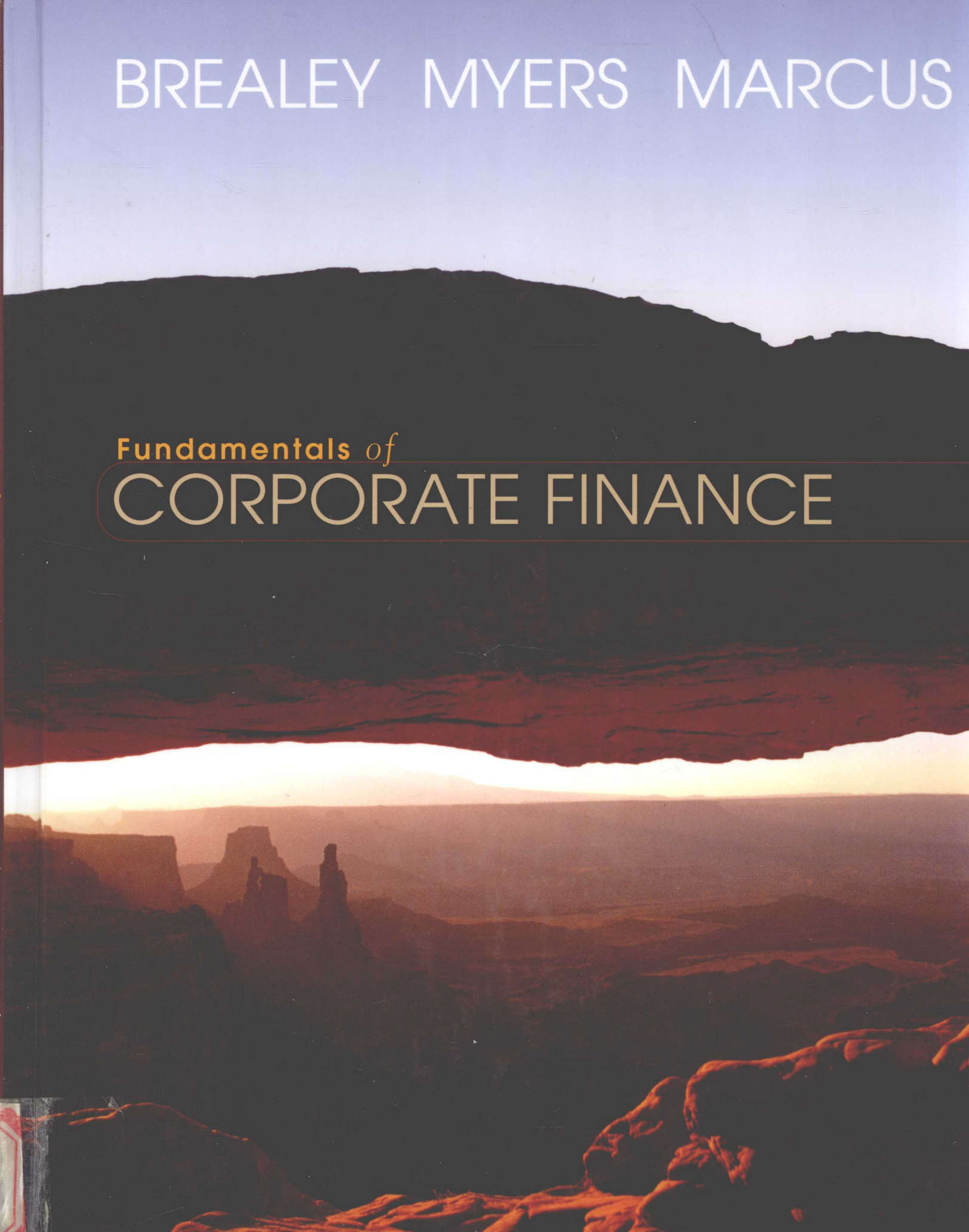


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Fundamentals *of*

CORPORATE FINANCE



Fundamentals of Corporate Finance

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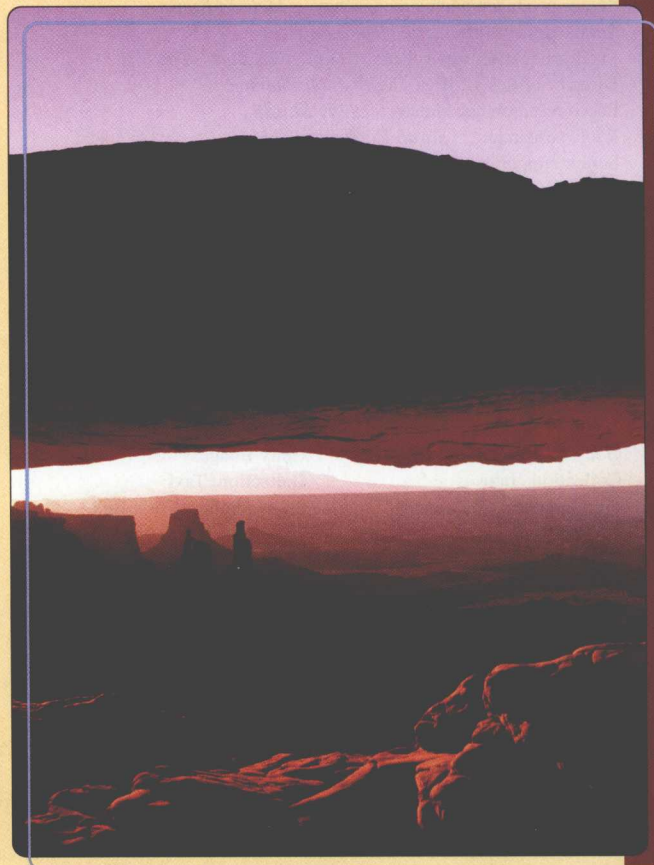
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Preface

This book is about corporate finance. It focuses on how companies invest in real assets and how they raise the money to pay for these investments.

