SIXTH EDITION

Corporate Finance

STEPHEN A. ROSS
Yale University

RANDOLPH W. WESTERFIELD University of Southern California

JEFFREY JAFFE
Wharton School of Business
University of Pennsylvania



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 Delhì Santiago Seoul Singapore Sydney Taipei Toronto

Contents

Accounting Liquidity 22 Debt versus Equity 24 Value versus Cost 24
2.2 The Income Statement 25
Generally Accepted Accounting Principles 26
Noncash Items 26 Time and Costs 26 2.3 Net Working Capital 27 2.4 Financial Cash Flow 27 2.5 Summary and Conclusions 30 Appendix 2A Financial Statement Analysis 33 Appendix 2B Statement of Cash Flows 40 Appendix 2C U.S. Federal Tax Rates 42
Part II
Value and Capital Budgeting 45
3 Financial Markets and Net Present Value: First Principles of Finance (Advanced) 46
 3.1 The Financial Market Economy 46 The Anonymous Market 47 Market Clearing 47 3.2 Making Consumption Choices over Time 48 3.3 The Competitive Market 51 How many Interest Rates Are There in a Competitive Market? 52 3.4 The Basic Principle 52 3.5 Practicing the Principle 53 A Lending Example 53 A Borrowing Example 54

4 Net Present Value 66	The No-Dividend Firm 118
Executive Summary 66 4.1 The One-Period Case 66 4.2 The Multiperiod Case 70 Future Value and Compounding 70 The Power of Compounding: A Digression 73 Present Value and Discounting 74 The Algebraic Formula 78 4.3 Compounding Periods 79 Distinction between Stated Annual Interest	5.7 The Dividend-Growth Model and the NPVGO Model (Advanced) 119 The Dividend Growth Model 119 The NPVGO Model 119 Summation 121 5.8 Price-Earnings Ratio 121 5.9 Stock Market Reporting 123 5.10 Summary and Conclusions 124 Appendix 5A The Term Structure of Interest Rates, Spot Rates, and Yield to Maturity 130
Rate and Effective Annual Interest	6 Came Altermative Investment Dules 140
Rate 80 Compounding over Many Years 81 Continuous Compounding (Advanced) 81 4.4 Simplifications 83 Perpetuity 83 Growing Perpetuity 84 Annuity 86 Growing Annuity 91 Case Study: Making the Decision to Convert Lottery Prize Winnings: The Case of the Singer Asset Finance Company 93 4.5 What Is a Firm Worth? 94 4.6 Summary and Conclusions 95	Executive Summary 140 6.1 Why Use Net Present Value? 140 6.2 The Payback Period Rule 141 Defining the Rule 141 Problems with the Payback Method 142 Managerial Perspective 143 Summary of the Payback Period Rule 143 6.3 The Discounted Payback Period Rule 143 6.4 The Average Accounting Return 144 Defining the Rule 144 Analyzing the Average Accounting Return Method 146
5 How to Value Bonds and Stocks 102	6.5 The Internal Rate of Return 146
Executive Summary 102 5.1 Definition and Example of a Bond 102 5.2 How to Value Bonds 102 Pure Discount Bonds 102 Level-Coupon Bonds 103 Consols 105 5.3 Bond Concepts 106 Interest Rates and Bond Prices 106 Yield to Maturity 106 Bond Market Reporting 107 5.4 The Present Value of Common Stocks 108 Dividends versus Capital Gains 108 Valuation of Different Types of Stocks 109 5.5 Estimates of Parameters in the Dividend- Discount Model 112 Where Does g Come From? 113 Where Does r Come From? 114 A Healthy Sense of Skepticism 115	 6.6 Problems with the IRR Approach 149 Definition of Independent and Mutually Exclusive Projects 149 Two General Problems Affecting Both Independent and Mutually Exclusive Projects 149 Problems Specific to Mutually Exclusive Projects 153 Redeeming Qualities of the IRR 157 A Test 158 6.7 The Profitability Index 158 6.8 The Practice of Capital Budgeting 160 6.9 Summary and Conclusions 163 7 Net Present Value and Capital Budgeting 169 Executive Summary 169 7.1 Incremental Cash Flows 169
5.6 Growth Opportunities 115 Growth in Earnings and Dividends versus Growth Opportunities 117	Cash Flows—Not Accounting Income 169 Sunk Costs 170
Dividends or Earnings: Which to Discount? 118	Opportunity Costs 170 Side Effects 171

