

# Contents

## PART 1 Overview of Corporate Finance

### CHAPTER 1

#### INTRODUCTION TO CORPORATE FINANCE 1

##### 1.1 Finance: A Quick Look 2

Finance: The Five Main Areas 2

*Corporate Finance* 2

*Investments* 2

*Financial Institutions* 3

*International Finance* 3

*Fintech* 3

Why Study Finance? 3

*Marketing and Finance* 3

*Accounting and Finance* 3

*Management and Finance* 4

*Technology and Finance* 4

*You and Finance* 5

##### 1.2 Corporate Finance and the Financial Manager 5

What is Corporate Finance? 5

The Financial Manager 6

Financial Management Decisions 7

*Capital Budgeting* 7

*Capital Structure* 7

*Working Capital Management* 7

*Conclusion* 8

##### 1.3 Forms of Business Organization 8

Sole Proprietorship 8

Partnership 8

Corporation 9

A Corporation by Another Name ... 10

Benefit Corporation 11

##### 1.4 The Goal of Financial Management 11

Possible Goals 12

The Goal of Financial Management 12

A More General Goal 13

Sarbanes-Oxley 13

##### 1.5 The Agency Problem and Control of the Corporation 14

Agency Relationships 14

Management Goals 14

Do Managers Act in the Stockholders' Interests? 15

*Managerial Compensation* 15

*Control of the Firm* 15

*Conclusion* 17

Stakeholders 17

##### 1.6 Financial Markets and the Corporation 18

Cash Flows to and from the Firm 18

Primary versus Secondary Markets 19

*Primary Markets* 19

*Secondary Markets* 19

*Dealer versus Auction Markets* 19

*Trading in Corporate Securities* 20

*Listing* 20

##### 1.7 Summary and Conclusions 21

### CHAPTER 2

#### FINANCIAL STATEMENTS, TAXES, AND CASH FLOW 24

##### 2.1 The Balance Sheet 25

Assets: The Left Side 25

Liabilities and Owners' Equity: The Right Side 25

Net Working Capital 26

Liquidity 27

Debt versus Equity 28

Market Value versus Book Value 28

##### 2.2 The Income Statement 29

GAAP and the Income Statement 30

Noncash Items 31

Time and Costs 31

##### 2.3 Taxes 33

Corporate Tax Rates 33

Average versus Marginal Tax Rates 33

##### 2.4 Cash Flow 35

Cash Flow from Assets 35

*Operating Cash Flow* 35

*Capital Spending* 36

*Change in Net Working Capital* 37

*Conclusion* 37

*A Note about "Free" Cash Flow* 37

Cash Flow to Creditors and Stockholders 38

*Cash Flow to Creditors* 38

*Cash Flow to Stockholders* 38

An Example: Cash Flows for Dole Cola 38

*Operating Cash Flow* 38

*Net Capital Spending* 40

*Change in NWC and Cash Flow from Assets* 40

*Cash Flow to Stockholders and Creditors* 40

##### 2.5 Summary and Conclusions 41

**CHAPTER 3****WORKING WITH FINANCIAL STATEMENTS 51**

- 3.1 Cash Flow and Financial Statements: A Closer Look 52**
  - Sources and Uses of Cash 52
  - The Statement of Cash Flows 54
- 3.2 Standardized Financial Statements 56**
  - Common-Size Statements 56
    - Common-Size Balance Sheets 56*
    - Common-Size Income Statements 57*
    - Common-Size Statements of Cash Flows 58*
  - Common-Base Year Financial Statements: Trend Analysis 58
  - Combined Common-Size and Base Year Analysis 58
- 3.3 Ratio Analysis 59**
  - Short-Term Solvency, or Liquidity, Measures 60
    - Current Ratio 60*
    - The Quick (or Acid-Test) Ratio 61*
    - Other Liquidity Ratios 62*
  - Long-Term Solvency Measures 62
    - Total Debt Ratio 63*
    - A Brief Digression: Total Capitalization versus Total Assets 63*
    - Times Interest Earned 64*
    - Cash Coverage 64*
  - Asset Management, or Turnover, Measures 64
    - Inventory Turnover and Days' Sales in Inventory 64*
    - Receivables Turnover and Days' Sales in Receivables 65*
    - Asset Turnover Ratios 66*
  - Profitability Measures 67
    - Profit Margin 67*
    - Return on Assets 67*
    - Return on Equity 68*
  - Market Value Measures 69
    - Price-Earnings Ratio 69*
    - Price-Sales Ratio 69*
    - Market-to-Book Ratio 70*
    - Enterprise Value-EBITDA Multiple 71*
    - A Note on Ratio Analysis 71*
  - Conclusion 71
- 3.4 The DuPont Identity 72**
  - A Closer Look at ROE 73
  - An Expanded DuPont Analysis 75
- 3.5 Using Financial Statement Information 76**
  - Why Evaluate Financial Statements? 76

