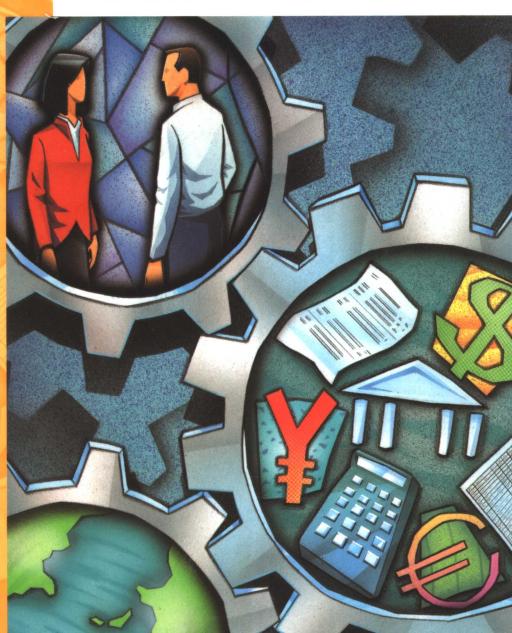
THIRD EDITION

Essentials of Corporate Finance

Ross

Westerfield

Jordan



Essentials of Corporate Finance

Stephen A. Ross

Massachusetts Institute of Technology

Randolph W. Westerfield

University of Southern California

Bradford D. Jordan

University of Kentucky



Boston Burr Ridge, IL Dubuque, IA Madison, WI New York San Francisco St. Louis Bangkok Bogotá Caracas Kuala Lumpur Lisbon London Madrid Mexico City Milan Montreal New Delhi Santiago Seoul Singapore Sydney Taipei Toronto

To our families and friends with love and gratitude —S.A.R. R.W.W. B.D.J.

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From 1988 to 1993, Professor Westerfield served as the chairman of the School's finance and business economics department and the Charles B. Thornton Professor of Finance. He came to USC from the Wharton School, University of Pennsylvania, where he was the chairman of the finance department and member of the finance faculty for 20 years. He is a member of the board of directors of the AACSB-the international association for management education, as well as Health Management Associates (HMA), and William Lyon Homes (WLH). His areas of expertise include corporate financial policy, investment management and analysis, mergers and acquisitions, and stock market price behavior.

Professor Westerfield has been consultant to a number of corporations, including AT&T, Mobil Oil and Pacific Enterprises, as well as to the United Nations, the U.S. Departments of Justice and Labor, and the State of California.



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with the third edition of Essentials of Corporate Finance, we have continued to refine our focus on our target audience, which is the undergraduate student taking a core course in business or corporate finance. This can be a tough course to teach. One reason is that the class is usually required of all business students, so it is not uncommon for a majority of the students to be non-finance majors. In fact, this may be the only finance course many of them will ever have. With this in mind, our goal in Essentials is to convey the most important concepts and principles at a level that is approachable for the widest possible audience.

To achieve our goal, we have worked to distill the subject down to its bare essentials (hence, the name of this book), while retaining a decidedly modern approach to finance. We have always maintained that the subject of corporate finance can be viewed as the working of a few very powerful intuitions. We also think that understanding the "why" is just as important, if not more so, than understanding the "how," especially in an introductory course. Based on the gratifying market feedback we have received from our first two editions, as well as from our other text, *Fundamentals of Corporate Finance* (now in its 5th edition), many of you agree.

By design, this book is not encyclopedic. As the table of contents indicates, we have a total of 18 chapters. Chapter length is about 30 pages, so the text is aimed squarely at a single-term course, and most of the book can be realistically covered in a typical semester or quarter. Writing a book for a one-term course necessarily means some picking and choosing, both with regard to topics and depth of coverage. Throughout, we strike a balance by introducing and covering the essentials (there's that word again!) while leaving some more specialized topics to follow-up courses.