		•			
	7.2	The Baldwin Company: An Example 171		9.2	Holding-Period Returns 225
		An Analysis of the Project 172		9.3	Return Statistics 231
		Which Set of Books? 175		9.4	Average Stock Returns and Risk-Free
		A Note on Net Working Capital 176			Returns 232
		Interest Expense 177		9.5	Risk Statistics 234
	7.3	Inflation and Capital Budgeting 177			Variance 234
		Interest Rates and Inflation 177			Normal Distribution and Its Implications
		Cash Flow and Inflation 180			for Standard Deviation 234
		Discounting: Nominal or Real? 181		9.6	Summary and Conclusions 236
	7.4	Investments of Unequal Lives: The		Appe	ndix 9A The Historical Market Risk
1		Equivalent Annual Cost Method 184			ium: The Very Long Run 240
ŀ		Replacement Chain 184			
		The General Decision to Replace	10	Retu	rn and Risk: The Capital-Asset-
		(Advanced) 187			ng Model (CAPM) 242
	7.5	Summary and Conclusions 189			
:		Study: Goodweek Tires, Inc. 198			utive Summary 242
		ndix 7A Depreciation 199		10.1	Individual Securities 242
				10.2	Expected Return, Variance, and
8	Strat	egy and Analysis in Using Net			Covariance 243
_		ent Value 200			Expected Return and Variance 243
					Covariance and Correlation 245
		utive Summary 200		10.3	The Return and Risk for
	8.1	Corporate Strategy and Positive NPV 200			Portfolios 247
		Corporate Strategy and the Stock			The Example of Supertech and
	_	Market 201			Slowpoke 248
	Case S	Study: How Firms Can Learn about NPV			The Expected Return on a Portfolio 248
		from the Stock Market: The AT&T			Variance and Standard Deviation of a
		Decision to Acquire NCR and to			Portfolio 249
		Change Its CEO 202 ·		10.4	The Efficient Set for Two Assets 252
	8.2	Decision Trees 203		10.5	The Efficient Set for Many
	8.3	Sensitivity Analysis, Scenario Analysis,			Securities 257
		and Break-Even Analysis 206			Variance and Standard Deviation in a
		Sensitivity Analysis and Scenario			Portfolio of Many Assets 259
		Analysis 206		10.6	Diversification: An Example 260
		Break-Even Analysis 209			Risk and the Sensible Investor 263
	8.4	Options 212		10.7	
		The Option to Expand 212			The Optimal Portfolio 266
		The Option to Abandon 213		10.8	•
.*		Discounted Cash Flows and Options 213			Definition of the Market-Equilibrium
		An Example 214			Portfolio 268
	8.5	Summary and Conclusions 215			Definition of Risk When Investors Hold
					the Market Portfolio 269
Part	·ш				The Formula for Beta 271
		-			A Test 271
Ris	k	219		10.9	Relationship between Risk and Expected
9	Coni	tal Market Theory: An Overview 220			Return (CAPM) 272
,	Capi	tal Market Theory: An Overview 220			Expected Return on Market 272
	Exec	utive Summary 220			Expected Return on Individual
	9.1	Returns 221			Security 273
		Dollar Returns 221		10.10	Summary and Conclusions 276
		Percentage Returns 222		Appe	ndix 10A Is Beta Dead? 283

