.

NEW ISSUES

April, 1981

\$400,000,000

J.C. Penney Company, Inc.

\$200,000,000

Zero Coupon Notes Due 1989

Price 33.247%

plus accrued amortization of original issue discount from May 1, 1981

\$200,000,000

6% Debentures Due 2006

Price 42.063%

plus accrued interest from May 1, 1981

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