

PART ONE OVERVIEW

CHAPTER ONE

Introduction to Corporate Finance 1

- 1.1 What Is Corporate Finance? 1
 - The Balance Sheet Model of the Firm 1*
 - The Financial Manager 3*
- 1.2 The Corporate Firm 4
 - The Sole Proprietorship 4*
 - The Partnership 4*
 - The Corporation 5*
 - A Corporation by Another Name . . . 6*
- 1.3 The Importance of Cash Flows 7
- 1.4 The Goal of Financial Management 9
 - Possible Goals 10*
 - The Goal of Financial Management 10*
 - A More General Goal 11*
- 1.5 The Agency Problem and Control of the Corporation 11
 - Agency Relationships 12*
 - Management Goals 12*
 - Do Managers Act in the Stockholders' Interests? 13*
 - Stakeholders 14*
- 1.6 Regulation 14
 - The Securities Act of 1933 and the Securities Exchange Act of 1934 16*

Summary and Conclusions 16

Closing Case: East Coast Yachts 18

CHAPTER TWO

Financial Statements and Cash Flow 19

- 2.1 The Balance Sheet 19
 - Accounting Liquidity 20*
 - Debt versus Equity 21*

Value versus Cost 21

- 2.2 The Income Statement 22
 - Generally Accepted Accounting Principles 22*
 - Noncash Items 23*
 - Time and Costs 24*
- 2.3 Taxes 24
 - Corporate Tax Rates 24*
 - Average versus Marginal Tax Rates 25*
- 2.4 Net Working Capital 27
- 2.5 Cash Flow of the Firm 28
- 2.6 The Accounting Statement of Cash Flows 31
 - Cash Flow from Operating Activities 31*
 - Cash Flow from Investing Activities 32*
 - Cash Flow from Financing Activities 32*

Summary and Conclusions 33

Closing Case: Cash Flows at East Coast Yachts 41

CHAPTER THREE

Financial Statements Analysis and Financial Models 43

- 3.1 Financial Statements Analysis 43
 - Standardizing Statements 43*
 - Common-Size Balance Sheets 44*
 - Common-Size Income Statements 45*
- 3.2 Ratio Analysis 46
 - Short-Term Solvency or Liquidity Measures 47*
 - Long-Term Solvency Measures 49*
 - Asset Management or Turnover Measures 50*
 - Profitability Measures 52*
 - Market Value Measures 53*
- 3.3 The DuPont Identity 56
 - A Closer Look at ROE 56*
 - Problems with Financial Statement Analysis 58*

- 3.4 Financial Models 59
 - A Simple Financial Planning Model* 59
 - The Percentage of Sales Approach* 61
- 3.5 External Financing and Growth 66
 - EFN and Growth* 66
 - Financial Policy and Growth* 68
 - A Note about Sustainable Growth Rate Calculations* 71
- 3.6 Some Caveats Regarding Financial Planning Models 72
- Summary and Conclusions 73
- Closing Case: Ratios and Financial Planning at East Coast Yachts 79**

PART TWO VALUATION AND CAPITAL BUDGETING

CHAPTER FOUR

Discounted Cash Flow Valuation 82

- 4.1 Valuation: The One-Period Case 82
- 4.2 The Multiperiod Case 85
 - Future Value and Compounding* 85
 - The Power of Compounding: A Digression* 88
 - Present Value and Discounting* 89
 - The Algebraic Formula* 93
- 4.3 Compounding Periods 94
 - Distinction between Stated Annual Interest Rate and Effective Annual Rate* 96
 - Compounding over Many Years* 98
 - Continuous Compounding* 98
- 4.4 Simplifications 100
 - Perpetuity* 100
 - Growing Perpetuity* 101
 - Annuity* 103
 - Trick 1: A Delayed Annuity 105
 - Trick 2: Annuity Due 106
 - Trick 3: The Infrequent Annuity 107
 - Trick 4: Equating Present Value of Two Annuities 107
 - Growing Annuity* 108
- 4.5 Loan Types and Loan Amortization 110
 - Pure Discount Loans* 110
 - Interest-Only Loans* 110
 - Amortized Loans* 111
- 4.6 What Is a Firm Worth? 114
- Summary and Conclusions 116
- Closing Case: The MBA Decision 127**