A Y E J	ı	Contents			
11		Iternative View of Risk and Return: Arbitrage Pricing Theory 285	PAR		Standard Policy 22°
		utive Summary 285	Ca	busi s	Structure and Dividend Policy 337
		Factor Models: Announcements, Surprises, and Expected Returns 286	13		orate-Financing Decisions and ient Capital Markets 339
	11.2	Risk: Systematic and Unsystematic 287		Exect	utive Summary 339
		Systematic Risk and Betas 288			Can Financing Decisions Create
		Portfolios and Factor Models 291		_	Value? 339
		Portfolios and Diversification 293		13.2	A Description of Efficient Capital
	11.5	Betas and Expected Returns 295			Markets 341
		The Linear Relationship 295		13.3	**
		The Market Portfolio and the Single			The Weak Form 343
		Factor 297			The Semistrong and Strong Forms 346
	11.6	The Capital-Asset-Pricing Model and the			Some Common Misconceptions about the
		Arbitrage Pricing Theory 298			Efficient-Market Hypothesis 348
		Differences in Pedagogy 298		13.4	
		Differences in Application 298			The Weak Form 349
	11.7				The Semistrong Form 350
		Pricing 300		12.5	The Strong Form 359
		Empirical Models 300 Style Portfolios 301		13.5	Implications for Corporate Finance 359 Accounting and Efficient Markets 359
	118	Summary and Conclusions 302			The Timing Decision 361
	11.0	Summary and Concrusions 302			Price-Pressure Effects 364
12		, Cost of Capital, and Capital		13.6	
	Bud	geting 307	4.4	T	
	Execu	ative Summary 307	14		g-Term Financing: ntroduction 371
		The Cost of Equity Capital 307		All 1	ntroduction 3/1
	12.2	Estimation of Beta 310			utive Summary 371
		Real-World Betas 312		14.1	Common Stock 371
		Stability of Beta 312			Par and No-Par Stock 371
		Using an Industry Beta 313			Authorized versus Issued Common
	12.3	Determinants of Beta 315			Stock 372
		Cyclicality of Revenues 315			Capital Surplus 372
		Operating Leverage 316			Retained Earnings 372
	12.4	Financial Leverage and Beta 318			Market Value, Book Value, and Replacement Value 373
		Extensions of the Basic Model 319 The Firm versus the Project: Vive la			Shareholders' Rights 374
	1	Différence 319			Dividends 375
		The Cost of Capital with Debt 320			Classes of Stock 375
	12.5	Estimating International Paper's Cost of		14.2	Corporate Long-Term Debt:
		Capital 323			The Basics 376
		Cost of Equity and Debt 324			Interest versus Dividends 376
		Determining r _{WACC} 324			Is It Debt or Equity? 377
	12.6	Reducing the Cost of Capital 324			Basic Features of Long-Term Debt 377
		What Is Liquidity? 325			Different Types of Debt 377
		Liquidity, Expected Returns, and the Cost			Repayment 378
		of Capital 325			Seniority 378
		Liquidity and Adverse Selection 325			Security 378
		What the Corporation Can Do 326			Indenture 378
	12.7	water the state of		14.3	
	Minio	case: AlliedProducts 332			Stated Value 379