The other things we have always stressed, and have continued to improve with this edition, are readability and pedagogy. *Essentials* is written in a relaxed, conversational style that invites the students to join in the learning process rather than being a passive information absorber. We have found that this approach dramatically increases students' willingness to read and learn on their own. Between larger and larger class sizes and the ever-growing demands on faculty time, we think this is an essential (!) feature for a text in an introductory course.

Throughout the development of this book, we have continued to take a hard look at what is truly relevant and useful. In doing so, we have worked to downplay purely theoretical issues and minimize the use of extensive and elaborate calculations to illustrate points that are either intuitively obvious or of limited practical use.

As a result of this process, three basic themes emerge as our central focus in writing *Essentials of Corporate Finance:*

An Emphasis on Intuition We always try to separate and explain the principles at work on a common sense, intuitive level before launching into any specifics. The underlying ideas are discussed first in very general terms and then by way of examples that illustrate in more concrete terms how a financial manager might proceed in a given situation.

A Unified Valuation Approach We treat net present value (NPV) as the basic concept underlying corporate finance. Many texts stop well short of consistently integrating this important principle. The most basic and important notion, that NPV represents the excess of market value over cost, often is lost in an overly mechanical approach that emphasizes computation at the expense of comprehension. In contrast, every subject we cover is

FROM THE AUTHORS

firmly rooted in valuation, and care is taken throughout to explain how particular decisions have valuation effects.

A Managerial Focus Students shouldn't lose sight of the fact that financial management concerns management. We emphasize the role of the financial manager as decision maker, and we stress the need for managerial input and judgment. We consciously avoid "black box" approaches to finance, and, where appropriate, the approximate, pragmatic nature of financial analysis is made explicit, possible pitfalls are described, and limitations are discussed.

Today, as we prepare to once again enter the market, our goal is to stick with and build on the principles that have brought us this far. However, based on an enormous amount of feedback we have received from you and your colleagues, we have made this edition and its package even more flexible than previous editions. We offer flexibility in coverage and pedagogy by providing a wide variety of features in the book to help students to learn about corporate finance. We also provide flexibility in package options by offering the most extensive collection of teaching, learning, and technology aids of any corporate finance text. Whether you use just the textbook, or the book in conjunction with other products, we believe you will find a combination with this edition that will meet your current as well as your changing needs.

Stephen A. Ross Randolph W. Westerfield Bradford D. Jordan

Organization of the Text

We designed *Essentials of Corporate Finance* to be as flexible and modular as possible. There are a total of nine parts, and, in broad terms, the instructor is free to decide the particular sequence. Further, within each part, the first chapter generally contains an overview and survey. Thus, when time is limited, subsequent chapters can be omitted. Finally, the sections placed early in each chapter are generally the most important, and later sections frequently can be omitted without loss of continuity. For these reasons, the instructor has great control over the topics covered, the sequence in which they are covered, and the depth of coverage.

Considers the goal of the corporation, the corporate form of organization, and the role of the financial manager. Also covers the various functional areas within finance and relates finance to other business areas.

Briefly reviews key accounting concepts and succinctly discusses cash flow versus accounting income, market value versus book value, and taxes.

Discusses key ratios and also covers sustainable growth. If desired, this chapter can be omitted without affecting the flow of subsequent chapters.

First of two chapters covering time value of money, allowing for a building block approach to this difficult subject.

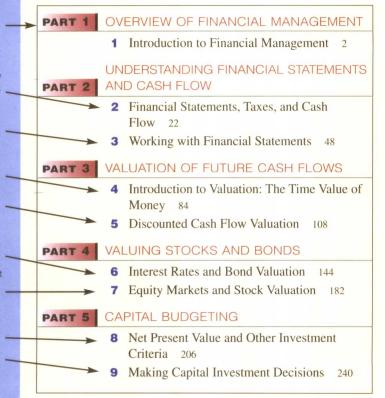
Contains detailed coverage on use of financial calculators and spreadsheets.

Covers bond valuation and yields, bond types and market operations, the yield curve, and the Fisher effect.

In addition to the dividend growth model, stock market operations and the interpretation of prices in the financial press are explained, including the new decimal format.