- Internal Uses 77*
- External Uses 77*
- Choosing a Benchmark 77
  - Time Trend Analysis 77*
  - Peer Group Analysis 78*
- Problems with Financial Statement Analysis 83
- 3.6 Summary and Conclusions 84**

**CHAPTER 4****LONG-TERM FINANCIAL PLANNING AND GROWTH 96**

- 4.1 What Is Financial Planning? 98**
  - Growth as a Financial Management Goal 98
  - Dimensions of Financial Planning 98
  - What Can Planning Accomplish? 99
    - Examining Interactions 99*
    - Exploring Options 99*
    - Avoiding Surprises 99*
    - Ensuring Feasibility and Internal Consistency 100*
    - Conclusion 100*
- 4.2 Financial Planning Models: A First Look 100**
  - A Financial Planning Model: The Ingredients 100
    - Sales Forecast 101*
    - Pro Forma Statements 101*
    - Asset Requirements 101*
    - Financial Requirements 101*
    - The Plug 101*
    - Economic Assumptions 102*
  - A Simple Financial Planning Model 102
- 4.3 The Percentage of Sales Approach 103**
  - The Income Statement 103
  - The Balance Sheet 104
  - A Particular Scenario 106
  - An Alternative Scenario 107
- 4.4 External Financing and Growth 109**
  - EFN and Growth 111
  - Financial Policy and Growth 113
    - The Internal Growth Rate 113*
    - The Sustainable Growth Rate 114*
    - Determinants of Growth 114*
  - A Note about Sustainable Growth Rate Calculations 116
- 4.5 Some Caveats Regarding Financial Planning Models 118**
- 4.6 Summary and Conclusions 119**

**CHAPTER 5****INTRODUCTION TO VALUATION: THE TIME VALUE OF MONEY 130**

- 5.1 Future Value and Compounding 131**
  - Investing for a Single Period 131
  - Investing for More Than One Period 131
  - A Note about Compound Growth 137
- 5.2 Present Value and Discounting 138**
  - The Single-Period Case 138
  - Present Values for Multiple Periods 139
- 5.3 More about Present and Future Values 142**
  - Present versus Future Value 142
  - Determining the Discount Rate 143
  - Finding the Number of Periods 146
- 5.4 Summary and Conclusions 150**

**CHAPTER 6****DISCOUNTED CASH FLOW VALUATION 156**

- 6.1 Future and Present Values of Multiple Cash Flows 157**
  - Future Value with Multiple Cash Flows 157
  - Present Value with Multiple Cash Flows 159
  - A Note about Cash Flow Timing 163
- 6.2 Valuing Level Cash Flows: Annuities and Perpetuities 164**
  - Present Value for Annuity Cash Flows 164
    - Annuity Tables 165*
    - Finding the Payment 167*
    - Finding the Rate 168*
  - Future Value for Annuities 170
  - A Note about Annuities Due 171
  - Perpetuities 172
  - Growing Annuities and Perpetuities 174
- 6.3 Comparing Rates: The Effect of Compounding 174**
  - Effective Annual Rates and Compounding 175
  - Calculating and Comparing Effective Annual Rates 175
  - EARs and APRs 177
  - Taking It to the Limit: A Note about Continuous Compounding 178
- 6.4 Loan Types and Loan Amortization 180**
  - Pure Discount Loans 180
  - Interest-Only Loans 181
  - Amortized Loans 181
- 6.5 Summary and Conclusions 186**

**CHAPTER 7****INTEREST RATES AND BOND VALUATION 201**

- 7.1 Bonds and Bond Valuation 202**

- Bond Features and Prices 202
- Bond Values and Yields 202
- Interest Rate Risk 206
- Finding the Yield to Maturity: More Trial and Error 207