Financial management is important, interesting, and challenging. It is *important* because today's capital investment decisions may determine the businesses that the firm is in 10, 20, or more years ahead. Also, a firm's success or failure depends in large part on its ability to find the capital that it needs.

Finance is *interesting* for several reasons. Financial decisions often involve huge sums of money. Large investment projects or acquisitions may involve billions of dollars. Also, the financial community is international and fast moving, with colorful heroes and a sprinkling of unpleasant villains.

Finance is *challenging*. Financial decisions are rarely cut and dried, and the financial markets in which companies operate are changing rapidly. Good managers can cope with routine problems, but only the best managers can respond to change. To handle new problems, you need more than rules of thumb; you need to understand why companies and financial markets behave as they do and when common practice may not be best practice. Once you have a consistent framework for making financial decisions, complex problems become more manageable.

This book provides that framework. It is not an encyclopedia of finance. It focuses instead on setting out the basic *principles* of financial management and applying them to the main decisions faced by the financial manager. It explains why the firm's owners would like the manager to increase firm value and shows how managers value investments that may pay off at different points of time or have different degrees of risk. It also describes the main features of financial markets and discusses why companies may prefer a particular source of finance.

Some texts shy away from modern finance, sticking instead with more traditional, procedural, or institutional approaches. These are supposed to be easier or more practical. We disagree emphatically. The concepts of modern finance, properly explained, make the subject simpler, not more difficult. They are also more practical. The tools of financial management are easier to grasp and use effectively when presented in a consistent conceptual framework. Modern finance provides that framework.

Modern financial management is not "rocket science." It is a set of ideas that can be made clear by words, graphs, and numerical examples. The ideas provide the "why" behind the tools that good financial managers use to make investment and financing decisions.

We wrote this book to make financial management clear, useful, interesting, and fun for the beginning student. We set out to show that modern finance and good financial practice go together, even for the financial novice.

Fundamentals and Principles of Corporate Finance

This book is derived in part from its sister text *Principles of Corporate Finance*. The spirit of the two books is similar. Both apply modern finance to give students

a working ability to make financial decisions. However, there are also substantial differences between the two books.

First, we provide much more detailed discussion of the principles and mechanics of the time value of money. This material underlies almost all of this text, and we spend a lengthy chapter providing extensive practice with this key concept.

Second, we use numerical examples in this text to a greater degree than in *Principles*. Each chapter presents several detailed numerical examples to help the reader become familiar and comfortable with the material.

Third, we have streamlined the treatment of most topics. Whereas *Principles* has 35 chapters, *Fundamentals* has only 26. The relative brevity of *Fundamentals* necessitates a broader-brush coverage of some topics, but we feel that this is an advantage for a beginning audience.

Fourth, we assume little in the way of background knowledge. While most users will have had an introductory accounting course, we review the concepts of accounting that are important to the financial manager in Chapter 3.

Principles is known for its relaxed and informal writing style, and we continue this tradition in *Fundamentals*. In addition, we use as little mathematical notation as possible. Even when we present an equation, we usually write it in words rather than symbols. This approach has two advantages. It is less intimidating, and it focuses attention on the underlying concept rather than the formula.

Organizational Design

Fundamentals is organized in nine parts.

Part 1 (Introduction) provides essential background material. In the first chapter we discuss how businesses are organized, the role of the financial manager, and the financial markets in which the manager operates. We explain how shareholders want managers to take actions that increase the value of their investment and we describe some of the mechanisms that help to align the interests of managers and shareholders. Of course the task of increasing shareholder value does not justify corrupt and unscrupulous behavior. We therefore discuss some of the ethical issues that confront managers.

Chapter 2 surveys and sets out the functions of financial markets and institutions. It shows how financial managers use these markets and institutions, and explains how markets provide useful signals to managers concerning the viability of potential investment projects.

A large corporation is a team effort, and so companies produce financial statements to help the players monitor their progress. Chapter 3 provides a brief overview of these financial statements and introduces two key distinctions—between market and book values and between cash flows and profits. This chapter also discusses some of the shortcomings in accounting practice that became apparent in the scandals of 2000–2002. The chapter concludes with a summary of federal taxes.

Part 2 (Value) is concerned with valuation. In Chapter 4 we introduce the concept of the time value of money, and, since most readers will be more familiar with their own financial affairs than with the big leagues of finance, we motivate our discussion by looking first at some personal financial decisions. We show how to value long-lived streams of cash flows and work through the valuation of perpetuities and annuities. Chapter 4 also contains a short concluding section on inflation and the distinction between real and nominal returns.