Contains new, up-to-date survey results on corporate capital budgeting practices.

Extensive coverage on NPV estimates.



PART 6 RISK AND RETURN

- **10** Some Lessons from Capital Market History 274
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PART 7 LONG-TERM FINANCING

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- Using the HP-10B and TI BA II Plus Financial Calculators 551

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Gives students a feel for typical rates of return on financial assets and also an historical perspective on risk

Discusses the expected return/risk trade-off and develops the security market line in a highly intuitive way that bypasses much of the usual portfolio theory and statistics.

Presents various approaches for determining cost of capital and suitable discount rates for risky projects.

Contains an intuitive discussion of optimal capital structure and also briefly considers the bankruptcy process.

Succinctly covers dividends and corporate payout policies.

Covers venture capital and contains new, up-to-date coverage of IPOs, including the 1999 experience.

Presents a general survey of short-term financial management, which is useful when time does not permit a more in-depth treatment.

Contains greater detail on cash, credit, and inventory management.

Introduces key aspects of international finance; includes up-to-date coverage on the euro.

Real Financial Decisions

We have included two key features that help students connect chapter concepts to how decision makers use this material in the real world.

In addition to illustrating relevant concepts and presenting up-to-date coverage, Essentials of Corporate Finance strives to present the material in a way that makes it coherent and easy to understand. To meet the varied needs of the intended audience, Essentials of Corporate Finance is rich in valuable learning tools and support.

Each feature can be categorized by the benefit to the student:

- Real Financial Decisions
- **Application Tools**
- Study Aids

APPLE COMPUTER began as a two-man partnership in a garage. It grew rapidly and, by 1985, became a large publicly traded corporation with 60 million shares of stock and a total market value in excess of \$1 billion. At that time, the firm's more visible cofounder, 30-year-old Steven Jobs, owned seven million shares of Apple stock worth about \$120

Despite his stake in the company and his role in its founding and suc cess, Jobs was forced to relinquish operating responsibilities in 1985 when Apple's financial performance turned sour, and he subsequently resigned

Of course, you can't keep a good entrepreneur down, Johs formed Pixar Animation Studios, the company that is responsible for the animation

in the hit movies Toy Story, A Bug's Life, and Toy Story 2. Pixar went public in 1995, and, follow reception by the stock market. Jobs's 80 percent stake was valued at about \$1.1 bill



Chapter-Opening Vignettes with Functional Integration Links

Each chapter begins with a recent real-world event to introduce students to chapter concepts. Since many non-finance majors will use this text, a brief paragraph linking the vignette and chapter concepts to majors in marketing, management, and accounting is included.

Most chapters include at least one Reality Bytes box, which takes a chapter issue and shows how it is being used right now in everyday financial decision making.

reality BYTES

SHE'S MADE OF PLASTIC, AND SHE'S FANTASTIC!

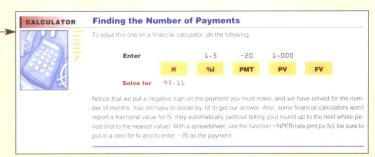
It used to be that trading in collectibles such as baschall cards, art, and old toys occurred mostly at anctions, waspared to a misterious arterior to the proposal traffic. However, with the growing popularity of online autocious such as effects trading in collectibles has expanded to an international arran. The motion problem of collectibles has expanded to an international arran. The motival production is produced to a finanticular and produced in the product of the production after a production and production after a production and prod

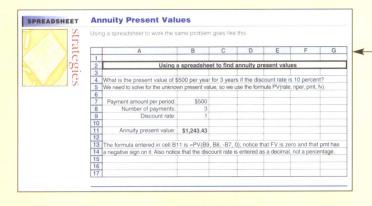
Application Tools

Realizing that there is more than one way to solve problems in corporate finance, we include two sections that will not only encourage students to learn different problem-solving methods, but that will also help them learn or brush up on their financial calculator and Excel spreadsheet skills.