- 7.2 More about Bond Features 212**
  - Is it Debt or Equity? 212
  - Long-Term Debt: The Basics 212
  - The Indenture 213
    - Terms of a Bond 214*
    - Security 214*
    - Seniority 215*
    - Repayment 215*
    - The Call Provision 215*
    - Protective Covenants 216*
- 7.3 Bond Ratings 217**
- 7.4 Some Different Types of Bonds 218**
  - Government Bonds 218
  - Zero Coupon Bonds 219
  - Floating-Rate Bonds 220
  - Other Types of Bonds 221
  - Sukuk 222

- 7.5 Bond Markets 224**
  - How Bonds Are Bought and Sold 225
  - Bond Price Reporting 225
  - A Note about Bond Price Quotes 229
- 7.6 Inflation and Interest Rates 229**
  - Real versus Nominal Rates 229
  - The Fisher Effect 230
  - Inflation and Present Values 231
- 7.7 Determinants of Bond Yields 232**
  - The Term Structure of Interest Rates 232
  - Bond Yields and the Yield Curve: Putting it all Together 235
  - Conclusion 236
- 7.8 Summary and Conclusions 236**

**CHAPTER 8****STOCK VALUATION 245**

- 8.1 Common Stock Valuation 246**
  - Cash Flows 246
  - Some Special Cases 248
    - Zero Growth 248*
    - Constant Growth 248*
    - Nonconstant Growth 251*
    - Two-Stage Growth 253*
  - Components of the Required Return 254
  - Stock Valuation Using Multiples 255
- 8.2 Some Features of Common and Preferred Stocks 257**
  - Common Stock Features 257
    - Shareholder Rights 257*

