Principles of Corporate Finance Global Edition

TENTH EDITION

Richard A. Brealey

Professor of Finance London Business School

Stewart C. Myers

Robert C. Merton (1970) Professor of Finance Sloan School of Management Massachusetts Institute of Technology

Franklin Allen

Nippon Life Professor of Finance Tl)e W})arton School University of Pennsylvania

UNIVERSITAT LIECHTENSTEIN Bibliothok



Brief Contents

I P	art One: Value		I Part Six Options	
1	Goals and Governance of the Firm	29	20 Understanding Options 5	530
2	How to Calculate Present Values	48	• •	553
	Valuing Bonds	73	- 1	582
4	The Value of Common Stocks	102	r	
5	Net Present Value and Other		I Part Seven Debt Financing	
	Investment Criteria	129	23 Credit Risk and the Value of Corporate Debt 6	605
6	Making Investment Decisions with		•	625
	the Net Present Value Rule	155	•	653
1 P	art TWO Risk		25 Leasing	333
	art 1770 Risk		I Part Eight Risk Management	
7	Introduction to Risk and Return	184	26 Managing Dist.	
8	Portfolio Theory and the Capital Asset			673
	Pricing Model	213	27 Managing International Risks 7	704
9	Risk and the Cost of Capital	241	I Part Nine Financial Planning and Working	
<u>I P</u>	art Three Best Practices in Capital Budgetin	ng	Capital Management	
10	Project Analysis	268	28 Financial Analysis 7	732
	Investment, Strategy, and Economic Rents	296	29 Financial Planning 7	759
	Agency Problems, Compensation, and	270	30 Working Capital Management 7	785
12	Performance Measurement	318		
			I Part Ten Mergers, Corporate Control,	
I P	art FOlir Financing Decisions and Market		and Governance	
	Efficiency		31 Mergers 8	820
13	Efficient Markets and Behavioral Finance	340		852
14	An Overview of Corporate Financing	369	33 Governance and Corporate Control	
15		390	Around the World	878
<u>I P</u>	art Five Payout Policy and Capital Structur	<u>e</u>	I Part Eleven Conclusion	
16	Payout Policy "	419	34 Conclusion: What We Do and Do Not	
	Does Debt Policy Matter?	446	Know about Finance	900
	How Much Should a Corporation Borrow?			
	Financing and Valuation	100		

Contents

I Part One Value

1 Goals and Governance of the Firm 29

- 1-1 Corporate Investment and Financing Decisions 30 Investment Decisions/Financing Decisions/Wljal Is a Corporation?
- 1-2 The Role of the Financial Manager and the Opportunity Cost of Capital 34

 The. Investment Trade-off
- 1-3 Goals of the Corporation 37
 Shareholders Want Managers to Maximize Market
 Value/A Fundamental Result/ShoxAd Managers Look
 After the Interests of TI)eir Shareholders f/Should Firms 3-3
 Be Managed for Shareholders or All Stakeholders?
- 1-4 Agency Problems and Corporate Governance 40
 Pushing Subprime Mortgages: Value Maximization
 Run Amok, or an Agency Problem?/Agency Problems
 Are Mitigated by Good Systems of Corporate
 Governance

Summary 43 * Problem Sets 44 o Appendix: Foundations of the Net Present Value Rule 46

2 How to Calculate Present Values 48

- 2-1 Future Values and Present Values 49

 Calculating Future Values/Calculating Present

 Values/Calculating the Present Value of an Investment

 Opportunity/Net Present Value/Risk and Present

 Value/Present Values and Rates of Return/Calculating

 Present Values When Tliere Are Multiple Cash Flows/

 T})e Opportunity Cost of Capital
- 2-2 Looking for Shortcuts—Perpetuities and
 Annuities 55
 How to Value Perpetuities/How to Value Annuities/
 PV Annuities Due/Calculating Annual Payments/
 Future Value of an Annuity
- **2-3** More Shortcuts—Growing Perpetuities and Annuities 61