Chapters 5 and 6 introduce the basic features of bonds and stocks and give students a chance to apply the ideas of Chapter 4 to the valuation of these securities. We show how to find the value of a bond given its yield and we show how prices of bonds fluctuate.

tuates as interest rates change. We look at what determines stock prices and how stock valuation formulas can be used to infer the return that investors expect. Finally, we see how investment opportunities are reflected in the stock price and why analysts focus on the price-earnings multiple. Chapter 6 also introduces the concept of market efficiency. This concept is crucial to interpreting a stock's valuation; it also provides a framework for the later treatment of the issues that arise when firms issue securities or make decisions concerning dividends or capital structure.

The remaining chapters of Part 2 are concerned with the company's investment decision. In Chapter 7 we introduce the concept of net present value and show how to calculate the NPV of a simple investment project. We also look at other measures of an investment's attractiveness—the internal rate of return rule and payback rule. We then turn to more complex investment proposals, including choices between alternative projects, machine replacement decisions, and decisions of when to invest. Finally, we show how the profitability index can be used to choose between investment projects when capital is scarce.

The first step in any NPV calculation is to decide what to discount. Therefore, in Chapter 8 we work through a realistic example of a capital budgeting analysis, showing how the manager needs to recognize the investment in working capital and how taxes and depreciation affect cash flows.

We start Chapter 9 by looking at how companies organize the investment process and ensure everyone works toward a common goal. We then go on to look at various techniques to help managers identify the key assumptions in their estimates, such as sensitivity analysis, scenario analysis, and break-even analysis. We also show how managers can use the notion of economic value added to assess projects. We conclude the chapter by describing how managers try to build future flexibility into projects so that they can capitalize on good luck and mitigate the consequences of bad luck.

Part 3 (Risk) is concerned with the cost of capital. Chapter 10 starts with a historical survey of returns on bonds and stocks and goes on to distinguish between the unique risk and market risk of individual stocks. Chapter 11 shows how to measure market risk and discusses the relationship between risk and expected return. Chapter 12 introduces the weighted-average cost of capital and provides a practical illustration of how to estimate it.

Part 4 (Financing) begins our discussion of the financing decision. Chapter 13 looks at the role of shareholders in large corporations and compares corporate governance in the USA and elsewhere. It also provides an overview of the securities that firms issue and their relative importance as sources of finance. In Chapter 14 we look at how firms issue securities and we follow a firm from its first need for venture capital, through its initial public offering, to its continuing need to raise debt or equity.

Part 5 (Debt and Dividend Policy) focuses on the two classic long-term financing decisions. How much the firm should borrow is addressed in Chapter 15, and how it should set its dividend policy is addressed in Chapter 16. In each case we start with Modigliani and Miller's (MM's) observation that in well-functioning markets the decision should not matter, but we use this observation to help the reader understand why financial managers in practice do pay attention to these decisions.

Part 6 (Financial Planning) starts with financial statement analysis in Chapter 17 and shows how analysts summarize the large volume of accounting information by calculating some key financial ratios. Long-term financial planning is discussed in Chapter 18, where we look at how the financial manager considers the combined effects of investment and financing decisions on the firm as a whole. We also show how

measures of internal and sustainable growth help managers check that the firm's planned growth is consistent with its financing plans. Chapter 19 is an introduction to working capital management. It also shows how managers ensure that the firm will have enough cash to pay its bills over the coming year and describes the principal sources of short-term borrowing.

Part 7 (Short-Term Financial Decisions) is concerned with two important short-term problems. Chapter 20 explains the mechanics of cash collection and disbursement and shows how firms invest idle cash. It also looks at the general problem of managing inventories and shows how the decision to stock up on cash is similar to the decision to stock up on inventories of raw materials or finished goods. The parallel between the task of inventory management and cash management enables us to cover these topics with less repetition than in most other texts. In Chapter 21 we describe the basic steps of credit management and we summarize bankruptcy procedures when customers cannot pay their bills.

Part 8 (Special Topics) covers several important but somewhat more advanced topics—mergers (Chapter 22), international financial management (Chapter 23), options (Chapter 24), and risk management (Chapter 25). Some of these topics are touched on in earlier chapters. For example, we introduce the idea of options in Chapter 9, when we show how companies build flexibility into capital projects. However, Chapter 24 generalizes this material, explains at an elementary level how options are valued, and provides some examples of why the financial manager needs to be concerned about options. International finance is also not confined to Chapter 23. As one might expect from a book that is written by an international group of authors, examples from different countries and financial systems are scattered throughout the book. However, Chapter 23 tackles the specific problems that arise when a corporation is confronted by different currencies.

Part 9 (Conclusion) contains a concluding chapter (Chapter 26), in which we review the most important ideas covered in the text. We also introduce some interesting questions that either were unanswered in the text or are still puzzles to the finance profession. Thus the last chapter is an introduction to future finance courses as well as a conclusion to this one.

Routes through the Book

There are about as many effective ways to organize a course in corporate finance as there are teachers. For this reason, we have ensured that the text is modular, so that topics can be introduced in different sequences.

We like to discuss the principles of valuation before plunging into detailed financial statement analysis or issues of financial planning. Nevertheless, we recognize that many instructors will prefer to move directly from Chapter 3 (Accounting and Finance) to Chapter 17 (Financial Statement Analysis) in order to provide a gentler transition from the typical prerequisite accounting course. We have made sure that Part 6 (Financial Planning) can easily follow Part 1.

Similarly, we like to discuss working capital after the student is familiar with the basic principles of valuation and financing, but we recognize that here also many instructors prefer to reverse our order. There should be no difficulty in taking Part 7 out of order.