Proxy Voting 258

Classes of Stock 258

Other Rights 259

Dividends 259

Preferred Stock Features 260

Stated Value 260

Cumulative and Noncumulative Dividends 260

Is Preferred Stock Really Debt? 260

**8.3 The Stock Markets 261**

Dealers and Brokers 261

Organization of the NYSE 262

Members 262

Operations 263

Floor Activity 263

Nasdaq Operations 264

ECNs 266

Stock Market Reporting 266

**8.4 Summary and Conclusions 268**

## **PART 4 Capital Budgeting**

### **CHAPTER 9**

#### **NET PRESENT VALUE AND OTHER INVESTMENT CRITERIA 278**

**9.1 Net Present Value 279**

The Basic Idea 279

Estimating Net Present Value 280

**9.2 The Payback Rule 283**

Defining the Rule 283

Analyzing the Rule 285

Redeeming Qualities of the Rule 285

Summary of the Rule 286

**9.3 The Discounted Payback 287**

**9.4 The Average Accounting Return 289**

**9.5 The Internal Rate of Return 291**

Problems with the IRR 295

*Nonconventional Cash Flows 295*

*Mutually Exclusive Investments 297*

*Investing or Financing? 299*

Redeeming Qualities of the IRR 300

The Modified Internal Rate of Return (MIRR) 301

*Method 1: The Discounting Approach 301*

*Method 2: The Reinvestment Approach 301*

*Method 3: The Combination Approach 302*

*MIRR or IRR: Which Is Better? 302*

**9.6 The Profitability Index 302**

**9.7 The Practice of Capital Budgeting 303**

**9.8 Summary and Conclusions 306**

### **CHAPTER 10**

#### **MAKING CAPITAL INVESTMENT DECISIONS 318**

**10.1 Project Cash Flows: A First Look 319**

Relevant Cash Flows 319

The Stand-Alone Principle 319

**10.2 Incremental Cash Flows 320**

Sunk Costs 320

Opportunity Costs 320

Side Effects 321

Net Working Capital 321

Financing Costs 321

Other Issues 322

**10.3 Pro Forma Financial Statements and Project Cash Flows 322**

Getting Started: Pro Forma Financial Statements 322

Project Cash Flows 323

*Project Operating Cash Flow 323*

*Project Net Working Capital and Capital*

*Spending 324*

Projected Total Cash Flow and Value 324

**10.4 More about Project Cash Flow 325**

A Closer Look at Net Working Capital 325

Depreciation 328

*Modified ACRS Depreciation (MACRS) 328*

*Bonus Depreciation 329*

*Book Value versus Market Value 330*

An Example: The Majestic Mulch and Compost Company (MMCC) 331

*Operating Cash Flows 332*

*Change in NWC 333*

*Capital Spending 334*

*Total Cash Flow and Value 334*

*Conclusion 334*

**10.5 Alternative Definitions of Operating Cash Flow 335**

The Bottom-Up Approach 336

The Top-Down Approach 336

The Tax Shield Approach 336

Conclusion 337

**10.6 Some Special Cases of Discounted Cash Flow Analysis 337**

Evaluating Cost-Cutting Proposals 337

Setting the Bid Price 339

Evaluating Equipment Options with Different Lives 341

**10.7 Summary and Conclusions 343**

### **CHAPTER 11**

#### **PROJECT ANALYSIS AND EVALUATION 356**

**11.1 Evaluating NPV Estimates 357**

The Basic Problem 357

Projected versus Actual Cash Flows	357
Forecasting Risk	357
Sources of Value	358
<b>11.2 Scenario and Other What-If Analyses</b>	<b>359</b>
Getting Started	359
Scenario Analysis	360
Sensitivity Analysis	362
Simulation Analysis	364
<b>11.3 Break-Even Analysis</b>	<b>364</b>
Fixed and Variable Costs	365
Variable Costs	365
Fixed Costs	366
Total Costs	366
Accounting Break-Even	367
Accounting Break-Even: A Closer Look	369
Uses for the Accounting Break-Even	369
<b>11.4 Operating Cash Flow, Sales Volume, and Break-Even</b>	<b>370</b>
Accounting Break-Even and Cash Flow	370

<i>The Base Case</i>	371
<i>Calculating the Break-Even Level</i>	371
<i>Payback and Break-Even</i>	371
Sales Volume and Operating Cash Flow	372
Cash Flow, Accounting, and Financial Break-Even Points	372
Accounting Break-Even Revisited	373
Cash Break-Even	373
Financial Break-Even	373
Conclusion	374
<b>11.5 Operating Leverage</b>	<b>375</b>
The Basic Idea	375
Implications of Operating Leverage	375
Measuring Operating Leverage	375
Operating Leverage and Break-Even	377
<b>11.6 Capital Rationing</b>	<b>378</b>
Soft Rationing	378
Hard Rationing	378
<b>11.7 Summary and Conclusions</b>	<b>379</b>

## **PART 5 Risk and Return**

### **CHAPTER 12**

#### **SOME LESSONS FROM CAPITAL MARKET HISTORY 388**

<b>12.1 Returns</b>	<b>389</b>
Dollar Returns	389
Percentage Returns	391
<b>12.2 The Historical Record</b>	<b>393</b>
A First Look	393
A Closer Look	395
<b>12.3 Average Returns: The First Lesson</b>	<b>400</b>
Calculating Average Returns	400
Average Returns: The Historical Record	400
Risk Premiums	401
The First Lesson	401
<b>12.4 The Variability of Returns: The Second Lesson</b>	<b>402</b>
Frequency Distributions and Variability	402
The Historical Variance and Standard Deviation	403
The Historical Record	404
Normal Distribution	405
The Second Lesson	407
2008: A Year to Remember	407
Using Capital Market History	408
More on the Stock Market Risk Premium	409
<b>12.5 More about Average Returns</b>	<b>411</b>
Arithmetic versus Geometric Averages	411
Calculating Geometric Average Returns	411
Arithmetic Average Return or Geometric Average Return?	414
<b>12.6 Capital Market Efficiency</b>	<b>415</b>
Price Behavior in an Efficient Market	415
The Efficient Markets Hypothesis	416

Some Common Misconceptions about the EMH	417
The Forms of Market Efficiency	418

#### **12.7 Summary and Conclusions 419**

### **CHAPTER 13**

#### **RETURN, RISK, AND THE SECURITY MARKET LINE 427**

<b>13.1 Expected Returns and Variances</b>	<b>428</b>
Expected Return	428
Calculating the Variance	430
<b>13.2 Portfolios</b>	<b>431</b>
Portfolio Weights	432
Portfolio Expected Returns	432
Portfolio Variance	433
<b>13.3 Announcements, Surprises, and Expected Returns</b>	<b>435</b>
Expected and Unexpected Returns	435
Announcements and News	435
<b>13.4 Risk: Systematic and Unsystematic</b>	<b>437</b>
Systematic and Unsystematic Risk	437
Systematic and Unsystematic Components of Return	437
<b>13.5 Diversification and Portfolio Risk</b>	<b>438</b>
The Effect of Diversification: Another Lesson from Market History	438
The Principle of Diversification	439
Diversification and Unsystematic Risk	440
Diversification and Systematic Risk	441
<b>13.6 Systematic Risk and Beta</b>	<b>441</b>
The Systematic Risk Principle	442

