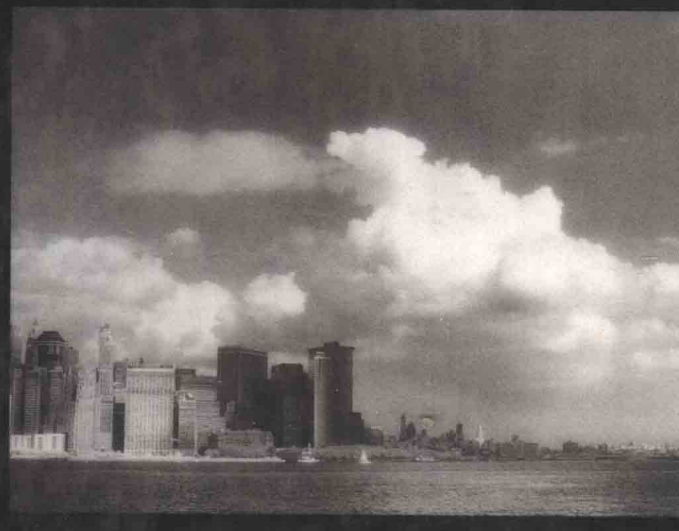


F I F T H E D I T I O N



PRINCIPLES
OF
CORPORATE
FINANCE

RICHARD A. BREALEY AND STEWART C. MYERS

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PRINCIPLES OF
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CORPORATE
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FINANCE
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Principles of Corporate Finance

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About the Authors

RICHARD A. BREALEY

London Business School. Tokai Bank Professor of Finance. Past President of European Finance Association and Director of the American Finance Association. Current research interests include portfolio theory and international finance. Member of editorial board of *Journal of Applied Corporate Finance*. Other books include *Introduction to Risk and Return from Common Stocks*. Director of Sun Life Assurance Company of Canada UK Holdings PLC and Tokai Derivative Products Ltd.

STEWART C. MYERS

Gordon Y Billard Professor of Finance at the Massachusetts Institute of Technology's Sloan School of Management. Research Associate of the National Bureau of Economic Research and past President and Director of the American Finance Association. His research is primarily concerned with the valuation of real and financial assets, corporate financial policy, and financial aspects of government regulation of business. Director of CAT Limited and The Brattle Group. Coauthor of *Optimal Financing Decisions* (with A. A. Robichek) and editor of *Modern Developments in Financial Management*.



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 (Stewart D. Hodges, *Study Guide to Accompany Principles of Corporate Finance*, McGraw-Hill, New York, 1997) 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 or Excel templates to undertake a variety of financial calculations. In addition, a stand-alone PC package (*PCF Toolkit*) can be used to solve a variety of practical finance problems or be used as a learning aid.

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 comprehensive set of 400 overhead acetates which can also be displayed as a "Powerpoint" presentation. An additional 1700 Powerpoint slides will be made available to adopters.

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 bold-face type the first time they appear. Second, most algebraic symbols representing dollar values are capital letters. Other symbols are generally lowercase letters. Thus the symbol for a dividend payment is "DIV," and the symbol for a percentage rate of return is " r ."

CHANGES IN THE FIFTH EDITION

Readers of the fourth edition of this book may be interested to know what's

different about the fifth edition, 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, there are important expository changes to the basic chapters on valuation and capital budgeting. We have reordered the material on the valuation of bonds and equities, and we have introduced an explanation of inflation and the distinction between nominal and real interest rates in Chapter 3. In Chapter 5 we have brought together the discussions of the profitability index and capital rationing. Later material which we believe is substantially improved and simplified includes the discussions of the weighted-average cost of capital in Chapter 19 and of risk management in Chapter 25.

Updating was needed for all but the most basic material. For example, our review of the capital asset pricing model covers recent controversies and empirical evidence. Similarly, the chapter on market efficiency now contains a brief survey of market anomalies.

Throughout the book we have added new, real-world examples. For instance, Chapter 4's discussion of the dividend discount model includes new estimates of the cost of capital for electric utilities. In Chapter 8 we show how arbitrage pricing theory has been used to derive the cost of capital for the same utilities. In Chapter 10 we describe how Merck uses simulation to analyze its investment in research and development.

Since financial managers increasingly need to understand other countries' financial systems, in Chapter 14 we compare ownership and corporate governance in Germany, Japan, and the United States. This is also one example of this edition's greater emphasis on agency issues.

Finally, we have added a large number of questions and problems. There are now about a thousand questions in all, an increase of 40 percent over the fourth edition.

Of course, one cannot always add and never subtract. Some examples become dated and are natural candidates for removal. But from time to time it is necessary to do more drastic pruning. Therefore, in this edition we have reduced the number of chapters by dropping the material on pensions. Instructors who would like to assign the material on pension schemes may obtain a revised version of the pension chapter from McGraw-Hill.

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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 were unaware when they married us that they were also marrying *The Principles of Corporate Finance*.

Richard A. Brealey
Stewart C. Myers

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