		Cumulative and Noncumulative Dividends 380			Direct Costs of Financial Distress: Legal and Administrative Costs of
		Is Preferred Stock Really Debt? 380			Liquidation or Reorganization 425
		The Preferred-Stock Puzzle 381			Indirect Costs of Financial Distress 426
	14.4	Patterns of Financing 382			Agency Costs 427
		Recent Trends in Capital Structure 385		16.3	Can Costs of Debt be Reduced? 430
		Which Are Best: Book or Market		20.2	Protective Covenants 430
		Values? 386			Consolidation of Debt 432
	14.6	Summary and Conclusions 387		164	Integration of Tax Effects and Financial
	17.0	Summary and Concresions 507		10.4	Distress Costs 432
15	Capi	tal Structure: Basic Concepts 390			Pie Again 433
	-	· · · · · · · · · · · · · · · · · · ·		16.5	
		ative Summary 390		10.5	Investments: A Note on Agency Cost
	15.1	The Capital-Structure Question and the			of Equity 435
	150	Pie Theory 390			Effect of Agency Costs of Equity on
·	15.2	Maximizing Firm Value Versus Maximizing			Debt-Equity Financing 437
		Stockholder Interests 391			Free Cash Flow 437
	15.3	Financial Leverage and Firm Value: An		16.6	
		Example 393		10.0	Rules of the Pecking Order 439
		Leverage and Returns to			Implications 440
		Shareholders 393		16.7	Growth and the Debt-Equity Ratio 441
		The Choice between Debt and		10.7	No-Growth 441
		Equity 395			Growth 441
		A Key Assumption 397		14 0	Personal Taxes 443
	15.4			10.8	
		(No Taxes) 398		16.0	The Miller Model 445
		Risk to Equityholders Rises with		10.9	How Firms Establish Capital Structure 448
		Leverage 398		16.10	
		Proposition II: Required Return to			Summary and Conclusions 452
		Equityholders Rises with			ndix 16A Some Useful Formulas of
		Leverage 399			cial Structure 461
		Example Illustrating Proposition I and			ndix 16B The Miller Model and the
		Proposition II 401			nated Income Tax 462
		MM: An Interpretation 405		_	tions and Problems 465.
	15.5	Taxes 408			ndix 16C 466
		The Basic Insight 408		Case	Study: The Decision to Use More Debt:
		The Quirk in the Tax Code 408			The Case of Goodyear Tire and
		Present Value of the Tax Shield 409			Rubber 466
		Value of the Levered Firm 410	15	Value	ation and Canital Budgetine for the
		Expected Return and Leverage under	17		ation and Capital Budgeting for the
		Corporate Taxes 411		Leve	red Firm 468
		The Weighted Average Cost of Capital		Execu	utive Summary 468
		r _{WACC} and Corporate Taxes 413		17.1	Adjusted-Present-Value Approach 468
		Stock Price and Leverage under		17.2	Flow-to-Equity Approach 470
		Corporate Taxes 414			Step 1: Calculating Levered Cash Flow
	15.6	Summary and Conclusions 416			(LCF) 470
1/	C	tal Cturatura, T turit- 4- 41- TIP			Step 2: Calculating r _s 471
10		ital Structure: Limits to the Use of			Step 3: Valuation 471
	Deb	t 422		17.3	Weighted-Average-Cost-of-Capital
	Exec	utive Summary ⁷ 422			Method 471
		Costs of Financial Distress 422		17.4	A Comparison of the APV, FTE, and
•		Bankruptcy Risk or Bankruptcy Cost? 422			WACC Approaches 473
	16.2	Description of Costs 425			A Suggested Guideline 474