 Growing Perpetuities/Growing Annuities

2-4 How Interest Is Paid and Quoted 63
 Continuous Compounding

 Summary 67 « Problem Sets 67
 Real-Time Data Analysis 71

3 Valuing Bonds 73

- 3-1 Using the Present Value Formula to Value Bonds 74 A Short Trip to Paris to Value a Government Bond/Back to the United States: Semiannual Coupons and Bond Prices
- 3-2 How Bond Prices Vary with Interest Rates 77 Duration and Volatility
- 3-3 The Term Structure of Interest Rates 81

 Spot Rates, Bond Prices, and the Law of One Price/
 Measuring the Term Structure/Why the Discount
 Factor Declines as Futurity Increases—and a
 Digression on Money Machines
- 3-4 Explaining the Term Structure 85

 Expectations Tljeory of the Term Structure/Introducing
 Risk/Inflation and Term Structure
- 3-5 Real and Nominal Rates of Interest 87
 Indexed Bonds and the Real Rate of Interest/Wljat
 Determines the Real Rate of Interest?/Inflation and
 Nominal Interest Rates
- 3-6 Corporate Bonds and the Risk of Default 93
 Corporate Bonds Come in Many Forms

 Summary 96 <> Further Reading 97
 Problem Sets 97

4 The Value of Common Stocks 102

- 4-1 How Common Stocks Are Traded 103
- 4-2 How Common Stocks Are Valued 104

 Valuation by Comparables/Tlje Determinants of

 Stock Prices/Today's Price/But What Determines

 Next Year's Price?
- 4-3 Estimating the Cost of Equity Capital 109

 Using the DCF Model to Set Gas and Electricity

 Prices/Dangers Lurk in Constant-Growth Formulas

- 4-4 The Link between Stock Price and Earnings per Share 115

 Calculating the Present Value of Growth

 Opportunities for Fledgling Electronics
- 4-5 Valuing a Business by Discounted Cash
 Flow 118
 Valuing the Concatenator Business/Valuation
 Format/Estimating Horizon Value/A Further
 Reality Check

Summary 122 • Further Reading 123 Problem Sets 123 o Real-Time Data Analysis 127 Mini-Case: Reeby Sports 128

5 Net Present Value and Other Investment Criteria 129

- 5-1 A Review of the Basics 129
 Net Present Value's Competitors/Three Points to
 Remember about NPV/NPV Depends on Cash
 Flow, Not on Book Returns
- 5-2 Payback 133

 Discounted Payback
- 5-3 Internal (or Discounted-Cash-Flow) Rate ofReturn 135

 Calculating the IRR/The IRR Rule/Pitfall

 I—Lending or Borrowing?/Pitfall 2—Multiple Rates of 'Return/'Pitfall 3—Mutually Exclusive Projects/Pitfall 4—What Happens When There Is More Than One Opportunity Cost of Capital?/The Verdict on IRR
- 5-4 Choosing Capital Investments When Resources Are Limited 143 An Easy Problem in Capital Rationing/Uses of Capital Rationing Models

Summary 147 • Further Reading 148 Problem Sets 148

Mini-Case: Vegetron's CFO Calls Again-152

6 Making Investment Decisions with the Net Present Value Rule 155

6-1 Applying the Net Present Value Rule 156
Rule 1: Only Cash Flow Is Relevant/Rule 2:
Estimate Cash Flows on an Incremental Basis/Rule
3: Treat Inflation Consistently

- 6-2 Example-IM&C'S Fertilizer Project 160
 Separating Investment and Financing
 Decisions/Investments in Working Capital/A
 Further Note on Depreciation/A Final Comment on
 Taxes/Project Analysis/Calculating NPVin Other
 Countries and Currencies
- 6-3 Investment Timing 168
- 6-4 Equivalent Annual Cash Flows 169
 Investing to Produce Reformulated Gasoline at
 California Refineries/Choosing Between Long- and
 Short-Lived Equipment/Equivalent Annual Cash
 Flow and Inflation/ Equivalent Annual Cash Flow
 and Technological Change/Deciding When to Replace
 an Existing Machine