CHAPTER FIVE

Interest Rates and Bond Valuation 129

- 5.1 Bonds and Bond Valuation 129
 - Bond Features and Prices* 130
 - Bond Values and Yields* 130
 - Interest Rate Risk* 133
 - Finding the Yield to Maturity: More Trial and Error* 135
- 5.2 More on Bond Features 136
 - Long-Term Debt: The Basics* 138
 - The Indenture* 139
 - Terms of a Bond 139
 - Security 140
 - Seniority 140
 - Repayment 140
 - The Call Provision 141
 - Protective Covenants 141
- 5.3 Bond Ratings 142
- 5.4 Some Different Types of Bonds 143
 - Government Bonds* 143
 - Zero Coupon Bonds* 144
 - Floating-Rate Bonds* 145
 - Other Types of Bonds* 145
- 5.5 Bond Markets 147
 - How Bonds Are Bought and Sold* 147
 - Bond Price Reporting* 147
 - A Note on Bond Price Quotes* 150
- 5.6 Inflation and Interest Rates 151
 - Real versus Nominal Rates* 151
 - The Fisher Effect* 152
- 5.7 Determinants of Bond Yields 153
 - The Term Structure of Interest Rates* 153
 - Bond Yields and the Yield Curve: Putting It All Together* 154
 - Conclusion* 156
- Summary and Conclusions 156
- Closing Case: Financing East Coast Yachts' Expansion Plans With a Bond Issue 162**

CHAPTER SIX

Stock Valuation 164

- 6.1 The Present Value of Common Stocks 164
 - Dividends versus Capital Gains* 164
 - Valuation of Different Types of Stocks* 165
 - Case 1 (Zero Growth) 166
 - Case 2 (Constant Growth) 166
 - Case 3 (Differential Growth) 167

6.2	Estimates of Parameters in the Dividend Discount Model 169
	<i>Where Does g Come From?</i> 169
	<i>Where Does R Come From?</i> 170
	<i>A Healthy Sense of Skepticism</i> 172
	<i>Total Payout</i> 173
	<i>The No-Payout Firm</i> 173
6.3	Comparables 174
	<i>Price-to-Earnings Ratio</i> 174
	<i>Enterprise Value Ratios</i> 176
6.4	Valuing Stocks Using Free Cash Flows 177
6.5	Some Features of Common and Preferred Stocks 178
	<i>Common Stock Features</i> 178
	Shareholder Rights 179
	Proxy Voting 180
	Classes of Stock 180
	Other Rights 181
	Dividends 181
	<i>Preferred Stock Features</i> 181
	Stated Value 182
	Cumulative and Noncumulative Dividends 182
	Is Preferred Stock Really Debt? 182
6.6	The Stock Markets 182
	<i>Dealers and Brokers</i> 183
	<i>Organization of the NYSE</i> 183
	Members 183
	Operations 184
	Floor Activity 184
	<i>NASDAQ Operations</i> 185
	ECNs 187
	<i>Stock Market Reporting</i> 188
	Summary and Conclusions 188
	Closing Case: Stock Valuation at Ragan Engines 194

CHAPTER SEVEN

Net Present Value and Other Investment Rules 195

7.1	Why Use Net Present Value? 195
7.2	The Payback Period Method 197
	<i>Defining the Rule</i> 197
	<i>Problems with the Payback Method</i> 198
	Problem 1: Timing of Cash Flows Within the Payback Period 199
	Problem 2: Payments after the Payback Period 199
	Problem 3: Arbitrary Standard for Payback Period 199