When we discuss project valuation in Part 2, we stress that the opportunity cost of capital depends on project risk. But we do not discuss how to measure risk or how return and risk are linked until Part 3. This ordering can easily be modified. For example, the chapters on risk and return can be introduced before, after, or midway through the material on project valuation.

Changes in the Fourth Edition

This fourth edition of *Fundamentals* includes many changes. The most obvious change will be the increased attention paid to Internet resources. We open each chapter with a list of several websites that the student will find helpful. Inside each chapter are typically two Internet Insider boxes that highlight interesting websites and suggest how they can be used to answer some simple questions.

We also have enhanced the analytic tools available with the text. There are more spreadsheet boxes integrated into each chapter. While the boxes may be skipped without harm, they give interested students a valuable introduction to financial modeling. We show how spreadsheets can be used in time value and security valuation problems as well as in long- and short-term planning applications. In addition, each chapter contains end-of-chapter student exercises using the Educational Version of Standard & Poor's Market Insight. This Web-based resource, which is available with the U.S. edition of the text, contains a wealth of current and past financial statement data plus stock price history as well as more descriptive material for a universe of more than 500 firms to allow students to engage in sophisticated company and industry analysis.

We have of course also rewritten, rearranged, and introduced new material to improve readability and update coverage. Here are some of the changes we have made.

Chapter 2 is a new chapter that introduces students to the financial environment. It shows how financial managers interact with financial markets and institutions, and shows how markets may provide managers with information about the opportunity cost of funds used to finance a project.

Chapter 3 (Accounting and Finance) includes a discussion of the accounting scandals of the last few years.

Chapters 4 and 5 (covering time value and bond pricing) have been updated and rearranged to improve logical flow. In addition, several spreadsheet applications have been added as enrichment material.

Chapter 6 (Valuing Stocks) now also contains much of the material previously appearing in a separate chapter on market efficiency. The discussion includes a new section on the dot.com bubble and behavioral finance. The placement of market efficiency with stock valuation enriches the discussion of each topic.

Chapter 7 on investment criteria has been streamlined and reorganized. It also contains a new concluding section summarizing and organizing the salient features of each criterion discussed in the chapter.

We have integrated economic value added into Chapter 9 (Project Analysis). We show how EVA can be used to evaluate projects, emphasizing the opportunity cost of the capital employed in the project. We also have added an introduction to real options to this chapter.

Chapter 10 on risk and return has been updated with new data sources, extending the historical evidence on risk and risk premia to earlier data as well as to international data.

Parts 6 and 7 on long-term and short-term financial planning contain significant new material. Chapter 17 (Financial Statement Analysis) contains several new sections, including a discussion of economic value added and examples and discussions of industry variations in financial ratios. Chapter 18 (Financial Planning) has a new introduction that provides context for the role of financial planning models; the chapter also contains an enhanced financial planning spreadsheet model. Chapter 20 (Cash and Inventory Management) has additional treatment of just-in-time inventory policy.

Part 8 also has been updated. Chapter 22 on mergers contains additional discussion of synergies (and failed synergies) in mergers. Chapter 23 (International Financial Management) contains a new discussion of exchange rate hedging. We have introduced a brief introduction to Black-Scholes option valuation (and a Black-Scholes spreadsheet) in Chapter 24 (Options) and have shown how real options play a role in capital budgeting.

Contents

Part One Introduction



Chapter 1

The Firm and the Financial Manager 2

- 1.1 Organizing a Business 4**
 - Sole Proprietorships 4
 - Partnerships 4
 - Corporations 4
 - Hybrid Forms of Business Organization 5
- 1.2 The Role of the Financial Manager 6**
 - The Capital Budgeting Decision 7
 - The Financing Decision 8
- 1.3 Who Is the Financial Manager? 8**
 - Careers in Finance 9
- 1.4 Goals of the Corporation 12**
 - Shareholders Want Managers to Maximize Market Value 12
 - Ethics and Management Objectives 13
 - Do Managers Really Maximize Value? 13
- 1.5 Topics Covered in This Book 18**
 - Snippets of History 21
- 1.6 Summary 21**
 - Quiz 22
 - Practice Problems 23
 - Solutions to Self-Test Questions 24

Chapter 2

The Financial Environment 26

- 2.1 The Flow of Savings to Corporations 28**
 - The Stock Market 29
 - Other Financial Markets 30
 - Financial Intermediaries 31
 - Financial Institutions 33
 - Total Financing of U.S. Corporations 35

2.2 Functions of Financial Markets and Intermediaries 36

- Transporting Cash across Time 36
- Liquidity 36
- The Payment Mechanism 37
- Reducing Risk 37
- Information Provided by Financial Markets 37
- The Opportunity Cost of Capital 39

2.3 Summary 40

- Quiz 41
- Practice Problems 41
- Solutions to Self-Test Questions 42

Chapter 3

Accounting and Finance 44

3.1 The Balance Sheet 46

- Book Values and Market Values 48

3.2 The Income Statement 50

- Profits versus Cash Flow 51

3.3 The Statement of Cash Flows 53

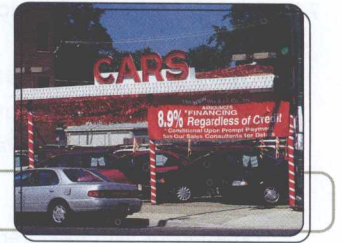
3.4 Accounting Practice and Accounting Malpractice 55