Measuring Systematic Risk	442	The Security Market Line	450
Portfolio Betas	444	Market Portfolios	450
<b>13.7 The Security Market Line</b>	<b>445</b>	The Capital Asset Pricing Model	450
Beta and the Risk Premium	445	<b>13.8 The SML and the Cost of Capital: A Preview</b>	<b>453</b>
The Reward-to-Risk Ratio	446	The Basic Idea	453
The Basic Argument	447	The Cost of Capital	453
The Fundamental Result	448	<b>13.9 Summary and Conclusions</b>	<b>454</b>

## **PART 6 Cost of Capital and Long-Term Financial Policy**

### **CHAPTER 14**

#### **COST OF CAPITAL 465**

<b>14.1 The Cost of Capital: Some Preliminaries</b>	<b>466</b>
Required Return versus Cost of Capital	466
Financial Policy and Cost of Capital	467
<b>14.2 The Cost of Equity 467</b>	
The Dividend Growth Model Approach	467
Implementing the Approach	468
Estimating $g$	468
Advantages and Disadvantages of the Approach	469
The SML Approach	469
Implementing the Approach	470
Advantages and Disadvantages of the Approach	470
<b>14.3 The Costs of Debt and Preferred Stock 471</b>	
The Cost of Debt	471
The Cost of Preferred Stock	471
<b>14.4 The Weighted Average Cost of Capital 472</b>	
The Capital Structure Weights	472
Taxes and the Weighted Average Cost of Capital	473
Calculating the WACC for Eastman Chemical	474
Eastman's Cost of Equity	475
Eastman's Cost of Debt	477
Eastman's WACC	478
Solving the Warehouse Problem and Similar Capital Budgeting Problems	480
Performance Evaluation: Another Use of the WACC	482
<b>14.5 Divisional and Project Costs of Capital 483</b>	
The SML and the WACC	483
Divisional Cost of Capital	484
The Pure Play Approach	484
The Subjective Approach	485
<b>14.6 Company Valuation with the WACC 486</b>	
<b>14.7 Flotation Costs and the Average Cost of Capital 489</b>	
The Basic Approach	489
Flotation Costs and NPV	490
Internal Equity and Flotation Costs	492
<b>14.8 Summary and Conclusions 492</b>	

### **CHAPTER 15**

#### **RAISING CAPITAL 502**

<b>15.1 Entrepreneurship: Early-Stage Financing and Venture Capital 503</b>	
Entrepreneurship	503
Venture Capital	503
Some Venture Capital Realities	505
Venture Capital Firms	506
Crowdfunding	507
Initial Coin Offerings (ICOS)	507
Conclusion	508
<b>15.2 Selling Securities to the Public: The Basic Procedure 508</b>	
<b>15.3 Alternative Issue Methods 511</b>	
<b>15.4 Underwriters 512</b>	
Choosing an Underwriter	512
Types of Underwriting	512
Firm Commitment Underwriting	512
Best Efforts Underwriting	513
Dutch Auction Underwriting	513
The Aftermarket	514
The Green Shoe Provision	514
Lockup Agreements	514
The Quiet Period	515
Direct Listing	515
<b>15.5 IPOs and Underpricing 515</b>	
IPO Underpricing: The 1999–2000 Experience	516
Evidence on Underpricing	519
The Partial Adjustment Phenomenon	520
Why Does Underpricing Exist?	521
<b>15.6 New Equity Sales and the Value of the Firm 522</b>	
<b>15.7 The Costs of Issuing Securities 523</b>	
The Costs of Selling Stock to the Public	523
The Costs of Going Public: A Case Study	524
<b>15.8 Rights 525</b>	
The Mechanics of a Rights Offering	525
Number of Rights Needed to Purchase a Share	526
The Value of a Right	527
Ex Rights	528
The Underwriting Arrangements	530
Effects on Shareholders	530

