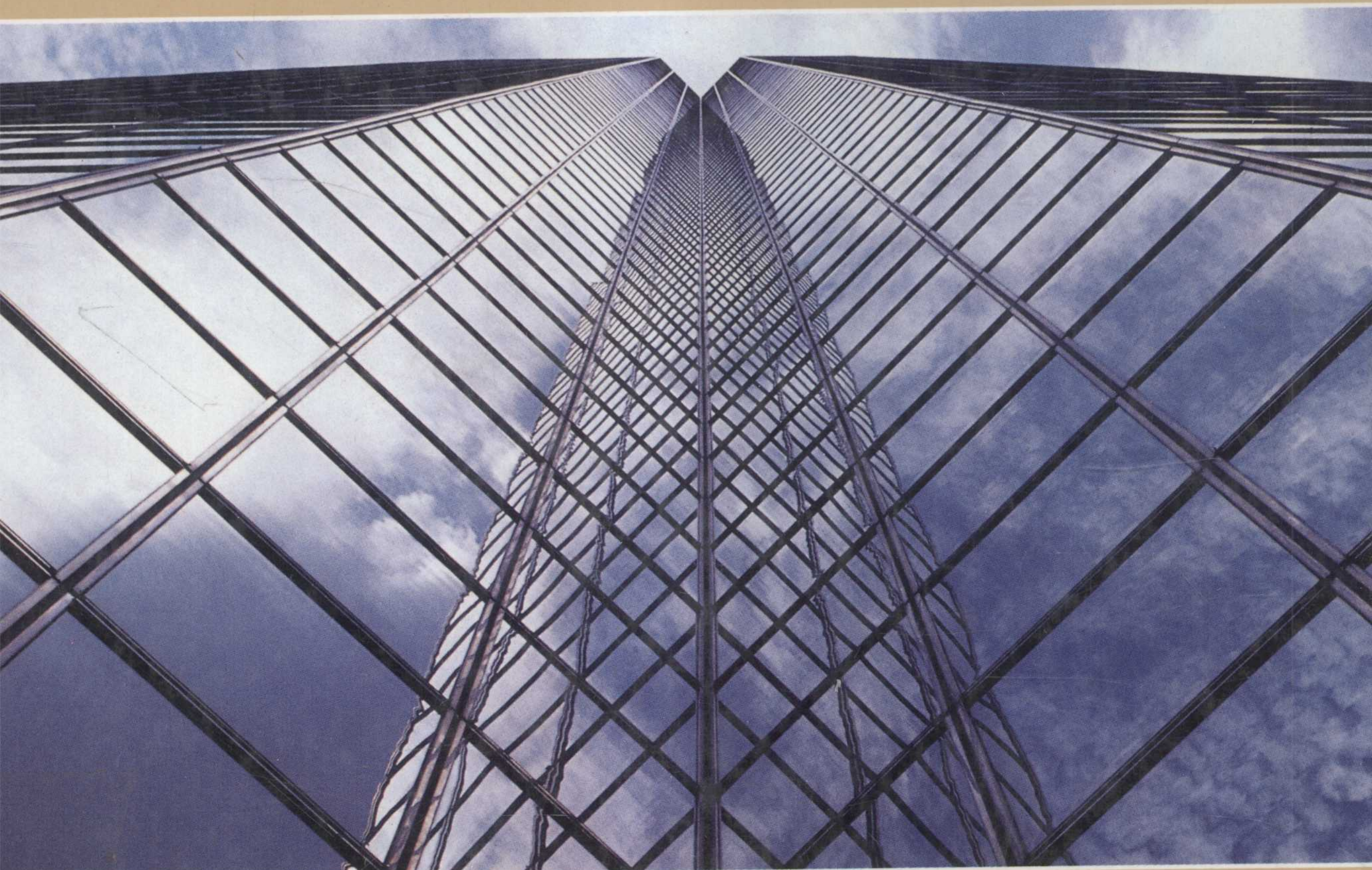
PRINCIPLES OF CORPORATE FINANCE

FOURTH EDITION



RICHARD A. BREALEY / STEWART C. MYERS

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FOURTH EDITION

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PRINCIPLES OF CORPORATE FINANCE

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PREFACE

THIS BOOK DESCRIBES the theory and practice of corporate finance. We hardly need to explain why financial managers should master the practical aspect of their job, but a word on the role of theory may be helpful.

Managers learn from experience how to cope with routine problems. But the best managers are also able to respond rationally to change. To do this you need more than time-honored rules of thumb; you must understand *why* companies and financial managers behave the way they do. In other words, you need a *theory* of corporate finance.

Does that sound intimidating? It shouldn't. Good theory helps you understand what is going on in the world around you. It helps you ask the right questions when times change and new problems must be analyzed. It also tells you what things you do *not* need to worry about.