3.5 Taxes 57

- Corporate Tax 57
- Personal Tax 58

3.6 Summary 59

- Quiz 60
- Practice Problems 60
- Challenge Problems 63
- S&P Problems 63
- Solutions to Self-Test Questions 64



Part Two Value

Chapter 4

The Time Value of Money 66

- 4.1 Future Values and Compound Interest 68
- 4.2 Present Values 71
 - Finding the Interest Rate 76
- 4.3 Multiple Cash Flows 80
 - Future Value of Multiple Cash Flows 80
 - Present Value of Multiple Cash Flows 81
- 4.4 Level Cash Flows: Perpetuities and Annuities 82
 - How to Value Perpetuities 83
 - How to Value Annuities 84
 - Annuities Due 89
 - Future Value of an Annuity 90
- 4.5 Inflation and the Time Value of Money 93
 - Real versus Nominal Cash Flows 93
 - Inflation and Interest Rates 96
 - Valuing Real Cash Payments 98
 - Real or Nominal? 99
- 4.6 Effective Annual Interest Rates 100
- 4.7 Summary 102
 - Quiz 103
 - Practice Problems 104
 - Challenge Problems 108
 - S&P Problems 109
 - Solutions to Self-Test Questions 109
 - Minicase 112

Chapter 5

Valuing Bonds 114

- 5.1 Bond Characteristics 116
 - Reading the Financial Pages 116
- 5.2 Bond Prices and Yields 118
 - How Bond Prices Vary with Interest Rates 119
 - Yield to Maturity versus Current Yield 120
 - Rate of Return 124
 - Interest Rate Risk 127
 - The Yield Curve 128
 - Nominal and Real Rates of Interest 129
 - Default Risk 131
 - Variations in Corporate Bonds 133
- 5.3 Summary 135
 - Quiz 136

- Practice Problems 136
- Challenge Problem 138
- S&P Problems 138
- Solutions to Self-Test Questions 138

Chapter 6

Valuing Stocks 140

- 6.1 Stocks and the Stock Market 142
 - Reading the Stock Market Listings 142
- 6.2 Book Values, Liquidation Values, and Market Values 144
- 6.3 Valuing Common Stocks 147
 - Today's Price and Tomorrow's Price 147
 - The Dividend Discount Model 149
- 6.4 Simplifying the Dividend Discount Model 152
 - The Dividend Discount Model with No Growth 152
 - The Constant-Growth Dividend Discount Model 152
 - Estimating Expected Rates of Return 154
 - Nonconstant Growth 155
- 6.5 Growth Stocks and Income Stocks 156
 - The Price-Earnings Ratio 158
 - Valuing Entire Businesses 159
- 6.6 There Are No Free Lunches on Wall Street 160
 - Method 1: Technical Analysis 161
 - Method 2: Fundamental Analysis 163
 - A Theory to Fit the Facts 165
 - Some Puzzles and Anomalies 165
- 6.7 Behavioral Finance and the Rise and Fall of the Dot.Coms 166
- 6.8 Summary 167
 - Quiz 168
 - Practice Problems 169
 - Challenge Problems 172
 - S&P Problems 172
 - Solutions to Self-Test Questions 173
 - Minicase 175

Chapter 7

Net Present Value and Other Investment Criteria 178

- 7.1 Net Present Value 180
 - A Comment on Risk and Present Value 181
 - Valuing Long-Lived Projects 182

- 7.2 Other Investment Criteria 185**
 - Payback 185
 - Internal Rate of Return 188
 - A Closer Look and the Rate of Return Rule 189
 - Calculating the Rate of Return for Long-Lived Projects 189
 - A Word of Caution 191
 - Some Pitfalls with the Internal Rate of Return Rule 191
- 7.3 Mutually Exclusive Projects 194**
 - Investment Timing 195
 - Long- versus Short-Lived Equipment 196
 - Replacing an Old Machine 197
 - Mutually Exclusive Projects and the IRR Rule 198
- 7.4 Capital Rationing 200**
 - Soft Rationing 200
 - Hard Rationing 200
 - Pitfalls of the Profitability Index 201
- 7.5 A Last Look 202**
- 7.6 Summary 203**
 - Quiz 204
 - Practice Problems 204
 - Challenge Problems 207
 - Solutions to Self-Test Questions 208

Chapter 8

Using Discounted Cash-Flow Analysis to Make Investment Decisions 210

- 8.1 Discount Cash Flows, Not Profits 212**
- 8.2 Discount Incremental Cash Flows 214**
 - Include All Indirect Effects 214
 - Forget Sunk Costs 215
 - Include Opportunity Costs 215
 - Recognize the Investment in Working Capital 216
 - Beware of Allocated Overhead Costs 216
- 8.3 Discount Nominal Cash Flows by the Nominal Cost of Capital 217**
- 8.4 Separate Investment and Financing Decisions 219**
- 8.5 Calculating Cash Flow 219**
 - Capital Investment 219
 - Investment in Working Capital 219
 - Cash Flow from Operations 220

- 8.6 An Example: Blooper Industries 222**
 - Calculating Blooper's Project Cash Flows 223
 - Calculating the NPV of Blooper's Project 224
 - Further Notes and Wrinkles Arising from Blooper's Project 225
- 8.7 Summary 230**
 - Quiz 230
 - Practice Problems 231
 - Challenge Problems 233
 - S&P Problems 234
 - Solutions to Spreadsheet Model Questions 234
 - Solutions to Self-Test Questions 235
 - Minicase 237