Summary 174 « Problem Sets 174

Mini-Case: New Economy Transport (A) and (B) 182

I Part Two Risk

7 Introduction to Risk and Return 184

- 7-1 Over a Century of Capital Market History in
 One Easy Lesson 184

 Arithmetic Averages and Compound Annual
 Returns/Using Historical Evidence to Evaluate Today's
 Cost of Capital/Dividend Yields and the Risk Premium
- 7-2 Measuring Portfolio Risk 191

 Variance and Standard Deviation/Measuring

 Variability/How Diversification Reduces Risk
- 7-3 Calculating Portfolio Risk 198

 General Formula for Computing Portfolio

 Risk/Limits to Diversification
- 7-4 How Individual Securities Affect Portfolio Risk 202

 Market Risk Is Measured by Beta/Why Security

 Betas Determine Portfolio Risk
- 7-5 Diversification and Value Additivity 205Summary 206

 Further Reading 207Problem Sets 207

8 Portfolio Theory and the Capital Asset Model Pricing 213

8-1 Harry Markowitz and the Birth of Portfolio
Theory 213
Combining Stocks into Portfolios/We Introduce
Borrowing and Lending

- 8-2 The Relationship between Risk and Return 220

 Some Estimates of Expected Returns/Review of the Capital Asset-Pricing Model/What If a Stock Did Not Lie on the Security Market Line?
- 8-3 Validity and Role of the Capital Asset Pricing
 Model 223

 Tests of the Capital Asset Pricing Model/Assumptions
 behind the Capital Asset Pricing Model
- 8-4 Some Alternative Theories 227
 Arbitrage Pricing Theory/A Comparison of the
 Capital Asset Pricing Model and Arbitrage Pricing
 TI)eory/The J7; ree-Factor Model

Summary 231 • Further Reading 232
Problem Sets 232 o Real-Time Data Analysis 238
Mini-Case: John and Marsha on Portfolio
Selection 239

9 Risk and the Cost of Capital 241

- 9-1 Company and Project Costs of Capital 242

 Perfect Pitch and the Cost of Capital/Debt and the

 Company Cost of Capital
- 9-2 Measuring the Cost of Equity 245

 Estimating Beta/Tlie Expected Return on Union

 Pacific Corporation's Common Stock/Union

 Pacific's After-Tax Weighted-Aijerage Cost of

 Capital/Union Pacific's Asset Beta
- 9-3 Analyzing Project Risk 249
 What Determines Asset Betas ?/Don't Be Fooled by
 Diversifiable Risk/Avoid Fudge Factors in Discount
 Rates/Discount Rates for International Projects
- 9-4 Certainty Equivalents—Another Way to Adjust for Risk 255

 Valuation by Certainty Equivalents/When to Use a Single Risk-Adjusted Discount Rate for Long-Lived Assets/A Common Mistake/When You Cannot Use a Single Risk-Adjusted Discount Rate for Long-Lived Assets

Summary 260 • Further Reading 261 Problem Sets 261 • Real-Time Data Analysis 265 Mini-Case: The Jones Family, Incorporated 266

I Part Three Best Practices in Capital Budgeting

10 Project Analysis 268

- **10-1** The Capital Investment Process 269

 Project Authorizations—and the Problem of Biased
 Forecasts/Postaudits
- 10-2 Sensitivity Analysis 271

 Value of Information/Limits to Sensitivity Analysis/
 Scenario Analysis/Break-Even Analysis/Operating
 Leverage and the Break-Even Point
- **10-3** Monte Carlo Simulation 277
 Simulating the Electric Scooter Project
- 10-4 Real Options and Decision Trees 281

 Tlx? Option to Expand/The Option to

 Abandon/Production Options/Timing Options/More
 on Decision Trees/Pro and Con Decision Trees

Summary 288 • Further Reading 289 Problem Sets 290

Mini-Case: Waldo County 294

II Investment, Strategy, and Economic Rents 296

- **11-1** Look First to Market Values 296 *Tl)e Cadillac and the Movie Star*
- **11-2** Economic Rents and Competitive Advantage 301
- 11-3 Marvin Enterprises Decides to Exploit a New Technology—an Example 304
 Forecasting Prices of Gargle Blasters/Tfje Value of Marvin's New Expansion/Alternative Expansion
 Plans/Tin Value of Marvin Stock/TI)e Lessons of Marvin Enterprises