18

17.5	Capital Budgeting When the Discount Rate Must Be Estimated 476		18.8	A Resolution of Real-World Factors? 514 Information Content of Dividends: A
17.6	APV Example 478			Brainteaser with Practical
*****	All-Equity Value 478			Applications 514
	Additional Effects of Debt 479			The Clientele Effect 515
17.7	Beta and Leverage 481		18.9	What We Know and Do Not Know about
	The Project Is Not Scale-Enhancing - 483		10.7	Dividend Policy 516
17.8	Summary and Conclusions 484			Corporate Dividends Are Substantial 516
	ndix 17A The Adjusted-Present-Value			Fewer Companies Pay Dividends 517
	oach to Valuing Leveraged Buyouts 489			Corporations Smooth Dividends 518
- 11				Dividends Provide Information to the
D:-23				Market 520
Divia	end Policy: Why Does It Matter? 495			A Sensible Dividend Policy 520
Execu	itive Summary 495		Case S	Study: How Firms Make the Decision to
	Different Types of Dividends 495			Pay Dividends: The Case of Apple
	Standard Method of Cash Dividend			Computer 521
	Payment 496		18.10	Summary and Conclusions 524
18.3	The Benchmark Case: An Illustration			ndix 18A Stock Dividends and Stock
	of the Irrelevance of Dividend Policy 498		Splits	529
	Current Policy: Dividends Set Equal to			
	Cash Flow 498	_		7
	Alternative Policy: Initial Dividend Is	PART	· V	
	Greater than Cash Flow 498	Lor	ıg-Ter	rm Financing 533
	The Indifference Proposition 499		•	C C
	Homemade Dividends 500	19	Issun	ng Securities to the Public 534
	A Test 502		Execu	ntive Summary 534
	Dividends and Investment Policy 502		19.1	The Public Issue 534
18.4	Taxes, Issuance Costs, and			The Basic Procedure for a New Issue 534
	Dividends 503		19.2	Alternative Issue Methods 535
	Firms without Sufficient Cash to Pay a		19.3	The Cash Offer 537
	Dividend 503			Investment Banks 539
	Firms with Sufficient Cash to Pay a			The Offering Price 541
	Dividend 504			Underpricing: A Possible Explanation 543
	Summary on Taxes 506		19.4	The Announcement of New Equity and
18.5	Repurchase of Stock 506			the Value of the Firm 543
	Dividend versus Repurchase 507			The Cost of New Issues 544
ļ.	Relationship between EPS and Market		19.6	Rights 547
	Value 507			The Mechanics of a Rights Offering 547
	Taxes 508			Subscription Price 548
	Targeted Repurchase 508			Number of Rights Needed to Purchase a
	Repurchase as Investment 508			Share 548
18.6	Expected Return, Dividends, and			Effect of Rights Offering on Price of
	Personal Taxes 509			Stock 549
	Empirical Evidence 510			Effects on Shareholders 550
18.7	Real-World Factors Favoring a High-			The Underwriting Arrangements 551
	Dividend Policy 512		19.7	The Rights Puzzle 551
:	Desire for Current Income 512		19.8	Shelf Registration 553
	Uncertainty Resolution 512		19.9	The Private Equity Market 554
	Tax Arbitrage 513			Private Placement 554
	Agency Costs 513			The Private Equity Firm 555