Managerial Perspective 199

Summary of Payback 200

7.3	The Discounted Payback Period Method 200
7.4	The Average Accounting Return Method 201
	<i>Defining the Rule</i> 201
	Step 1: Determining Average Net Income 202
	Step 2: Determining Average Investment 202
	Step 3: Determining AAR 202
	<i>Analyzing the Average Accounting Return Method</i> 202
7.5	The Internal Rate of Return 203
7.6	Problems with the IRR Approach 206
	<i>Definition of Independent and Mutually Exclusive Projects</i> 206
	<i>Two General Problems Affecting Both Independent and Mutually Exclusive Projects</i> 206
	Problem 1: Investing or Financing? 206
	Problem 2: Multiple Rates of Return 208
	NPV Rule 208
	Modified IRR 209
	The Guarantee Against Multiple IRRs 209
	General Rules 210
	<i>Problems Specific to Mutually Exclusive Projects</i> 210
	The Scale Problem 210
	The Timing Problem 212
	<i>Redeeming Qualities of IRR</i> 214
	<i>A Test</i> 214
7.7	The Profitability Index 215
	<i>Calculation of Profitability Index</i> 215
	Application of the Profitability Index 215
7.8	The Practice of Capital Budgeting 217
	Summary and Conclusions 219
	Closing Case: Bullock Gold Mining 229

CHAPTER EIGHT

Making Capital Investment Decisions 230

8.1	Incremental Cash Flows 230
	<i>Cash Flows—Not Accounting Income</i> 230
	<i>Sunk Costs</i> 231
	<i>Opportunity Costs</i> 231
	<i>Side Effects</i> 232
	<i>Allocated Costs</i> 232
8.2	The Baldwin Company: An Example 233
	<i>An Analysis of the Project</i> 234
	Investments 234
	Income and Taxes 235

Salvage Value	236
Cash Flow	237
Net Present Value	237
<i>Which Set of Books?</i>	237
<i>A Note on Net Working Capital</i>	237
<i>A Note on Depreciation</i>	238
<i>Interest Expense</i>	239
8.3 Inflation and Capital Budgeting	239
<i>Discounting: Nominal or Real?</i>	240
8.4 Alternative Definitions of Operating Cash Flow	242
<i>The Bottom-Up Approach</i>	243
<i>The Top-Down Approach</i>	243
<i>The Tax Shield Approach</i>	243
<i>Conclusion</i>	244
8.5 Investments of Unequal Lives: The Equivalent Annual Cost Method	244
<i>The General Decision to Replace</i>	246
Summary and Conclusions	248
Closing Case: Expansion at East Coast Yachts	259
Bethesda Mining Company	259

CHAPTER NINE

Risk Analysis, Real Options, and Capital Budgeting 261

9.1 Decision Trees	261
Warning	263
9.2 Sensitivity Analysis, Scenario Analysis, and Break-Even Analysis	263
<i>Sensitivity Analysis And Scenario Analysis</i>	263
Revenues	264
Costs	265
<i>Break-Even Analysis</i>	267
Accounting Profit	267
Financial Break-Even	269
9.3 Monte Carlo Simulation	270
Step 1: Specify the Basic Model	270
Step 2: Specify a Distribution for Each Variable in the Model	270
Step 3: The Computer Draws One Outcome	272
Step 4: Repeat the Procedure	272
Step 5: Calculate NPV	272
9.4 Real Options	273
<i>The Option to Expand</i>	273
<i>The Option to Abandon</i>	274
<i>Timing Options</i>	276

Summary and Conclusions	277
Closing Case: Bunyan Lumber, LLC	285

PART THREE RISK AND RETURN

CHAPTER TEN

Risk and Return: Lessons from Market History 287

10.1 Returns	287
<i>Dollar Returns</i>	287
<i>Percentage Returns</i>	289
10.2 Holding Period Returns	291
10.3 Return Statistics	297
10.4 Average Stock Returns and Risk-Free Returns	298
10.5 Risk Statistics	300
<i>Variance</i>	300
<i>Normal Distribution and Its Implications for Standard Deviation</i>	301
10.6 The U.S. Equity Risk Premium: Historical and International Perspectives	302
10.7 2008: A Year of Financial Crisis	305
10.8 More on Average Returns	306
<i>Arithmetic versus Geometric Averages</i>	306
<i>Calculating Geometric Average Returns</i>	307
<i>Arithmetic Average Return or Geometric Average Return?</i>	308