Summary 311 • Further Reading 312 Problem Sets 312

Mini-Case: Ecsy-Cola 317

12 Agency Problems, Compensation, and Performance Measurement 318

12-1 Incentives and Compensation 318

Agency Problems in Capital Budgeting/

Monitoring/Management Compensation/Incentive

Compensation

- **12-2** Measuring and Rewarding Performance: Residual Income and EVA 326 *Pros and Cons of EVA*
- 12-3 Biases in Accounting Measures of
 Performance 329
 Example: Measuring the Profitability of the
 Nodhead Supermarket/Measuring Economic
 Profitability/Do the Biases Wash Out in the
 Long Run ?/What Can We Do about Biases in
 Accounting Profitability Measures ?/Framings and
 Earnings Targets

Summary 335 o Further Reading 335 Problem Sets 336

I Part Four Financing Decisions and Market Efficiency

13 Efficient Markets and Behavioral Finance 340

- **13-1** We Always Come Back to NPV 341

 Differences between Investment and Financing
 Decisions
- 13-2 What Is an Efficient Market? 342

 A Startling Discovery: Price Changes Are
 Random/Time Forms of Market Efficiency/Efficient
 Markets: Jl)e Evidence
- 13-3 The Evidence against Market Efficiency 349

 Do Investors Respond Slowly to New

 Information ?/Bubbles and Market Efficiency
- 13-4 Behavioral Finance 355

 Limits to Arbitrage/Incentive Problems and the Subprime Crisis
- 13-5 The Six Lessons of Market Efficiency 358

 Lesson I: Markets Have No Memory/Lesson
 2: Trust Market Prices/Lesson 3: Read the
 Entrails/Lesson 4: There Are No Financial
 Illusions/Lesson 5: Tin Do-It-Yourself
 Alternative/Lesson 6: Seen One Stock, Seen Tliem
 All/What if Markets Are Not Efficient? Implications
 for the Financial Manager

Summary 363 • Further Reading 364 Problem Sets 365

14 An Overview of Corporate Financing 369

- 14-1 Patterns of Corporate Financing 369

 Do Firms Rely Too Much on Internal Funds?/How

 Much Do Firms Borrow?
- 14-2 Common Stock 373

 Ownership of the Corporation/Voting

 Procedures/Dual-class Shares and Private

 Benefits/Equity in Disguise/Preferred Stock
- 14-3 Debt 379

 Debt Comes in Many Forms/A Debt by Any Other

 Name/Variety V the Very Spice of Life
- **14-4** Financial Markets and Institutions 382

 The Financial Crisis of 2007-2009/The Role of Financial Institutions

Summary 385 » Further Reading 386 Problem Sets 387 « Real-Time Data Analysis 389

15 How Corporations issue Securities 390

- **15-1** Venture Capital 390

 Tin Venture Capital Market
- 15-2 The Initial Public Offering 394

 Arranging an Initial Public Offering/The Sale of

 Marvin Stock/Tlie Underwriters/Costs of a New

 Issue/Underpricing of IPOs/Hot Ne?&-Issue Periods
- **15-3** Alternative Issue Procedures for IPOs 403 *Types of Auction: a Digression*
- 15-4 Security Sales by Public Companies 404
 General Cash Offers/International Security
 Issues/The Costs of a General Cash Offer/Market
 Reaction to Stock Issues/Rights Issues
- 15-5 Private Placements and Public Issues 409 Summary 410 « Further Reading 411 Problem Sets 411 o Real-Time Data Analysis 415 Appendix: Marvin's New-Issue Prospectus 415

I Part Five Payout Policy and Capital Structure

16 Payout Policy 419

16-1 Facts about Payout 419

- 16-2 How Firms Pay Dividends and Repurchase Stock 420 How Firms Repurchase Stock
- 16-3 How Do Companies Decide on Payouts? 422
- **16-4** The Information in Dividends and Stock Repurchases 424

