



Third Edition

CORPORATE FINANCE

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Homewood, IL 60430
Boston, MA 02116



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Cover photo: Chicago Photographic Company

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Executive editor: *Michael W. Junior*

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Production manager: *Bette K. Ittersagen*

Designer: *Michael Warrell*

Art coordinator: *Mark Malloy*

Compositor: *Better Graphics, Inc.*

Typeface: *10/12 Times Roman*

Printer: *R. R. Donnelley & Sons Company*

Library of Congress Cataloging-in-Publication Data

Ross, Stephen A.

Corporate finance / Stephen A. Ross, Randolph W. Westerfield,
Jeffrey F. Jaffe. — 3rd ed.

p. cm. — (Irwin finance taking the lead)

Includes bibliographical references and indexes.

ISBN 0-256-09487-X ISBN 0-256-12873-1 (International ed.)

1. Corporations—Finance. I. Westerfield, Randolph. II. Jaffe,
Jeffrey F., date III. Title. IV. Series.

HG4026.R675 1993

658.15—dc20

92-25582

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0 DOC 9 8 7 6 5 4 3 2

To our families and friends with love and gratitude.

ABOUT THE AUTHORS

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PREFACE

The teaching and the practicing of corporate finance have become more challenging than ever before. The last 15 years have seen fundamental changes in financial markets and financial instruments. Scarcely a day goes by without an announcement in the financial press about such matters as takeovers, junk bonds, financial restructuring, and leveraged buyouts. Both the theory and practice of corporate finance have been moving ahead with uncommon speed, and our teaching must keep pace.

These developments place new burdens on the teaching of corporate finance. On one hand, the changing world of finance makes it more difficult to keep materials up to date. On the other hand, the teacher must distinguish the permanent from the temporary and avoid the temptation to follow fads. Our solution to this problem is to emphasize the modern fundamentals of the theory of finance and to make the theory come to life with contemporary examples. All too often the beginning student views corporate finance as a collection of unrelated topics that are unified largely because they are bound together between the covers of one book. As in the first and second editions, our aim is to present corporate finance as the working of a small number of integrated and powerful intuitions.

The Intended Audience of This Book

This book has been written for the introductory courses in corporate finance at the MBA level and for intermediate courses in many undergraduate programs. Some instructors will find our text appropriate for the introductory course at the undergraduate level as well.

We assume that most students either will have taken or will be concurrently enrolled in courses in accounting, statistics, and economics. This exposure will help students understand some of the more difficult material. However, the book is self-contained, and a prior knowledge of these areas is not essential. The only mathematics prerequisite is basic algebra.

Changes in the Third Edition

All of the examples, tables, and figures in the text have been edited to include the most up-to-date revisions in laws, regulations, and data. In addition, the following specific changes have been made.

New Chapters

Two new chapters have been added to the text. They are

Chapter 8, Strategy and Analysis in Using Net Present Value. In the previous edition we had one chapter considering the practical aspects of capital budgeting. The new edition adds new material on strategy and analysis in using the net present value (NPV) rule to make capital-budgeting decisions. This new chapter has been added to identify the sources of positive net present value and to see how financial markets can be used to gain insight into where NPV comes from. The new chapter describes techniques for assessing the reasonableness of NPV estimates.

Chapter 30, Financial Distress. In the previous edition we had no separate chapter on how firms manage financial distress. Now we have a new chapter that describes financial distress and the decisions that financially distressed firms must make. The chapter contains new material on bankruptcy, private workouts, reorganization, and liquidation. The chapter reflects our belief that many financial restructurings of the 1990s will involve firms undergoing financial distress.

Decision-Making in Corporate Finance

Almost every firm must make a number of key financial decisions during its life. The new edition of our book identifies many of these decisions and describes how individual firms have made these decisions. The key financial decisions we cover are

The decision to become a corporation: The case of PLM International, Inc.

The decision to have an initial public offering (IPO): The case of Medstone International, Inc.

The decision to pay dividends for the first time: The case of Apple Computer, Inc.

The decision to use more debt: The case of Goodyear Tire and Rubber.

The decision to acquire another company: The case of AT&T acquiring NCR.