Summary and Conclusions 309

Closing Case: A Job at East Coast Yachts, Part 1 313

CHAPTER ELEVEN

Return and Risk: The Capital Asset Pricing Model (CAPM) 316

11.1 Individual Securities	316
11.2 Expected Return, Variance, and Covariance	317
<i>Expected Return and Variance</i>	317
<i>Covariance and Correlation</i>	318
11.3 The Return and Risk for Portfolios	321
<i>The Expected Return on a Portfolio</i>	321
<i>Variance and Standard Deviation of a Portfolio</i>	322
The Variance	322
Standard Deviation of a Portfolio	322
The Diversification Effect	323
An Extension to Many Assets	324
11.4 The Efficient Set	324
<i>The Two-Asset Case</i>	324
<i>The Efficient Set for Many Securities</i>	328

- 11.5 Riskless Borrowing and Lending 329
The Optimal Portfolio 331
- 11.6 Announcements, Surprises, and Expected Returns 333
Expected and Unexpected Returns 333
Announcements and News 334
- 11.7 Risk: Systematic and Unsystematic 335
Systematic and Unsystematic Risk 335
Systematic and Unsystematic Components of Return 335
- 11.8 Diversification and Portfolio Risk 336
The Effect of Diversification: Another Lesson from Market History 336
The Principle of Diversification 336
Diversification and Unsystematic Risk 338
Diversification and Systematic Risk 338
- 11.9 Market Equilibrium 339
Definition of the Market Equilibrium Portfolio 339
Definition of Risk When Investors Hold the Market Portfolio 339
The Formula for Beta 342
A Test 343
- 11.10 Relationship Between Risk and Expected Return (CAPM) 344
Expected Return on Individual Security 344
- Summary and Conclusions 347
- Closing Case: A Job at East Coast Yachts, Part 2** 356
- 12.7 Cost of Fixed Income Securities 370
Cost of Debt 370
Cost of Preferred Stock 371
- 12.8 The Weighted Average Cost of Capital 372
- 12.9 Valuation With R_{WACC} 374
Project Evaluation and the R_{WACC} 374
Firm Valuation with the R_{WACC} 374
- 12.10 Estimating Eastman Chemical's Cost of Capital 377
Eastman's Cost of Equity 377
Eastman's Cost of Debt 378
Eastman's WACC 379
- 12.11 Flotation Costs and the Weighted Average Cost of Capital 380
The Basic Approach 380
Flotation Costs and NPV 381
Internal Equity and Flotation Costs 382
- Summary and Conclusions 382
- Closing Case: The Cost of Capital for Goff Computer, Inc.** 389

PART FOUR CAPITAL STRUCTURE AND DIVIDEND POLICY

CHAPTER THIRTEEN

Efficient Capital Markets and Behavioral Challenges 390

CHAPTER TWELVE

Risk, Cost of Capital, and Valuation 357

- 12.1 The Cost of Equity Capital 357
- 12.2 Estimating the Cost of Equity Capital with the CAPM 358
The Risk-Free Rate 360
Market Risk Premium 361
Method 1: Using Historical Data 361
Method 2: Using the Dividend Discount Model (DDM) 361
- 12.3 Estimation of Beta 362
Real-World Betas 362
Stability of Beta 363
Using an Industry Beta 364
- 12.4 Determinants of Beta 365
Cyclicalities of Revenues 365
Operating Leverage 366
Financial Leverage and Beta 366
- 12.5 Dividend Discount Model 367
Comparison of DDM and CAPM 368
- 12.6 Cost of Capital for Divisions and Projects 369
- 13.1 A Description of Efficient Capital Markets 390
Foundations of Market Efficiency 392
Rationality 392
Independent Deviations from Rationality 392
Arbitrage 393
- 13.2 The Different Types of Efficiency 393
The Weak Form 393
The Semistrong and Strong Forms 393
Some Common Misconceptions about the Efficient Market Hypothesis 395
The Efficacy of Dart Throwing 395
Price Fluctuations 396
Stockholder Disinterest 396
- 13.3 The Evidence 396
The Weak Form 396
The Semistrong Form 398
Event Studies 398
The Record of Mutual Funds 400
The Strong Form 401
- 13.4 The Behavioral Challenge to Market Efficiency 401