Chapter 9

Project Analysis 238

- 9.1 How Firms Organize the Investment Process 240**
 - Stage 1: The Capital Budget 240
 - Stage 2: Project Authorizations 240
 - Problems and Some Solutions 241
- 9.2 Some "What-If" Questions 242**
 - Sensitivity Analysis 242
 - Scenario Analysis 245
- 9.3 Break-Even Analysis 246**
 - Accounting Break-Even Analysis 246
 - Economic Value Added and Break-Even Analysis 247
 - Operating Leverage 251
- 9.4 Real Options and the Value of Flexibility 253**
 - The Option to Expand 253
 - A Second Real Option: The Option to Abandon 254
 - A Third Real Option: The Timing Option 255
 - A Fourth Real Option: Flexible Production Facilities 256
- 9.5 Summary 256**
 - Quiz 257
 - Practice Problems 257
 - Challenge Problems 260
 - S&P Problems 260
 - Solutions to Self-Test Questions 260
 - Minicase 263



Part Three Risk

Chapter 10

Introduction to Risk, Return, and the Opportunity Cost of Capital 266

- 10.1 Rates of Return: A Review 268**
- 10.2 A Century of Capital Market History 269**
 - Market Indexes 269

The Historical Record 270
 Using Historical Evidence to Estimate Today's Cost of Capital 272

10.3 Measuring Risk 274

Variance and Standard Deviation 275
 A Note on Calculating Variance 277
 Measuring the Variation in Stock Returns 277

10.4 Risk and Diversification 279

Diversification 279
 Asset versus Portfolio Risk 280
 Market Risk versus Unique Risk 283

10.5 Thinking about Risk 284

Message 1: Some Risks Look Big and Dangerous but Really Are Diversifiable 285
 Message 2: Market Risks Are Macro Risks 286
 Message 3: Risk Can Be Measured 287

10.6 Summary 287

Quiz 288
 Practice Problems 289
 S&P Problems 290
 Solutions to Self-Test Questions 291

Chapter 11

Risk, Return, and Capital Budgeting 292

11.1 Measuring Market Risk 294

Measuring Beta 294
 Betas for Amazon.com and ExxonMobil 296
 Portfolio Betas 298

11.2 Risk and Return 300

Why the CAPM Works 302
 The Security Market Line 303
 How Well Does the CAPM Work? 304
 Using the CAPM to Estimate Expected Returns 306

11.3 Capital Budgeting and Project Risk 308

Company versus Project Risk 308
 Determinants of Project Risk 309
 Don't Add Fudge Factors to Discount Rates 310

11.4 Summary 311

Quiz 311
 Practice Problems 312

Challenge Problem 316
 S&P Problems 317
 Solutions to Self-Test Questions 317

Chapter 12

The Cost of Capital 318

12.1 Geothermal's Cost of Capital 320

12.2 The Weighted-Average Cost of Capital 321

Calculating Company Cost of Capital as a Weighted Average 322
 Market versus Book Weights 324
 Taxes and the Weighted-Average Cost of Capital 325
 What If There Are Three (or More) Sources of Financing? 325
 Wrapping Up Geothermal 326
 Checking Our Logic 327

12.3 Measuring Capital Structure 328

12.4 Calculating Required Rates of Return 330

The Expected Return on Bonds 330
 The Expected Return on Common Stock 330
 The Expected Return on Preferred Stock 331

12.5 Calculating the Weighted-Average Cost of Capital 332

Real Company WACCs 332

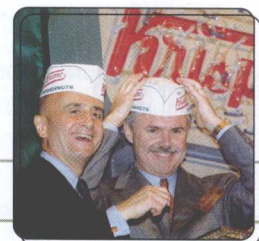
12.6 Interpreting the Weighted-Average Cost of Capital 333

When You Can and Can't Use WACC 333
 Some Common Mistakes 333
 How Changing Capital Structure Affects Expected Returns 334
 What Happens When the Corporate Tax Rate Is Not Zero 335

12.7 Flotation Costs and the Cost of Capital 335

12.8 Summary 336

Quiz 337
 Practice Problems 337
 Challenge Problems 339
 S&P Problems 339
 Solutions to Self-Test Questions 340
 Minicase 341



Part Four Financing

Chapter 13

An Overview of Corporate Financing 344

13.1 Creating Value with Financing Decisions 346

13.2 Common Stock 347

Ownership of the Corporation 348
 Voting Procedures 349
 Classes of Stock 350
 Corporate Governance in the United States and Elsewhere 350

- 13.3 Preferred Stock 351**
- 13.4 Corporate Debt 352**
 - Debt Comes in Many Forms 353
 - Innovation in the Debt Market 357
- 13.5 Convertible Securities 358**
- 13.6 Patterns of Corporate Financing 359**
 - Do Firms Rely Too Heavily on Internal Funds? 359
 - External Sources of Capital 360
- 13.7 Summary 362**
 - Quiz 362
 - Practice Problems 363
 - S&P Problems 364
 - Solutions to Self-Test Questions 364

Chapter 14

How Corporations Issue Securities 366

- 14.1 Venture Capital 368**

- 14.2 The Initial Public Offering 370**
 - Arranging a Public Issue 370
- 14.3 The Underwriters 375**
- 14.4 General Cash Offers by Public Companies 376**
 - General Cash Offers and Shelf Registration 377
 - Costs of the General Cash Offer 378
 - Market Reaction to Stock Issues 378
- 14.5 The Private Placement 379**
- 14.6 Summary 380**
 - Quiz 381
 - Practice Problems 381
 - Challenge Problem 383
 - S&P Problems 383
 - Solutions to Self-Test Questions 384
 - Minicase 385
 - Appendix: Hotch Pot's New-Issue Prospectus 386