The decision to file for bankruptcy: The case of Revco, Inc.

We use the experiences of actual firms to illustrate the important points in relevant chapters. Much of what we know about finance and these firms we learn from *The Wall Street Journal*, *Business Week*, *The Economist*, Value-Line, and Standard & Poor's. We acknowledge these financial periodicals in describing the decisions confronting firms.

Reorganization of Risk and Return

Many new developments have occurred in the area of risk and return. We incorporate these developments in four completely rewritten chapters: Chapter 9, Capital Market Theory: An Overview; Chapter 10, Return and Risk: The Capital-Asset-Pricing Model (CAPM); Chapter 11, An Alternative View of Risk and Return: The Arbitrage Pricing Theory; and Chapter 12, Risk, Return and Capital Budgeting.

The important new features include material in Chapter 9 that provides a complete overview of risk and return. This chapter is self-contained and allows instructors to bypass Chapters 10 and 11 if they choose. Many instructors find this desirable if their students have had prior exposure to risk concepts or if the material is not needed. Chapter 10 is a self-contained chapter on the CAPM, and Chapter 11 remains a self-contained treatment of the Arbitrage Pricing Theory.

New Material on Valuation

A new Chapter 17 entitled Valuation and Capital Budgeting for Levered Firms replaces Chapter 16 in the second edition. The chapter discusses three prevalent approaches to valuation when debt is being used: the weighted-average-cost-of-capital (WACC) approach, the adjusted-present-value (APV) approach, and the flow-to-equity (FTE) approach. Two colleagues from The Wharton School, Isik Inselbag and Howard Kaufold, illustrate the APV approach by valuing the RJR-Nabisco LBO (see the appendix to Chapter 17).

Attention to Pedagogy

We see three keys to good pedagogy in a corporate finance text: (1) extensive examples, questions, and problems; (2) consistency in the level of difficulty; and (3) conceptual coherence.

There is room for both easy and difficult textbooks in corporate finance. Of course, good textbooks should not shift haphazardly from difficult to easy, and vice versa. Our objective is to write a text that is consistently moderate in difficulty. Our book is designed for two audiences—the MBA and the intermediate undergraduate. Therefore our objective has been to write a book with sufficient flexibility to be taught to both of these audiences. We have written the core material on value, risk, capital budgeting, and capital structure at a consistently moderate level of difficulty. Some chapters can be omitted without loss of continuity for a more introductory-level treatment. More specialized chapters, such as those on options, warrants and convertibles, and mergers and acquisitions, may be covered in more advanced courses.

We have found that many textbooks lack conceptual coherence. We attempt to use consistently the intuitions of arbitrage, net present value, efficient markets, and options throughout the book. However, we have also attempted

to enliven some of the conceptual material by including the recent results of modern financial research. This research has at times raised more questions than answers; therefore we have presented some of the puzzles, anomalies, and unresolved questions of corporate finance. We hope that this will pique the curiosity of the students and motivate them to work harder to grasp the complexities of modern corporate finance.

Study Features

Getting the theory and concepts current and up-to-date is only one phase of developing a corporate finance text. To be an effective teaching tool, the text must present the theory and concepts in a coherent way that can be easily learned. With this in mind, we have included several study features:

1. *Concept Questions.* After each major section in a chapter is a unique learning tool called “Concept Questions.” Concept Questions point to essential material and allow students to test their recall and comprehension periodically.
2. *Key Terms.* Students will note that important words are highlighted in boldface type the first time they appear. They are also listed at the end of the chapter along with the page number on which they first appear. New words appear in *italics* when they are first mentioned. Both key terms and new words are defined in the glossary at the end of the text.
3. *Demonstration Problems.* Throughout the text we have provided worked-out examples to give students a clear understanding of the logic and structure of the solution process.
4. *Boxed Material.* Interesting concepts and topics are examined and expanded in boxes.
5. *Equations.* Key equations are highlighted in color for easy reference.
6. *Problem Sets.* Because problems are so critical to a student’s learning, we have extensively revised and rewritten the sets at the end of each chapter. The refined problems have been thoroughly reviewed and class-tested. The problem sets are graded for difficulty, moving from easier problems intended to build confidence and skill to more difficult problems designed to challenge the enthusiastic student. Problems have been grouped according to the concepts they test on. Additionally, we have tried to make the problems in the critical “concept” chapters, such as those on value, risk, and capital structure, especially challenging and interesting. We provide answers to selected problems at the end of the book.
7. *Enumerated Chapter Summaries.* At the end of each chapter a numbered summary provides a quick review of key concepts in the chapter.
8. *Suggested Readings.* Each chapter is followed by a short, annotated list of books and articles to which interested students can refer for additional information.