Rationality 401

Independent Deviations from Rationality 402

Arbitrage 402

13.5 Empirical Challenges to Market Efficiency 403

13.6 Reviewing the Differences 408

Representativeness 409

Conservatism 409

13.7 Implications for Corporate Finance 409

1. *Accounting Choices, Financial Choices, and Market Efficiency* 410

2. *The Timing Decision* 410

3. *Speculation and Efficient Markets* 413

4. *Information in Market Prices* 413

Summary and Conclusions 415

Closing Case: Your 401(K) Account at East Coast Yachts 421

CHAPTER FOURTEEN

Capital Structure: Basic Concepts 423

14.1 The Capital Structure Question and the Pie Theory 423

14.2 Maximizing Firm Value versus Maximizing Stockholder Interests 424

14.3 Financial Leverage and Firm Value: An Example 426

Leverage and Returns to Shareholders 426

The Choice between Debt and Equity 428

A Key Assumption 430

14.4 Modigliani and Miller: Proposition II (No Taxes) 430

Risk to Equityholders Rises with Leverage 430

Proposition II: Required Return to Equityholders Rises with Leverage 431

MM: An Interpretation 436

14.5 Taxes 437

The Basic Insight 437

Present Value of the Tax Shield 439

Value of the Levered Firm 439

Expected Return and Leverage under Corporate Taxes 441

The Weighted Average Cost of Capital (R_{WACC}) and Corporate Taxes 442

Stock Price and Leverage under Corporate Taxes 442

Summary and Conclusions 444

Closing Case: Stephenson Real Estate Recapitalization 450

CHAPTER FIFTEEN

Capital Structure: Limits to the Use of Debt 452

15.1 Costs of Financial Distress 452

Direct Bankruptcy Costs 453

Indirect Bankruptcy Costs 453

Agency Costs 454

Summary of Selfish Strategies 456

15.2 Can Costs of Debt be Reduced? 457

Protective Covenants 457

Consolidation of Debt 458

15.3 Integration of Tax Effects and Financial Distress Costs 458

Pie Again 458

15.4 Signaling 461

15.5 Shirking, Perquisites, and Bad Investments: A Note on Agency Cost of Equity 462

Effect of Agency Costs of Equity on Debt-Equity Financing 464

Free Cash Flow 464

15.6 The Pecking-Order Theory 465

Rules of the Pecking Order 466

Rule #1 Use Internal Financing 466

Rule #2 Issue Safe Securities First 467

Implications 467

15.7 How Firms Establish Capital Structure 468

15.8 A Quick Look at the Bankruptcy Process 473

Liquidation and Reorganization 473

Bankruptcy Liquidation 473

Bankruptcy Reorganization 474

Financial Management and the Bankruptcy Process 475

Agreements to Avoid Bankruptcy 476

Summary and Conclusions 476

Closing Case: McKenzie Corporation's Capital Budgeting 480

CHAPTER SIXTEEN

Dividends and Other Payouts 481

16.1 Different Types of Dividends 481

16.2 Standard Method of Cash Dividend Payment 482

16.3 The Benchmark Case: An Illustration of the Irrelevance of Dividend Policy 484

Current Policy: Dividends Set Equal to Cash Flow 484

Alternative Policy: Initial Dividend Is Greater than Cash Flow 484

The Indifference Proposition 485

- Homemade Dividends 486
- A Test 487
- Dividends and Investment Policy 487
- 16.4 Repurchase of Stock 488
 - Dividend versus Repurchase: Conceptual Example 489
 - Dividends versus Repurchases: Real-World Considerations 490
 1. Flexibility 490
 2. Executive Compensation 490
 3. Offset to Dilution 490
 4. Undervaluation 490
 5. Taxes 491
- 16.5 Personal Taxes, Issuance Costs, and Dividends 491
 - Firms without Sufficient Cash to Pay a Dividend 491
 - Firms with Sufficient Cash to Pay a Dividend 492
 - Summary on Personal Taxes 493
- 16.6 Real-World Factors Favoring A High-Dividend Policy 493