Calculator Hints

Calculator Hints is a self-contained section in various chapters that first introduces students to calculator basics, and then illustrates how to solve problems with the calculator. Appendix D goes into more detailed instructions by solving problems with two specific calculators.





Spreadsheet Strategies

The unique Spreadsheet Strategies feature is also in a self-contained section, and shows students how to set up spreadsheets to solve problems—a vital part of every business student's education.

Spreadsheet Templates

Almost every chapter ends with a list of problems that are linked to spreadsheet software available in the Student Center of the Web site at www.mhhe.com/rwj. These Excel templates are a valuable extension of the Spreadsheet Strategies feature.



www.mhhe.com/rwj

Spreadsheet Templates 6, 10, 19

Study Aids

We want students to get the most from this book and their course, and we realize that students have different learning styles and study needs. We therefore present a number of study features to appeal to a wide range of students.

Learning Objectives

Each chapter begins with a number of learning objectives that are key to the student's understanding of the chapter.

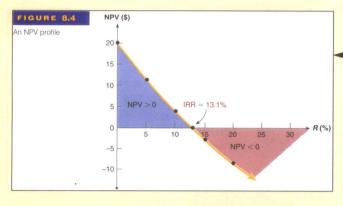
TO GET THE MOST OUT OF THE CHAPTER,
WHEN YOU ARE FINISHED STUDYING IT, MAKE
SURE YOU HAVE A GOOD UNDERSTANDING OF:

The basic types of financial management decisions
and the role of the financial manager

The goal of financial management

The financial implications of the different forms of
business organization

The conflicts of interest that can arise between
managers and owners



Pedagogical Use of Color

We use a full color palette in *Essentials* to not only make the text more inviting, but, more importantly, as a functional element to help students follow the discussion. In almost every chapter, color plays an important, largely self-evident role. A guide to the use of color is found on the endsheets.

Critical Thinking Questions

Every chapter ends with a set of Critical Thinking
Questions that challenge the student to apply the concepts they have learned from the real-world examples in the chapter to new situations.

CRITICAL THINKING AND CONCEPTS REVIEW

- The Financial Management Decision Process. What are the three types of financial management decisions? For each type of decision, give an example of a business transaction that would be relevant.
- Sole Proprietorships and Partnerships. What are the four primary disadvantages to the sole proprietorship and partnership forms of business organization? What benefits are there to these types of business organization as opposed to the corporate form?
- Corporations. What is the primary disadvantage of the corporate form of organization? Name at least two of the advantages of corporate organization.
- 4. Corporate Finance Organization. In a large corporation, what are the two distinct groups that report to the chief financial officer? Which group is the focus of corporate finance?
- 5. Goal of Financial Management. What goal should always motivate the actions of the firm's financial manager?

Concept Questions

Chapter sections are intentionally kept short to promote a step-by-step, building-block approach to learning. Each section is then followed by a series of short concept questions that highlight the key ideas just presented. Students use these questions to make sure they can identify and understand the most important concepts as they read.

CONCEPT QUESTIONS

- 1.6a What is a dealer market? How do dealer and auction markets differ?
- **1.6b** What is the largest auction market in the United States?
- **1.6c** What does OTC stand for? What is the large OTC market for stocks called?

Summary Tables

These tables succinctly restate key principles, results, and equations. They appear whenever it is useful to emphasize and summarize a group of related concepts.

The cash flow identity

Cash flow from assets = Cash flow to creditors (bondholders)

+ Cash flow to stockholders (owners)

II. Cash flow from assets

- Cash flow from assets = Operating cash flow
 - Net capital spending
 - Change in net working capital (NWC)

where

Operating cash flow = Earnings before interest and taxes (EBIT)

- + Depreciation Taxes
- Net capital spending = Ending net fixed assets Beginning net fixed assets
 - + Depreciation

Change in NWC = Ending NWC - Beginning NWC

III. Cash flow to creditors (bondholders)

Cash flow to creditors = Interest paid - Net new borrowing

IV. Cash flow to stockholders (owners)

Cash flow to stockholders = Dividends paid - Net new equity raised

TABLE 2.5

Cash flow summary

Numbered Examples

Separate numbered and titled examples are extensively integrated into the chapters. These examples provide detailed applications and illustrations of the text material in a step-by-step format. Each example is completely self-contained so that students don't have to search for additional information. Based on our classroom testing, these examples are among the most useful learning aids because they provide both detail and explanation.