Supplements

As with the text, developing supplements of extraordinary quality and utility was the primary objective. Each component in the supplements package underwent extensive review and revision. As a result, the package contains several features not offered with any other corporate finance text.

Instructor's Manual

Lecture Notes with ideas or comments on context and teaching, up-to-date practical examples, selected equations, and suggestions for handouts and transparencies to use with your lectures. Prepared by Kirt Butler, Michigan State University, the *Instructor's Manual* includes:

Supplemental Problems in addition to those in the text are offered for use during lectures or for testing.

Answers to the Text Problems and Concept Questions are provided.

A *Computer Section* describes how to use *Spreadsheet Models for Corporate Finance* offered free to adopters of the text. It offers suggestions on classroom use of the 20 Lotus 1-2-3 worksheets and tips on good spreadsheet techniques. New to this edition is a pull-out student manual that guides the software user through the models. It provides additional assistance to that already included on the disk.

Test Bank

Prepared by David Burnie, Western Michigan University, the Test Bank includes over 800 multiple-choice questions and problems—approximately 30 per chapter.

Irwin's Computerized Testing Software

This advanced-feature test generator allows you to add and edit questions; save and reload tests; create up to 99 different versions of each test; attach graphics to questions; import and export ASCII files; and select questions based on type, level of difficulty, or keyword. This software provides password protection of saved tests and question databases, and can run on a network.

TeleTest

IRWIN's *free* customized exam preparation service! Simply choose your desired questions from the Test Bank, and call IRWIN's Educational Software Services (ESS) at **1-800-331-5094**. Within 24 hours of receiving your order, ESS will send by first-class mail a laser-printed master test with answer key to you.

Student Problem Manual

Written by Robert Hanson, San Diego State University, the Student Problem Manual is a direct companion to the text. It is uniquely designed to involve the student in the learning process. Each chapter contains a Chapter Mission Statement, 15 problems and worked-out solutions, and 15–20 fill-in Concept Test questions and answers.

Software

Provided free to adopters, *Spreadsheet Models for Corporate Finance* consists of 20 Lotus 1-2-3 spreadsheets. Developed by Delvin D. Hawley of the University of Mississippi, the software provides additional review of concepts and refines students' spreadsheet techniques and skills for constructing simple models.

Acetates

Over 100 acetates provide numerous worked-out solutions to problems and highlight key charts and tables.

Acknowledgments

Over time many people have contributed their time and expertise to the development and writing of this text. We extend our thanks once again for their assistance countless insights.