 - Desire for Current Income 494
 - Behavioral Finance 495
 - Agency Costs 496
 - Information Content of Dividends and Dividend Signaling 496
- 16.7 The Clientele Effect: A Resolution of Real-World Factors? 497
- 16.8 What We Know and Do Not Know about Dividend Policy 498
 - Corporate Dividends Are Substantial 498
 - Fewer Companies Pay Dividends 499
 - Corporations Smooth Dividends 500
 - Some Survey Evidence about Dividends 501
- 16.9 Putting It All Together 502
- 16.10 Stock Dividends and Stock Splits 504
 - Example of a Small Stock Dividend 505
 - Example of a Stock Split 505
 - Example of a Large Stock Dividend 506
 - Value of Stock Splits and Stock Dividends 506
 - The Benchmark Case 506
 - Popular Trading Range 506
 - Reverse Splits 507
- Summary and Conclusions 508
- Closing Case: Electronic Timing, Inc. 514

PART FIVE SPECIAL TOPICS

CHAPTER SEVENTEEN

Options and Corporate Finance 516

- 17.1 Options 516
- 17.2 Call Options 517
 - The Value of a Call Option at Expiration 517

- 17.3 Put Options 518
 - The Value of a Put Option at Expiration 518
- 17.4 Selling Options 520
- 17.5 Option Quotes 521
- 17.6 Combinations of Options 522
- 17.7 Valuing Options 525
 - Bounding the Value of a Call 525
 - Lower Bound 525
 - Upper Bound 525
 - The Factors Determining Call Option Values 525
 - Exercise Price 525
 - Expiration Date 526
 - Stock Price 526
 - The Key Factor: The Variability of the Underlying Asset 527
 - The Interest Rate 528
 - A Quick Discussion of Factors Determining Put Option Values 528
- 17.8 An Option Pricing Formula 529
 - A Two-State Option Model 530
 - Determining the Delta 530
 - Determining the Amount of Borrowing 531
 - Risk-Neutral Valuation 531
 - The Black-Scholes Model 532
- 17.9 Stocks and Bonds as Options 536
 - The Firm Expressed in Terms of Call Options 537
 - The Stockholders 537
 - The Bondholders 538
 - The Firm Expressed in Terms of Put Options 538
 - The Stockholders 538
 - The Bondholders 539
 - A Resolution of the Two Views 539
 - A Note on Loan Guarantees 540
- Summary and Conclusions 541
- Closing Case: Exotic Cuisines Employee Stock Options 549**

CHAPTER EIGHTEEN

Short-Term Finance and Planning 551

- 18.1 Tracing Cash and Net Working Capital 552
- 18.2 The Operating Cycle and the Cash Cycle 553
 - Defining the Operating and Cash Cycles 553
 - The Operating Cycle 554
 - The Cash Cycle 554
 - The Operating Cycle and the Firm's Organization Chart 555

	<i>Calculating the Operating and Cash Cycles</i>	555
	The Operating Cycle	557
	The Cash Cycle	558
	<i>Interpreting the Cash Cycle</i>	559
18.3	Some Aspects of Short-Term Financial Policy	559
	<i>The Size of the Firm's Investment in Current Assets</i>	560
	<i>Alternative Financing Policies for Current Assets</i>	561
	An Ideal Case	561
	Different Policies For Financing Current Assets	563
	<i>Which Financing Policy Is Best?</i>	564
	<i>Current Assets and Liabilities in Practice</i>	565
18.4	The Cash Budget	565
	<i>Sales and Cash Collections</i>	566
	<i>Cash Outflows</i>	567
	<i>The Cash Balance</i>	567
18.5	Short-Term Borrowing	568
	<i>Unsecured Loans</i>	568
	Compensating Balances	569
	Cost of a Compensating Balance	569
	Letters of Credit	569
	<i>Secured Loans</i>	570
	Accounts Receivable Financing	570
	Inventory Loans	571
	<i>Commercial Paper</i>	571
	<i>Trade Credit</i>	571
	Understanding Trade Credit Terms	571
	Cash Discounts	571
18.6	A Short-Term Financial Plan	572
	Summary and Conclusions	573
	Closing Case: Keafer Manufacturing Working Capital Management	582