 TIJC Information Content of Share Repurchases
- 16-5 The Payout Controversy 425
 Dividend Policy Is Irrelevant in Perfect
 Capital Markets/Dividend Irrelevance—An
 Illustration/Calculating Share Price/Stock
 Repurchase/Stock Repurchase and Valuation
- **16-6** The Rightists 430

 Payout Policy, Investment Policy, and Management
 Incentives
- 16-7 Taxes and the Radical Left 432
 Why Pay Any Dividends at All?/Empirical Evidence
 on Dividends and Taxes/Tfje Taxation of Dividends
 and Capital Gains/Alternative Tax Systems
- 16-8 The Middle-of-the-Roaders 437
 Payout Policy and the Life Cycle of the Firm

 Summary 439 Further Reading 440
 Problem Sets 440

17 Does Debt Policy Matter? 446

- 17-1 The Effect of Financial Leverage in a Competitive Tax-free Economy 447

 Enter Modigliani and Miller/The Law of Conservation of Value/An Example of Proposition I
- 17-2 Financial Risk and Expected Returns 452

 Proposition 2/How Changing Capital Structure

 Affects Beta
- 17-3 The Weighted-Average Cost of Capital 456

 Two Warnings/Rates of Return on Levered.

 Equity—The Traditional Position/Today's

 Unsatisfied Clienteles Are Probably Interested in

 Exotic Securities/Imperfections and Opportunities
- 17-4 A Final Word on the After-Tax Weighted-Average Cost of Capital 461Summary 462 o Further Reading 462Problem Sets 463

18 How Much Should a Corporation Borrow? 468

- 18-1 Corporate Taxes 468

 How Do Interest Tax Shields Contribute to the Value of Stockholders' Equity?/Recasting Merck's Capital Structure/MM and Taxes
- 18-2 Corporate and Personal Taxes 472
- 18-3 Costs of Financial Distress 475

 Bankruptcy Costs/Evidence on Bankruptcy
 Costs/Direct versus Indirect Costs of
 Bankruptcy/Financial Distress without
 Bankruptcy/Debt and Incentives/Risk Shifting:
 The First Game/Refusing to Contribute Equity
 Capital: TIK Second Game/And Three More Games,
 Briefly/Wliat the Games Cost/Costs of Distress Vary
 with Type of Asset/Tin Trade-off T7)eory of Capital
 Structure
- 18-4 The Pecking Order of Financing Choices

 Debt and Equity Issues with Asymmetric

 Information/Implications of the. Pecking Order/The

 Trade-off Tlieory vs. the Pecking-Order Theory—Some

 Recent Tests/The Bright Side and the Dark Side

 of Financial Slack/Is Tliere a Theory of Optimal

 Capital Structure?

Summary 493 o Further Reading 495 Problem Sets 495

19 Financing and Valuation 499

- 19-1 The After-Tax Weigh ted-Average Cost of Capital 499 Review of Assumptions
- 19-2 Valuing Businesses 503

 Valuing Rio Corporation/Estimating Horizon

 Value/WACC vs. the Flow-to-Equity Method
- 19-3 Using WACC in Practice 507

 Some Tricks of the Trade/'Mistakes People Make in
 Using the Weighted-Average Formula/Adjusting
 WACC When Debt Ratios and Business Risks
 Differ/Unlevering ami Relevering Betas/The
 Importance of Rebalancing/The Modigliani-Miller
 Formula, Plus Some Final Advice

19-4 Adjusted Present Value 514

APVfor the Perpetual Crusher/Other Financing Side Effects/APVfor Businesses/APV'for International Investments

19-5 Your Questions Answered 518

Summary 520 o Further Reading 521

Problem Sets 522 o Appendix: Discounting Safe,

Nominal Cash Flows 526

I Part Six Options

20 Understanding Options 530

- 20-1 Calls, Puts, and Shares 531
 Call Options and Position Diagrams/Put
 Options/Selling Calls, Puts, and Shares/Position
 Diagrams Are Not Profit Diagrams
- **20-2** Financial Alchemy with Options 535 *Spotting the Option*
- 20-3 What Determines Option Values? 541
 Risk and Option Values