EXAMPLE 3.2 Payables Turnover

Here is a variation on the receivables collection period. How long, on average, does it take for Prufrock Corporation to pay its bills? To answer, we need to calculate the accounts payable turnover rate using cost of goods sold. We will assume that Prufrock purchases everything on credit.

The cost of goods sold is \$1,344, and accounts payable are \$344. The turnover is therefore \$1,344/\$344 = 3.9 times. So payables turned over about every 365/3.9 = 94 days. On average, then, Prufrock takes 94 days to pay. As a potential creditor, we might take note of this fact.

Key Terms

These are printed in blue the first time they appear, and are defined within the text and in the margin.

As shown in Figure 2.1, the difference between a firm's current assets and its current liabilities is called **net working capital**. Net working capital is positive when current assets exceed current liabilities. Based on the definitions of current assets and current liabilities, this means that the cash that will become available over the next 12 months exceeds the cash that must be paid over that same period. For this reason, net working capital is usually positive in a healthy firm.

net working capital Current assets less current liabilities.

Key Equations

These are called out in the text and identified by equation numbers.

Appendix B shows the key equations by chapter.

Profit Margin Companies pay a great deal of attention to their *profit margin*:

Profit margin =
$$\frac{\text{Net income}}{\text{Sales}}$$

= $\frac{\$363}{\$2,311}$ = 15.7%

Highlighted Phrases

Throughout the text, important ideas are presented separately and printed in a blue box to indicate their importance the students.

Given that the goal of financial management is to increase share value, our discussion in this section leads us to the *net present value rule*:

An investment should be accepted if the net present value is positive and rejected if it is negative.

Chapter Summary and Conclusions

These paragraphs review the chapter's key points and provide closure to the chapter.

SUMMARY AND CONCLUSIONS

This chapter has introduced you to the basic principles of present value and discounted cash flow valuation. In it, we explained a number of things about the time value of money, including:

- For a given rate of return, the value at some point in the future of an investment made today can be determined by calculating the future value of that investment.
- The current worth of a future cash flow can be determined for a given rate of return by calculating the present value of the cash flow involved.
- 3. The relationship between present value and future value for a given rate r and time t is given by the basic present value equation:

$$PV = FV_r/(1 + r)^t$$

As we have shown, it is possible to find any one of the four components (PV, FV_t , r, or t) given the other three.

Chapter Review and Self-Test Problems

Review and self-test problems appear after the chapter summaries. Detailed answers to the self-test problems immediately follow. These questions and answers allow students to test their abilities in solving key problems related to the content of the chapter.

CHAPTER REVIEW AND SELF-TEST PROBLEMS

- 5.1 Present Values with Multiple Cash Flows. A first-round draft choice quarterback has been signed to a three-year, \$10 million contract. The details provide for an immediate cash bonus of \$1 million. The player is to receive \$2 million in salary at the end of the first year, \$3 million the next, and \$4 million at the end of the last year. Assuming a 10 percent discount rate, is this package worth \$10 million? How much is it worth?
- 5.2 Future Value with Multiple Cash Flows. You plan to make a series of deposits in an interest-bearing account. You will deposit \$1,000 today, \$2,000 in two years, and \$8,000 in five years. If you withdraw \$3,000 in three years and \$5,000 in seven years, how much will you have after eight years if the interest rate is 9 percent? What is the present value of these eash flows?
- 5.3 Annuity Present Value. You are looking into an investment that will pay you \$12,000 per year for the next 10 years. If you require a 15 percent return, what is the most you would pay for this investment?
- 5.4 APR versus EAR. The going rate on student loans is quoted as 9 percent APR. The terms of the loan call for monthly payments. What is the effective annual rate, or EAR, on such a student loan?