Throughout the book we show how to use financial theory to solve practical problems, and also to illuminate the facts and institutional material that students of corporate finance must absorb.

Of course the theory presented in this book is not perfect and complete—no theory is. There are some famous controversies in which financial economists cannot agree on what firms ought to do. We have not glossed over these controversies. We set out the main arguments for each side and tell you where we stand.

There are also a few cases where theory indicates that the practical rules of thumb employed by today's managers are leading to poor decisions. Where financial managers appear to be making mistakes, we say so, while admitting that there may be hidden reasons for their actions. In brief, we have tried to be fair but to pull no punches.

Once understood, good theory is common sense. Therefore we have tried to present it at a commonsense level. We have avoided abstract proofs and heavy mathematics. However, parts of the book may require a significant intellectual effort for those unused to economic reasoning. We have marked the most difficult sections with asterisks, and suggest that you skim these sections on the first reading.

A WORD ABOUT LEARNING AIDS

There are no ironclad prerequisites for reading this book except algebra and the English language. An elementary knowledge of accounting, statistics, and microeconomics is helpful, however.

Each chapter of the book closes with a summary, an annotated list of suggestions for further reading, a quick and easy quiz, and some more challenging questions and problems. Answers to the quiz questions may be found at the end of the book, along with present value and option tables and a glossary.

The study guide for this book (Charles A. D'Ambrosio and Stewart D. Hodges, *Study Guide to Accompany Principles of Corporate Finance, McGraw-Hill, New York, 1991*) includes chapter summaries, additional illustrations, problems, and other useful material.

McGraw-Hill will make available a microcomputer software package that uses Lotus 1-2-3 templates to undertake a variety of financial cal-

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culations. We have also helped to develop a stand-alone microcomputer software package (PCF Toolkit). These programs can be used to solve a variety of practical finance problems; alternatively, they can be used as a learning aid so that you can work through problems one step at a time. We think that *PCF Toolkit* is simple to use, with attractive and intuitive graphics, and very flexible.

For teachers who are using the book there is an *Instructor's Manual*, a *Test Bank* with approximately 900 multiple choice and true/false questions, and a package of 400 overhead masters.

We should mention two matters of style now to prevent confusion later. First, you will notice that the most important financial terms are set in boldface type the first time they appear. Second, most algebraic symbols representing dollar values are set in capital letters. Other symbols are lower case letters. Thus the symbol for a dividend payment is DIV; the symbol for a percentage rate of return is r. We hope this will make our algebra easier to follow.

CHANGES IN THE FOURTH EDITION

Readers of the third edition of this book may be interested to know what's different about the fourth, apart from polishing. First, we have substantially rewritten chapters or sections where we felt that we could make the ideas easier to follow. For example, we have reordered the material in Chapters 7 and 8 on risk and required returns. We have also substantially revised Chapters 20 and 21 on options, so that Chapter 21 now focuses on the application of option theory to real investment decisions.

Updating was needed for all but the most basic material. For example, it no longer makes sense to write about market efficiency without some discussion of the October 1987 crash. We include such a discussion and we say how we believe it has affected ideas about efficiency. Chapter 8 now includes more material on the consumption-based asset pricing model and arbitrage pricing theory (including a practical example of how one firm is using APT to estimate the cost of capital). We have substantially rewritten the chapters on mergers (Chapter 33) and corporate debt (Chapters 23 and 24) to include more discussion of hostile takeovers, LBOs, corporate restructuring and junk bonds. Chapter 15 includes a discussion of SEC Rule 144a which allows trading of private placements; Chapter 35 includes a section on ESOPs, and so on. We think that these changes keep the book up-to-date both with recent events and recent ideas.

There are more subtle changes. For example, financial managers in the United States need to understand other countries' financial systems better. Therefore, when United States practice differs from other countries', we have tried to comment. For example, in the overview of corporate financing in Chapter 14, we have discussed how corporate capital structure in the United States differs from Japan and Germany.

We have also devoted more space in this edition to agency issues. It is difficult to understand many recent developments in finance, such as the growth in hostile takeovers and in corporate restructuring, without recognizing that managers may have different interests from investors or employees. We have now introduced these agency issues right at the beginning of the book and built on these ideas in later chapters.

Finally, we have added many end-of-chapter questions and we have indicated where our new software, *PCF Toolkit*, can help students to work through these questions.

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This list is almost surely incomplete. We know how much we owe to our colleagues at the London Business School and MIT's Sloan School of Management. In many cases, the ideas that appear in this book are as much theirs as ours. Finally, we record the thanks due to our wives, Diana and Maureen, who with each new edition must be increasingly sick of this book.

Richard A. Brealey
Stewart C. Myers

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