Part Five Debt and Dividend Policy

Chapter 15

Debt Policy 392

- 15.1 How Borrowing Affects Value in a Tax-Free Economy 394**
 - MM's Argument 395
 - How Borrowing Affects Earnings per Share 396
 - How Borrowing Affects Risk and Return 398
 - Debt and the Cost of Equity 400
- 15.2 Capital Structure and Corporate Taxes 403**
 - Debt and Taxes at River Cruises 403
 - How Interest Tax Shields Contribute to the Value of Stockholders' Equity 404
 - Corporate Taxes and the Weighted-Average Cost of Capital 405
 - The Implications of Corporate Taxes for Capital Structure 406
- 15.3 Costs of Financial Distress 407**
 - Bankruptcy Costs 408
 - Financial Distress without Bankruptcy 409
 - Costs of Distress Vary with Type of Asset 411
- 15.4 Explaining Financing Choices 412**
 - The Trade-off Theory 412
 - A Pecking Order Theory 413
 - The Two Faces of Financial Slack 414
- 15.5 Summary 416**
 - Quiz 417
 - Practice Problems 418

- Challenge Problems 420
- S&P Problems 421
- Solutions to Self-Test Questions 421
- Minicase 423

Chapter 16

Dividend Policy 424

- 16.1 How Dividends Are Paid 426**
 - Cash Dividends 426
 - Some Legal Limitations on Dividends 427
 - Stock Dividends and Stock Splits 427
- 16.2 Share Repurchase 428**
 - The Role of Share Repurchases 429
 - Repurchases and Share Valuation 430
- 16.3 How Do Companies Decide on Dividend Payments? 431**
- 16.4 Why Dividend Policy Should Not Matter 432**
 - Dividend Policy Is Irrelevant in Competitive Markets 433
 - The Assumptions behind Dividend Irrelevance 435
- 16.5 Why Dividends May Increase Firm Value 436**
 - Market Imperfections 436
 - Dividends as Signals 437
- 16.6 Why Dividends May Reduce Firm Value 439**
 - Why Pay Any Dividends at All? 439
 - Taxation of Dividends and Capital Gains under Current Tax Law 440

16.7 Summary 441

Quiz 442

Practice Problems 443

Challenge Problem 445

S&P Problems 445

Solutions to Self-Test Questions 445

Part Six Financial Planning**Chapter 17****Financial Statement Analysis 448****17.1 Financial Ratios 450**

Leverage Ratios 452

Liquidity Ratios 454

Efficiency Ratios 456

Profitability Ratios 457

17.2 The Du Pont System 459

Other Financial Ratios 461

17.3 Using Financial Ratios 461

Accounting Principles and Financial Ratios 461

Choosing a Benchmark 463

17.4 Measuring Company Performance 466**17.5 The Role of Financial Ratios 469****17.6 Summary 470**

Quiz 471

Practice Problems 472

Challenge Problem 474

S&P Problems 475

Solutions to Self-Test Questions 475

Minicase 477

Practice Problems 499

Challenge Problems 502

S&P Problems 503

Solutions to Self-Test Questions 503

Minicase 504

Chapter 19**Working Capital Management and Short-Term Planning 506****19.1 Working Capital 508**

The Components of Working Capital 508

Working Capital and the Cash Conversion Cycle 509

The Working Capital Trade-off 512

19.2 Links between Long-Term and Short-Term Financing 513**19.3 Tracing Changes in Cash and Working Capital 515****19.4 Cash Budgeting 517**