 Summary 547 o Further Reading 547
 Problem Sets 547 Real-Time Data Analysis 552

21 Valuing Options 553

- 21-1 A Simple Option-Valuation Model 553

 Why Discounted Cash Flow Won't Work for
 Options/Constructing Option Equivalents from
 Common Stocks and Borrowing/Valuing the Google
 Put Option
- 21-2 The Binomial Method for Valuing
 Options 558

 Example: The Two-Stage Binomial Method/Tlie
 General Binomial Method/The Binomial Method
 and Decision Trees
- 21-3 The Black-Scholes Formula 562

 Using the Black-Scholes Formula/The Risk of
 an Option/The Black-Scholes Formula and the
 Binomial Method
- 21-4 Black-Scholes in Action 566

 Executive Stock Options/Warrants/Portfolio
 Insurance/Calculating Implied Volatilities

- **21-5** Option Values at a Glance 570
- 21-6 The Option Menagerie 571

Summary 572 o Further Reading 572

Problem Sets 573 © Real-Time Data Analysis 577

Mini-Case: Bruce Honiball's Invention 577 Appendix: How Dilution Affects Option

Value 578

22 Reai Options 582

- 22-1 The Value of Follow-on Investment
 Opportunities 582
 Questions and Answers about Blitzen's Mark
 Il/Other Expansion Options
- 22-2 The Timing Option 586

 Valuing the Malted Herring Option/Optimal Timing
 for Real Estate Development
- 22-3 The Abandonment Option 589

 The Zircon Subductor Project/Abandonment Value and Project Life/Temporary Abandonment
- **22-4** Flexible Production 594
- **22-5** Aircraft Purchase Options 595
- **22-6** A Conceptual Problem? 597 *Practical Challenges*

Summary 599 • Further Reading 600 Problem Sets 600

I Part Seven Debt Financing

23 Credit Risk and the Value of Corporate Debt 605

- **23-1** Yields on Corporate Debt 605 What Determines the Yield Spread?
- 23-2 The Option to Default 609

 How the Default Option Affects a Bond's Risk and
 Yield/A Digression: Valuing Government Financial
 Guarantees
- **23-3** Bond Ratings and the Probability of Default 615
- **23-4** Predicting the Probability of Default 616 Credit Scoring/Market-Based Risk Models

23-5 Value at Risk 620 Summary 622 * Further Reading 622 Problem Sets 623 • Real-Time Data Analysis 624

24 The Many Different Kinds of Debt 625

- **24-1** Domestic Bonds, Foreign Bonds, and Eurobonds 626
- **24-2** The Bond Contract 627 *Indenture, or Trust Deed/The Bond Terms*
- **24-3** Security and Seniority 629 *Asset-Backed Securities*
- **24-4** Repayment Provisions 631 Sinking Funds/Call Provisions
- 24-5 Debt Covenants 633
- 24-6 Convertible Bonds and Warrants 635

 TIK Value of a Convertible, at Maturity/
 Forcing Conversion/Why Do Companies
 Issue Convertibles?/Valuing Convertible Bonds/A
 Variation on Convertible Bonds: The Bond-Warrant
 Package
- 24-7 Private Placements and Project Finance 640

 Project Finance/Project Finance—Some Common

 Features/Tlje Role of Project Finance
- **24-8** Innovation in the Bond Market 643 Summary 645 • Further Reading 646 Problem Sets 647

Mini-Case: The Shocking Demise of Mr. Thorndike 651

25 Leasing 653

- 25-1 What Is a Lease? 653
- **25-2** Why Lease? 654

 Sensible Reasons for Leasing/Some Dubious Reasons for Leasing
- **25-3** Operating Leases 658

 Example of an Operating Lease/Lease or Buy?
- 25-4 Valuing Financial Leases 660

 Example of a Financial Lease/Who Really Owns
 the Leased Asset?/Leasing and the Internal
 Revenue Service/A First Pass at Valuing a Lease
 Contract/The Story So Ear

- **25-5** When Do Financial Leases Pay? 665 *Leasing Around the World*
- 25-6 Leveraged Leases 666