	Suppliers of Venture Capital 556	21.7 Debt Displacement and Lease
	Stages of Financing 557	Valuation 596
	Case Study: The Decision to Do an Initial Publi	•
	Offering (IPO): The Case of	(Advanced) 596
	Medstone International, Inc. 558	Optimal Debt Level in the Xomox
	19.10 Summary and Conclusions 560	Example (Advanced) 597
	•	21.8 Does Leasing Ever Pay:
20	Long-Term Debt 563	The Base Case 600
	_	21.9 Reasons for Leasing 601
	Executive Summary 563	Good Reasons for Leasing 601
	20.1 Long-Term Debt: A Review 563	Bad Reasons for Leasing 604
	20.2 The Public Issue of Bonds 564	21.10 Some Unanswered Questions 604
	The Basic Terms 565	Are the Uses of Leases and of Debt
	Security 566	Complementary? 605
	Protective Covenants 567	Why Are Leases Offered by Both
	The Sinking Fund 567	Manufacturers and Third-Party
	The Call Provision 568	Lessors? 605
	20.3 Bond Refunding 568	Why Are Some Assets Leased More Than
	 Should Firms Issue Callable Bonds? 56 	
	Calling Bonds: When Does It Make	21.11 Summary and Conclusions 605
	Sense? 572	Appendix 21A APV Approach to
	20.4 Bond Ratings 572	Leasing 608
	Junk Bonds 573	
	20.5 Some Different Types of Bonds 578	
	Floating-Rate Bonds 578	PART VI
	Deep-Discount Bonds 579	11.00
	•	
	Income Bonds 580	Options, Futures, and
	Income Bonds 580 20.6 Direct Placement Compared to Public	Options, Futures, and Corporate Finance 611
	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580	Corporate Finance 611 22. Ontions and Corporate Finance: Basic
	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58	Corporate Finance 611 22 Options and Corporate Finance: Basic
	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612
	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590	Corporate Finance 611 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt Capacity with Corporate Taxes 59	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620 Bounding the Value of a Call 621
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt Capacity with Corporate Taxes 59 Present Value of Riskless Cash	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620 Bounding the Value of a Call 621 The Factors Determining Call-Option Values 622
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt Capacity with Corporate Taxes 59 Present Value of Riskless Cash Flows 593 Optimal Debt Level and Riskless Cash Flows (Advanced) 594	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620 Bounding the Value of a Call 621 The Factors Determining Call-Option
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt Capacity with Corporate Taxes 59 Present Value of Riskless Cash Flows 593 Optimal Debt Level and Riskless Cash	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620 Bounding the Value of a Call 621 The Factors Determining Call-Option Values 622 A Quick Discussion of Factors
21	Income Bonds 580 20.6 Direct Placement Compared to Public Issues 580 20.7 Long-Term Syndicated Bank Loans 58 20.8 Summary and Conclusions 583 Leasing 586 Executive Summary 586 21.1 Types of Leases 586 The Basics 586 Operating Leases 587 Financial Leases 588 21.2 Accounting and Leasing 589 21.3 Taxes, the IRS, and Leases 590 21.4 The Cash Flows of Leasing 591 21.5 A Detour on Discounting and Debt Capacity with Corporate Taxes 59 Present Value of Riskless Cash Flows 593 Optimal Debt Level and Riskless Cash Flows (Advanced) 594	Corporate Finance 22 Options and Corporate Finance: Basic Concepts 612 Executive Summary 612 22.1 Options 612 22.2 Call Options 613 The Value of a Call Option at Expiration 613 22.3 Put Options 614 The Value of a Put Option at Expiration 614 22.4 Selling Options 616 22.5 Reading The Wall Street Journal 617 22.6 Combinations of Options 618 22.7 Valuing Options 620 Bounding the Value of a Call 621 The Factors Determining Call-Option Values 622 A Quick Discussion of Factors Determining Put-Option Values 624

					•
	22.9	Stocks and Bonds as Options 633			A Reconciliation 687
		The Firm Expressed in Terms of Call		24.7	Why are Warrants and Convertibles
		Options 634			Issued? 687
		The Firm Expressed in Terms of Put			Matching Cash Flows 687
		Options 635			Risk Synergy 687
		A Resolution of the Two Views 636			Agency Costs. 688
		A Note on Loan Guarantees 638			Backdoor Equity 688
	22.10	Capital-Structure Policy and Options 639		24.8	· · · · · · · · · · · · · · · · · · ·
		Selecting High-Risk Projects 639		24.9	Summary and Conclusions 690
		Mergers and Options 640			
	22.12	Investment in Real Projects and	25	Deri	vatives and Hedging Risk 695
	20.10	Options 642		Exect	utive Summary 695
	22.13	Summary and Conclusions 645			Derivatives, Hedging, and Risk 695
	0.4			25.1	Forward Contracts 696
23		ons and Corporate Finance:			Futures Contracts 697
	Exter	nsions and Applications 650			Hedging 703
	Execu	ntive Summary 650			Study: Making the Decision to Use
		Executive Stock Options 650			Derivatives: The Case of
	•	Why Options? 650			Metallgesellschaft 705
		Valuing Executive Compensation 652		25.4	Interest-Rate Futures Contracts 706
	23.2	Valuing a Start-Up 655			Pricing of Treasury Bonds 706
	23.3	More on the Binomial Model 658			Pricing of Forward Contracts 707
		Heating Oil 658			Futures Contracts 709
	23.4	Shutdown and Reopening Decisions 665			Hedging in Interest-Rate Futures 709
		Valuing a Gold Mine 665		25.5	Duration Hedging 714
		The Abandonment and Opening			The Case of Zero-Coupon Bonds 714
		Decisions 665			The Case of Two Bonds with the Same
		Valuing the Simple Gold Mine 667			Maturity but with Different
	23.5	Summary and Conclusions 671			Coupons 714
	,				Duration 716
24	Wart	ants and Convertibles 674			Matching Liabilities with Assets 718
	Execu	utive Summary 674		25.6	Swaps Contracts 721
		Warrants 674			Interest-Rate Swaps 721
	24.2	The Difference between Warrants and			Currency Swaps 722
		Call Options 676			Exotics 723
		How the Firm Can Hurt Warrant		25.7	Actual Use of Derivatives 724
٠.	1	Holders 678		25.8	Summary and Conclusions 725
	24.3	Warrant Pricing and the Black-Scholes			
		Model (Advanced) 679	_		
	24.4		PAR	r VII	·
	24.5	The Value of Convertible Bonds 681	Fin	ancia	l Planning and
		Straight Bond Value 681			rm Finance 731
		Conversion Value 681	•	C	weeks Einer siel Madels and Tone
		Option Value 682	26		oorate Financial Models and Long-
	24.6	Reasons for Issuing Warrants and		Tern	n Planning 732
		Convertibles 684		Exec	utive Summary 732
		Convertible Debt, versus Straight Debt 684			What Is Corporate Financial
		Convertible Debt versus Common			Planning? 733
		Stock 685		26.2	A Financial-Planning Model: The
		The "Free Lunch" Story 686			Ingredients 734
		The "Expensive Lunch" Story 686		26.3	What Determines Growth? 738