End-of-Chapter Questions and Problems

We have found that many students learn better when they have plenty of opportunity to practice. We therefore provide extensive end-of-chapter questions and problems—many more than in the previous edition. The questions and problems are generally segregated into two levels—Basic and Intermediate. All problems are fully annotated so that students and instructors can readily identify particular types. Throughout the text, we have worked to supply interesting problems that illustrate real-world applications of chapter material. Answers to selected end-of-chapter questions appear in Appendix C.

QUESTIONS AND PROBLEMS

 Simple Interest versus Compound Interest. First Rajan Bank pays 5 percent simple interest on its savings account balances, whereas First Mullineaux Bank pays 5 percent interest compounded annually. If you made a \$5,000 deposit in each bank, how much more money would you earn from your First Mullineaux Bank account at the end of 10 years?

(Questions 1-15)

2. Calculating Future Values. For each of the following, compute the future value:

Present Value Value	Years	Interest Rate	Future
\$ 2,250	4	18%	
9,310	9	6	
76,355	15	12	

Comprehensive Teaching and Learning Package

We have made every effort to include the support material that is most critical for you and your students. Each product has been significantly revised and refreshed for the Third Edition.

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Instructor's Manual, prepared by Cheri Etling, University of Tampa ISBN 0072340568

A great place to find new lecture ideas!

This thoroughly updated IM contains two sections. The first section contains a chapter outline and other lecture materials designed for use with the Annotated Instructor's Edition. There is an annotated outline for each chapter, and included in the outlines are Lecture Tips, Real-World Tips, Ethics Notes, suggested PowerPoint slides, and, when appropriate, a video synopsis. Detailed solutions for all end-of-chapter problems appear in the second section.

Test Bank, prepared by David Kuipers, Texas Tech University ISBN 0072340592

New format for a better testing process!

The Third Edition Test Bank has been thoroughly reorganized to more closely link with the text. Each chapter is divided into four parts: Part I contains questions that test the understanding of key terms in the book. Part II includes questions patterned after the learning objectives, concept questions, chapter-opening vignettes, boxes, and highlighted phrases. Part III contains multiple-choice and true/false problems patterned after the end-of-chapter questions, in basic and intermediate levels. Part IV provides essay questions to test problem-solving skills and more advanced understanding of concepts.

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All of the chapter presentations in PowerPoint are produced in an acetate package for use with an overhead projector.

Videos

ISBN 0072423420

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McGraw-Hill/Irwin produced a new series of finance videos that are 10-minute case studies on topics such as Financial Markets, Careers, Rightsizing, Capital Budgeting, EVA, and International Finance. Discussion questions for these videos are available in the Instructor's Center at www.mhhe.com/rwj.

Student Supplements

The Wall Street Journal Edition ISBN 0072340649

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Student Problem Manual, prepared by Thomas Eyssell, University of Missouri—St. Louis

ISBN 007234055X

Need additional help solving problems?

This valuable resource provides students with additional problems for practice. Each chapter begins with Concepts for Review, followed by Chapter Highlights. These reemphasize the key terms and concepts in the chapter. A short Concept Test, averaging 10 questions and answers, appears next. Each chapter concludes with additional problems for the student to review. Answers to these problems appear at the end of the Student Problem Manual.

Ready Notes ISBN 0072340541

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Financial Analysis with an Electronic Calculator, Fourth Edition, by Mark A. White, University of Virginia, McIntire School of Commerce ISBN 0072299738

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The information and procedures in this supplementary text enable students to master the use of financial calculators and develop a working knowledge of financial mathematics and problem solving. Complete instructions are included for solving all major problem types on three popular models: HP 10-B, TI BA II Plus, and Sharp EL733A. Hands-on problems with detailed solutions allow students to practice the skills outlined in the text and obtain instant reinforcement. *Financial Analysis with an Electronic Calculator* is a self-contained supplement to the introductory financial management course.