 Summary 668 <>> Further Reading 668

 Problem Sets 669

I Part Eight Risk Management

26 Managing Risk 673

- 26-1 Why Manage Risk? 673

 Reducing the Risk of Cash Shortfalls or Financial
 Distress/Agency' Costs May Be Mitigated by Risk
 Management/The Evidence on Risk Management
- **26-2** Insurance 676

 How BP Changed Its Insurance Strategy
- 26-3 Reducing Risk with Options 679
- 26-4 Forward and Futures Contracts 680

 A Simple Foiward Contract/Futures Exchanges/Tlje
 Mechanics of Futures Trading/Trading and Pricing
 Financial Futures Contracts/Spot and Futures
 Prices—Commodities/More about Forward
 Contracts/Homemade Forward Rate Contracts
- 26-5 Swaps 688
 Interest Rate Swaps/Currency Swaps/Total Return
 Swaps
- 26-6 How to Set Up a Hedge 69226-7 Is "Derivative" a Four-Letter Word? 694Summary 696 © Further Reading 697Problem Sets 698

27 Managing tnternational Risks 704

- 27-1 The Foreign Exchange Market 704
- 27-2 Some Basic Relationships 706
 Interest Rates and Exchange Rates/The Forward
 Premium and Changes in Spot Rates/Changes in the
 Exchange Rate and Injlatt'on Rates/Interest Rates
 and Inflation Rates/Is Life Really Tliat Simple?
- **27-3** Hedging Currency Risk 715 *Transaction Exposure and Economic Exposure*

25i

27-4 Exchange Risk and International Investment
 Decisions 718
 TI)e Cost of Capital for International Investments/
 Do Some Countries Have a Lower Interest Rate?

27-5 Political Risk 722

Summary 724 o Further Reading 725 Problem Sets 726 • Real-Time Data Analysis 729 Mini-Case: Exacta, s.a. 730

I Part Nine Financial Planning and Working Capital Management

28 Financial Analysis 732

- **28-1** Financial Statements 732
- **28-2** Lowe's Financial Statements 733

 TIK Balance Sheet/The Income Statement
- 28-3 Measuring Lowe's Performance 736

 Economic Value Added (E VA)/Accounting Rates of
 Return/Problems with EVA and Accounting Rates
 of Return
- 28-4 Measuring Efficiency 741
- 28-5 Analyzing the Return on Assets: the Du Pont System 742 77:f Du Pont System
- **28-6** Measuring Leverage 744

 Leverage and the Return on Equity
- **28-7** Measuring Liquidity 746
- **28-8** Interpreting Financial Ratios 748 Summary 752 o Further Reading 752 Problem Sets 753

29 Financial Planning 759

- **29-1** Links between Short-Term and Long-Term Financing Decisions 759
- **29-2** Tracing Changes in Cash 762 *The Cash Cycle*
- 29-3 Cash Budgeting 765

 Preparing the Cash Budget: Inflows/Preparing the
 Cash Budget: Outflows

- **29-4** The Short-Term Financing Plan 768

 Options for Short-Term Financing/Dynamic's

 Financing Plan/Evaluating the Plan/A Note on

 Short-Term Financial Planning Models
- 29-5 Long-term Financial Planning 771

 Why BuildFinancialPlans?/A Long-Term

 Financial Planning Model for Dynamic Mattress/

 Pitfalls in Model Design/Choosing a Plan
- 29-6 Growth and External Financing 776Summary 777 o Further Reading 778Problem Sets 778 o Real-Time Data Analysis 784

30 Working Capital Management 785

- **30-1** Inventories 786
- **30-2** Credit Management 788

 Terms of Sale/Tlie Promise to Pay/Credit

 Analysis/The Credit Decision/Collection Policy
- 30-3 Cash 794

 How Purchases Are Paid For/Speeding Up Check

 Collections/International Cash Management/Paying
 for Bank Services
- 30-4 Marketable Securities 799

 Calculating the Yield on Money-Market
 Investments/Yields on Money-Market
 Investments/The International Money
 Market/'Money-Market Instruments
- **30-5** Sources of Short-Term Borrowing 805