Nasser Arshadi, *University of Missouri at St. Louis*

John W. Ballantine, *Babson College*

Thomas Bankston, *Angelo State University*

Swati Bhatt, *Rutgers University*

Roger Bolton, *Williams College*

Gordon Bonner, *University of Delaware*

Oswald Bowlin, *Texas Technical University*

Ronald Braswell, *Florida State University*

Kirt Butler, *Michigan State University*

Andreas Christofi, *Pennsylvania State University at Harrisburg*

Mark Cross, *Louisiana Technical University*

William Damon, *Vanderbilt University*

Sudip Datta, *Bentley College*

Anand Desai, *University of Florida*

David Distad, *University of California at Berkeley*

Dennis Draper, *University of Southern California*

Jean-Francois Dreyfus, *New York University*

Gene Drzycimski, *University of Wisconsin at Oshkosh*

Robert Eldridge, *Fairfield University*

Gary Emery, *University of Oklahoma*

Don Fehrs, *University of Notre Dame*

Michael Fishman, *Northwestern University*

James Haltiner, *College of William and Mary*

Delvin Hawley, *University of Mississippi*

Hal Heaton, *Brigham Young University*

- John Helmuth, *Rochester Institute of Technology*
 Andrea Heuson, *University of Miami*
 Hugh Hunter, *Eastern Washington University*
 James Jackson, *Oklahoma State University*
 Brad Jordan, *University of Missouri at Columbia*
 Jarl Kallberg, *New York University*
 Jonathan Karpoff, *University of Washington*
 Narayana Kocherlakota, *University of Iowa*
 Nelson Lacey, *University of Massachusetts*
 Josef Lakonishok, *University of Illinois*
 Dennis Lasser, *SUNY-Binghamton*
 James T. Lindley, *University of Southern Mississippi*
 Dennis Logue, *Dartmouth College*
 Ileen Malitz, *Fairleigh Dickinson University*
 Terry Maness, *Baylor University*
 Suren K. Mansinghka, *San Francisco State University*
 Robert L. McDonald, *Northwestern University*
 Huge McLaughlin, *Bentley College*
 Larry Merville, *University of Texas at Richardson*
 Rick Meyer, *University of South Florida*
 Dennis Officer, *University of Kentucky*
 Ajay Patel, *University of Missouri at Columbia*
 Glenn N. Pettengill, *Emporia State University*
 Franklin Potts, *Baylor University*
 Annette Poulsen, *University of Georgia*
 Steven Raymar, *Indiana University*
 Stuart Rosenstein, *Southern Illinois University*
 Anthony Sanders, *Ohio State University*
 James Schallheim, *University of Utah*
 Mary Jean Scheuer, *California State University at Northridge*
 Lemma Senbet, *University of Maryland*
 Kuldeep Shastri, *University of Pittsburgh*
 A. Charlene Sullivan, *Purdue University*
 R. Bruce Swensen, *Adelphi University*
 Ernest Swift, *Georgia State University*
 Richard Taylor, *Arkansas State University*
 Charles Trzcinka, *State University of New York at Buffalo*
 Haluk Unal, *University of Maryland at College Park*
 Lankford Walker, *Eastern Illinois University*
 Ralph Walkling, *Ohio State University*
 F. Katherine Warne, *Southwestern Bell Co.*
 Berry Wilson, *Georgetown University*
 Thomas Zorn, *University of Nebraska at Lincoln*
 Kent Zumwalt, *Colorado State University*

For their help on the third edition we would like to thank Mukesh Bajaj, Dennis Draper, Meir Schneller, Gail Babcock, Yuk Shee Chan, Kim Dietrich, Alan Shapiro, Harry De Angelo, Aris Protopapadakis, L. Sankarasubramanian, and Suh-Pyng Ku, all of the University of Southern California. We also owe a debt of gratitude to Mike Alderson of the University of Missouri-St. Louis for his careful and thorough examination of all numerical content, tables and figures; Edward I. Altman, of New York University; Steve Heston of Yale University; and Jay Ritter of the University of Illinois.

Over the past three years, readers have provided assistance by detecting and reporting errors. Our goal is to offer the best textbook available on the subject, so this information was invaluable as we prepared the third edition. We want to ensure that all future editions are error-free and therefore we will offer \$10 per arithmetic error to the first individual reporting it. Any arithmetic error resulting in subsequent errors will be counted double. All errors should be mailed to the following address: Professor Randolph W. Westerfield, School of Business Administration, University of Southern California, University Park, Los Angeles, CA 90089.

Much credit must go to a superior group of people at Irwin. Our special thanks goes to Tom Sharpe, Developmental Editor, who deftly smoothed out potentially chaotic situations in the publishing process, to Mike Junior, Executive Editor, whose vision and optimism made this edition a reality, and to Joanne Dorff, Sponsoring Editor.

In addition, Helen Pitts of the School of Business Administration at USC gave us a great deal of assistance in preparing the manuscript. Paul Hiles of the Wharton School also provided much help.

Finally, we wish to thank our families and friends, Carol, Kate, Jon, Jan, Mark, and Lynne for their forbearance and help.

Stephen A. Ross
Randolph W. Westerfield
Jeffrey F. Jaffe

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