27

28

26.4	Some Caveats of Financial-Planning			Summary and Conclusions 790
26.5	Models 741			ndix 28A Adjustable-Rate Preferred
26.5	Summary and Conclusions 742			, Auction-Rate Preferred Stock, and ng-Rate Certificates of Deposit 793
Shor	t-Term Finance and Planning 746		110441	ing react Communities of Doposit 193
		29	Cred	it Management 798
	ative Summary 746			_
27.1	Tracing Cash and Net Working Capital 746			itive Summary 798
27.2	Defining Cash in Terms of Other		29.1	Terms of the Sale 798
	Elements 747			Credit Period 799
	The Sources-and-Uses-of-Cash			Cash Discounts 800
	Statement 748			Credit Instruments 801
27.3	The Operating Cycle and the Cash		29.2	The Decision to Grant Credit: Risk and
	Cycle 750			Information 802
27.4	Some Aspects of Short-Term Financial Policy 753			The Value of New Information about Credit Risk 804
	The Size of the Firm's Investment in			Future Sales 804
	Current Assets 753		29.3	Optimal Credit Policy 805
	Alternative Financing Policies for Current		29.4	Credit Analysis 808
	Assets 756		29.4	Credit Information 808
	Which Is Best? 758			
27.5	•		29.5	Credit Scoring 808 Collection Policy 809
27.5	Cash Outflow 760		29.3	Average Collection Period 809
	The Cash Balance 761			Aging Schedule 809
27.6				Collection Effort 810
27.0	Unsecured Loans 761			Factoring 810
	Secured Loans 762		29.6	
27.7	Other Sources 762		29.7	Summary and Conclusions 811
21.1	Summary and Conclusions 763			
Cash	Management 771	PAR	r VIII	· · · · · · · · · · · · · · · · · · ·
Exect	utive Summary 771	Spe	ecial T	Topics 81
28.1	Reasons for Holding Cash 772	30	Merg	gers and Acquisitions 816
28.2	Determining the Target Cash Balance 773		Evac	utive Summary 816
	The Baumol Model 773			The Basic Forms of Acquisitions 817
	The Miller-Orr Model 776			Merger or Consolidation 817
	Other Factors Influencing the Target Cash Balance 778			Acquisition of Stock 817
20.2				Acquisition of Assets 818
28.3	Managing the Collection and			A Classification Scheme 818
	Disbursement of Cash 779			A Note on Takeovers 818
	Accelerating Collections 782		20.2	The Tax Forms of Acquisitions 819
	Delaying Disbursements 786		30.2	
	Disbursement Float ("Playing the Float		30.3	The Purchase Method 821
	Game") 787			•
	Zero-Balance Accounts 787			Pooling of Interests 822
	Drafts 787			Purchase or Pooling of Interests: A
00.4	Ethical and Legal Questions 787		20.4	Comparison 822
28.4	Investing Idle Cash 788		50.4	Determining the Synergy from an
	Seasonal or Cyclical Activities 788		20.5	Acquisition 823
	Planned Expenditures 788		30.5	Source of Synergy from Acquisitions 82
	Different Types of Money-Market			Revenue Enhancement 824 Cost Reduction 825
	Securities 789			Cost reduction 025