 Bank Loans/Commercial Paper/Medium-Term

 Notes

Summary 810 * Further Reading 812 Problem Sets 812 o Real-Time Data Analysis 819

I **Part Ten** Mergers, Corporate Control, and Governance

31 Mergers 820

31-1 Sensible Motives for Mergers 820

Economies of Scale/Economies of Vertical
Integration/Complementary Resources/Surplus
Funds/Eliminating Inefficiencies/Industry
Consolidation

- 31-2 Some Dubious Reasons for Mergers 826

 Diversification/Increasing Earnings per Share: Tlie
 Bootstrap Game/Lower Financing Costs
- 31-3 Estimating Merger Gains and Costs 829
 Right and Wrong Ways to Estimate the
 Benefits of Mergers/More on Estimating
 Costs—What If the Target's Stock Price
 Anticipates the Merger?/Estimating Cost
 Wlnn the Merger Is Financed by Stock/Asymmetric
 Information
- 31-4 The Mechanics of a Merger 833

 Mergers, Antitrust Law, and Popular Opposition/
 The Form of Acquisition/Merger Accounting/Some
 Tax Considerations
- 31-5 Proxy Fights, Takeovers, and the Market for Corporate Control 836

 Proxy Contests/Takeovers/Oracle Bids for PeopleSoft/Takeover Defenses/Who Gains Most in Mergers?
- 31-6 Mergers and the Economy 842
 Merger Waves/Do Mergers Generate Net Benefits?

 Summary 844 o Further Reading 845
 Problem Sets 845 » Appendix: Conglomerate
 Mergers and Value Additivity 849

32 Corporate Restructuring 852

- **32-1** Leveraged Buyouts 852

 RJR Nabisco/Barbarians at the Gate?/Leveraged

 Restructurings/LB Os and Leveraged Restructurings
- **32-2** Fusion and Fission in Corporate Finance 857 Spin-offs/Cawe-outs/'Asset Sales/Privatization and Nationalization
- **32-3** Private Equity 861

 Private-Equity Partnerships/Are Private-Equity
 Funds Today's Conglomerates?
- **32-4** Bankruptcy 867

 Is Chapter II Efficient?/Workouts/Alter native
 Bankruptcy Procedures

Summary 872 *a* Further Reading 873 Problem Sets 874

33 Governance and Corporate Control Around the World 878

- **33-1** Financial Markets and Institutions 878

 Investor Protection and the Development of Financial

 Markets
- 33-2 Ownership, Control, and Governance 883

 Ownership and Control in Japan/Ownership
 and Control in Germany/European Boards
 of Directors/Ownership and Control in Other
 Countries/Conglomerates Revisited
- 33-3 Do These Differences Matter? 891
 Risk and Short-termism/'Growth Industries
 and Declining Industries/Transparency and
 Governance

Summary 895 *o* Further Reading 896 Problem Sets 896

I Part Eleven Conclusion

34 Conclusion: What We Do and Do Not Know about Finance 900

- 34-1 What We Do Know: The Seven Most
 Important Ideas in Finance 900
 /. Net Present Value/2. The Capital Asset Pricing
 Model/3. Efficient Capital Markets/4. Value
 Additivity and the Law of Conservation of Value/5.
 Capital Structure T7jeory/6. Option Tf)eory/7.
 Agency Theory
- 34-2 What We Do Not Know: 10 Unsolved Problems in Finance 903

 /. What Determines Project Risk and Present Value?/2.
 Risk and Return— What Have We Missed?/3. How Important Are the Exceptions to the Efficient-Market TlKory?/4. Is Management an Off-Balance-Sheet Liability?/5. How Can We Explain the Success of New Securities and New Markets?/^. How Can We Resolve the Payout Controversy?/?. What Risks Should a Firm Take?/8. What Is the Value of Liquidity?/9. How Can We Explain Merger Waves?/10. Why Are Financial Systems So Prone to Crisis?

34-3 A Final Word 909

Glossary 910

Index 928

Note: Present value tables are available on the book's

Web site, www.mhhe.com/bma.