Forecast Sources of Cash 517

Forecast Uses of Cash 518

The Cash Balance 519

19.5 A Short-Term Financing Plan 520

Options for Short-Term Financing 520

Evaluating the Plan 522

19.6 Sources of Short-Term Financing 523

Bank Loans 523

Commercial Paper 524

Secured Loans 524

19.7 The Cost of Bank Loans 526

Simple Interest (APR) 526

Discount Interest 526

Interest with Compensating Balances 527

19.8 Summary 528

Quiz 529

Practice Problems 530

Challenge Problem 532

S&P Problems 532

Solutions to Self-Test Questions 532

Minicase 535

Chapter 18**Financial Planning 480****18.1 What Is Financial Planning 482**

Financial Planning Focuses on the Big Picture 482

Why Build Financial Plans? 482

18.2 Financial Planning Models 484

Components of a Financial Planning Model 484

An Example of a Planning Model 485

An Improved Model 487

18.3 Planners Beware 491

Pitfalls in Model Design 491

The Assumption in Percentage of Sales Models 491

The Role of Financial Planning Models 493

18.4 External Financing and Growth 493**18.5 Summary 497**

Quiz 498



Part Seven Short-term Financial Decisions

Chapter 20

Cash and Inventory Management 538

20.1 Cash Collection, Disbursement, and Float 540

Float 540

Valuing Float 541

20.2 Managing Float 542

Speeding Up Collections 543

Controlling Disbursements 545

Electronic Funds Transfer 547

20.3 Inventories and Cash Balances 548

Managing Inventories 548

Just-in-Time Inventory Management 551

Managing Inventories of Cash 551

Uncertain Cash Flows 553

Cash Management in the Largest Corporations 554

Investing Idle Cash: The Money Market 555

20.4 Summary 556

Quiz 557

Practice Problems 558

Challenge Problem 560

S&P Problems 560

Solutions to Self-Test Questions 560

Chapter 21

Credit Management and Bankruptcy 562

21.1 Terms of Sale 564

21.2 Credit Agreements 566

21.3 Credit Analysis 566

Financial Ratio Analysis 567

Numerical Credit Scoring 567

When to Stop Looking for Clues 568

21.4 The Credit Decision 569

Credit Decisions with Repeat Orders 571

Some General Principles 572

21.5 Collection Policy 573

21.6 Bankruptcy 574

Bankruptcy Procedures 574

The Choice between Liquidation and Reorganization 576

21.7 Summary 578

Quiz 579

Practice Problems 580

Challenge Problems 581

S&P Problems 582

Solutions to Self-Test Questions 582

Minicase 584



Part Eight Special Topics

Chapter 22

Mergers, Acquisitions, and Corporate Control 585

22.1 The Market for Corporate Control 588

Method 1: Proxy Contests 589

Method 2: Mergers and Acquisitions 589

Method 3: Leveraged Buyouts 590

Method 4: Divestitures and Spin-offs 590

22.2 Sensible Motives for Mergers 591

Economies of Scale 592

Economies of Vertical Integration 593

Combining Complementary Resources 593

Mergers as a Use for Surplus Funds 594

22.3 Dubious Reasons for Mergers 594

Diversification 594

The Bootstrap Game 595

22.4 Evaluating Mergers 596

Mergers Financed by Cash 596

Mergers Financed by Stock 598

A Warning 600

Another Warning 600

22.5 Merger Tactics 600

- 22.6 Leveraged Buyouts 602**
 - Barbarians at the Gate? 603
- 22.7 The Benefits and Costs of Mergers 605**
- 22.8 Summary 607**
 - Quiz 608
 - Practice Problems 608
 - Challenge Problems 609
 - S&P Problems 610
 - Solutions to Self-Test Questions 610
 - Minicase 612

Chapter 23

International Financial Management 614

- 23.1 Foreign Exchange Markets 616**
- 23.2 Some Basic Relationships 618**
 - Exchange Rates and Inflation 619
 - Inflation and Interest Rates 622
 - Interest Rates and Exchange Rates 624
 - The Forward Rate and the Expected Spot Rate 625
 - Some Implications 626
- 23.3 Hedging Exchange Rate Risk 627**
- 23.4 International Capital Budgeting 628**
 - Net Present Value Analysis 628
 - The Cost of Capital for Foreign Investment 630
 - Avoiding Fudge Factors 631
- 23.5 Summary 632**
 - Quiz 633
 - Practice Problems 633
 - Challenge Problem 635
 - S&P Problems 635
 - Solutions to Self-Test Questions 635
 - Minicase 638

Chapter 24

Options 640

- 24.1 Calls and Puts 642**
 - Selling Calls and Puts 644
 - Financial Alchemy with Options 646
- 24.2 What Determines Option Values? 647**
 - Upper and Lower Limits on Option Values 648
 - The Determinants of Option Value 649
 - Option-Valuation Models 651
- 24.3 Spotting the Option 653**
 - Options on Real Assets 654
 - Options on Financial Assets 655
- 24.4 Summary 657**
 - Quiz 658
 - Practice Problems 659
 - Challenge Problems 661
 - S&P Problems 661
 - Solutions to Self-Test Questions 662

Chapter 25

Risk Management 664

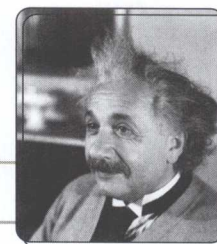
- 25.1 Why Hedge? 666**
- 25.2 Reducing Risk with Options 666**
- 25.3 Futures Contracts 668**
 - The Mechanics of Futures Trading 670
 - Commodity and Financial Futures 672
- 25.4 Forward Contracts 673**
- 25.5 Swaps 674**
- 25.6 Innovation in the Derivatives Market 677**
- 25.7 Is "Derivative" a Four-Letter Word? 677**
- 25.8 Summary 679**
 - Quiz 679
 - Practice Problems 680
 - Challenge Problem 681
 - S&P Problems 681
 - Solutions to Self-Test Questions 681

Part Nine Conclusion

Chapter 26

What We Do and Do Not Know about Finance 686

- 26.1 What We Do Know: The Six Most Important Ideas in Finance 688**
 - Net Present Value 688
 - Risk and Return 688
 - Efficient Capital Markets 689
 - MM's Irrelevance Propositions 689
 - Option Theory 689
 - Agency Theory 690
- 26.2 What We Do Not Know: Seven Unsolved Problems in Finance 690**
 - What Determines Project Risk and Present Value? 690



Risk and Return—Have We Missed Something? 690
 Are There Important Exceptions to the Efficient-Market Theory? 691
 How Can We Explain Capital Structure? 692
 How Can We Resolve the Dividend Controversy? 692
 How Can We Explain Merger Waves? 692
 What Is the Value of Liquidity? 692

26.3 A Final Word 693

Quiz 694
 Answers to Quiz 697

Appendix A: Present Value Tables 699

Appendix B: Solutions to Selected
 End-of-Chapter Problems 709

Glossary 722

Global Index 727

Index 729