	Tax Gains 827
	The Cost of Capital 829
30.6	Calculating the Value of the Firm after an
	Acquisition 829
	Avoiding Mistakes 830
30.7	<u> </u>
	Risk 830
	The Base Case 831
	One Firm Has Debt 832
	How Can Shareholders Reduce Their
	Losses from the Coinsurance
	Effect? 833
30.8	Two "Bad" Reasons for Mergers 833
	Earnings Growth 833
	Diversification 834
30.9	The NPV of a Merger 835
	Cash 835
	Common Stock 837
	Cash versus Common Stock 838
30.10	Defensive Tactics 838
	Divestitures 838
	The Corporate Charter 839
	Repurchase Standstill Agreements 839
	Exclusionary Self-Tenders 840
	Going Private and Leveraged Buyouts 840
	Other Devices and Jargon of Corporate
	Takeovers 841
30.11	Some Evidence on Acquisitions 842
	Do Acquisitions Benefit
1	Shareholders? 842
	The Short Run 842
	The Long Run 844
	Real Productivity 845
30.12	The Japanese Keiretsu 845
30.13	Summary and Conclusions 847.
Minic	case: U.S. Steel's Acquisition of
Mara	thon Oil 852
a. /	ncial Distress 854
31 ' Finai	ncial Distress 854
Execu	itive Summary 854
31.1	What Is Financial Distress? 854
31,2	What Happens in Financial Distress? 856
31.3	Bankruptcy Liquidation and
	Reorganization 857

Bankruptcy Liquidation 858
Bankruptcy Reorganization 862

Private Workout or Bankruptcy:

863

864

Which Is Best?

The Marginal Firm

Holdouts 864
Complexity 865
Lack of Information 865
31.5 Prepackaged Bankruptcy 865
Case Study: The Decision to File for Bankruptcy:
The Case of Revco 866
31.6 Summary and Conclusions 868
Appendix 31A Predicting Corporate
Bankruptcy: The Z-Score Model 869

32 International Corporate Finance 872

Executive Summary 872 32.1 Terminology 872 32.2 Foreign Exchange Markets and Exchange Rates 874 Exchange Rates 875 Types of Transactions 876 32.3 The Law of One Price and Purchasing-Power Parity 877 32.4 Interest Rates and Exchange Rates: Interest-Rate Parity 879 The Dollar Investment 879 The Deutschemark Investment 880 The Forward-Discount and Expected Spot Rates 881 Exchange-Rate Risk 881 Which Firms Hedge Exchange-Rate Risk? 883 32.5 International Capital Budgeting 883 Foreign Exchange Conversion 883 Unremitted Cash Flows 886 The Cost of Capital for International Firms 886 International Financial Decisions 888 Short-Term and Medium-Term Financing 889 International Bond Markets 889 32.7 Reporting Foreign Operations 891 32.8 Summary and Conclusions 892 Appendix A Mathematical Tables 897 Appendix B Solutions to Selected End-of-

Glossary 917 Name Index I-1 Subject Index I-4

Chapter Problems 913