CHAPTER NINETEEN

Raising Capital 583

19.1	Early-Stage Financing and Venture Capital	583
	<i>Venture Capital</i>	584
	<i>Stages of Financing</i>	586
	<i>Some Venture Capital Realities</i>	586
	<i>Crowdfunding</i>	587
19.2	Selling Securities to the Public: The Basic Procedure	587
19.3	Alternative Issue Methods	588
19.4	Underwriters	590
	<i>Choosing an Underwriter</i>	590

Types of Underwriting 591

	Firm Commitment Underwriting	591
	Best Efforts Underwriting	591
	Dutch Auction Underwriting	591
	<i>The Green Shoe Provision</i>	592
	<i>The Aftermarket</i>	592
	<i>Lockup Agreements</i>	592
	<i>The Quiet Period</i>	593
19.5	IPOs and Underpricing	593
	<i>Evidence on Underpricing</i>	594
	<i>IPO Underpricing: The 1999–2000 Experience</i>	595
	<i>Why Does Underpricing Exist?</i>	597
	<i>The Partial Adjustment Phenomenon</i>	599
19.6	What CFOs Say About the IPO Process	600
19.7	SEOs and the Value of the Firm	600
19.8	The Cost of Issuing Securities	601
19.9	Rights	604
	<i>The Mechanics of a Rights Offering</i>	606
	<i>Subscription Price</i>	606
	<i>Number of Rights Needed to Purchase a Share</i>	607
	<i>Effect of Rights Offering on Price of Stock</i>	607
	<i>Effects on Shareholders</i>	609
	<i>The Underwriting Arrangements</i>	609
	<i>The Rights Puzzle</i>	609
19.10	Dilution	610
	<i>Dilution of Proportionate Ownership</i>	610
	<i>Dilution of Value: Book versus Market Values</i>	610
	A Misconception	611
	The Correct Arguments	611
19.11	Issuing Long-Term Debt	612
19.12	Shelf Registration	612
	Summary and Conclusions	613
	Closing Case: East Coast Yachts Goes Public	618

CHAPTER TWENTY

International Corporate Finance 619

20.1	Terminology	620
20.2	Foreign Exchange Markets and Exchange Rates	621
	<i>Exchange Rates</i>	622
	Exchange Rate Quotations	622
	Cross-Rates and Triangle Arbitrage	623
	Types of Transactions	624
20.3	Purchasing Power Parity	625
	<i>Absolute Purchasing Power Parity</i>	625

	<i>Relative Purchasing Power Parity</i>	627
	The Basic Idea	627
	The Result	628
	Currency Appreciation and Depreciation	629
20.4	Interest Rate Parity, Unbiased Forward Rates, and the International Fisher Effect	629
	<i>Covered Interest Arbitrage</i>	629
	<i>Interest Rate Parity</i>	631
	<i>Forward Rates and Future Spot Rates</i>	631
	<i>Putting It All Together</i>	632
	Uncovered Interest Parity	632
	The International Fisher Effect	632
20.5	International Capital Budgeting	633
	<i>Method 1: The Home Currency Approach</i>	634
	<i>Method 2: The Foreign Currency Approach</i>	634
	<i>Unremitted Cash Flows</i>	635
20.6	Exchange Rate Risk	635
	<i>Short-Run Exposure</i>	635
	<i>Long-Run Exposure</i>	636
	<i>Translation Exposure</i>	637
	<i>Managing Exchange Rate Risk</i>	638

20.7	Political Risk	638
	Summary and Conclusions	639

Closing Case: East Coast Yachts Goes International 644

CHAPTER TWENTY ONE

Mergers and Acquisitions (web only)

APPENDIX A

Mathematical Tables 645

APPENDIX B

Solutions to Selected End-of-Chapter Problems 654

APPENDIX C

Using the HP 10B and TI BA II Plus Financial Calculators 659

NAME INDEX 663

COMPANY INDEX 665

SUBJECT INDEX 668