- 15.9 Dilution** 531
  - Dilution of Proportionate Ownership 531
  - Dilution of Value: Book versus Market Values 531
    - A Misconception* 532
    - The Correct Arguments* 532
- 15.10 Issuing Long-Term Debt** 533
- 15.11 Shelf Registration** 534
- 15.12 Summary and Conclusions** 535

## CHAPTER 16

### FINANCIAL LEVERAGE AND CAPITAL STRUCTURE POLICY 541

- 16.1 The Capital Structure Question** 542
  - Firm Value and Stock Value: An Example 542
  - Capital Structure and the Cost of Capital 543
- 16.2 The Effect of Financial Leverage** 544
  - The Basics of Financial Leverage 544
    - Financial Leverage, EPS, and ROE: An Example* 544
    - EPS versus EBIT* 545
  - Corporate Borrowing and Homemade Leverage 547
- 16.3 Capital Structure and the Cost of Equity Capital** 548
  - M&M Proposition I: The Pie Model 548
  - The Cost of Equity and Financial Leverage: M&M Proposition II 549
  - Business and Financial Risk 551
- 16.4 M&M Propositions I and II with Corporate Taxes** 552
  - The Interest Tax Shield 553
  - Taxes and M&M Proposition I 553
  - Taxes, the WACC, and Proposition II 554
  - Conclusion 555
- 16.5 Bankruptcy Costs** 557
  - Direct Bankruptcy Costs 558
  - Indirect Bankruptcy Costs 558
- 16.6 Optimal Capital Structure** 559
  - The Static Theory of Capital Structure 559
  - Optimal Capital Structure and the Cost of Capital 560
  - Optimal Capital Structure: A Recap 561
  - Capital Structure: Some Managerial Recommendations 563
    - Taxes* 563
    - Financial Distress* 563
- 16.7 The Pie Again** 563
  - The Extended Pie Model 564
  - Marketed Claims versus Nonmarketed Claims 565
- 16.8 The Pecking-Order Theory** 565
  - Internal Financing and the Pecking Order 565
  - Implications of the Pecking Order 566
- 16.9 Observed Capital Structures** 567
- 16.10 A Quick Look at the Bankruptcy Process** 569
  - Liquidation and Reorganization 569
    - Bankruptcy Liquidation* 569
    - Bankruptcy Reorganization* 570
  - Financial Management and the Bankruptcy Process 571

Agreements to Avoid Bankruptcy 572

### 16.11 Summary and Conclusions 572

## CHAPTER 17

### DIVIDENDS AND PAYOUT POLICY 580

- 17.1 Cash Dividends and Dividend Payment** 581
  - Cash Dividends 581
  - Standard Method of Cash Dividend Payment 581
  - Dividend Payment: A Chronology 582
  - More about the Ex-dividend Date 582
- 17.2 Does Dividend Policy Matter?** 584
  - An Illustration of the Irrelevance of Dividend Policy 584
    - Current Policy: Dividends Set Equal to Cash Flow* 584
    - Alternative Policy: Initial Dividend Greater Than Cash Flow* 585
  - Homemade Dividends 585
  - A Test 586
- 17.3 Real-World Factors Favoring a Low Dividend Payout** 587
  - Taxes 587
  - Flotation Costs 587
  - Dividend Restrictions 587
- 17.4 Real-World Factors Favoring a High Dividend Payout** 588
  - Desire for Current Income 588
  - Tax and Other Benefits from High Dividends 589
    - Corporate Investors* 589
    - Tax-Exempt Investors* 589
  - Conclusion 589
- 17.5 A Resolution of Real-World Factors?** 589
  - Information Content of Dividends 590
  - The Clientele Effect 591
- 17.6 Stock Repurchases: An Alternative to Cash Dividends** 591
  - Cash Dividends versus Repurchase 592
  - Real-World Considerations in a Repurchase 594
  - Share Repurchase and EPS 594
- 17.7 What We Know and Do Not Know about Dividend and Payout Policies** 595
  - Dividends and Dividend Payers 595
  - Corporations Smooth Dividends 597
  - Putting It All Together 598
  - Some Survey Evidence on Dividends 600
- 17.8 Stock Dividends and Stock Splits** 602
  - Some Details about Stock Splits and Stock Dividends 602
    - Example of a Small Stock Dividend* 602
    - Example of a Stock Split* 603
    - Example of a Large Stock Dividend* 603
  - Value of Stock Splits and Stock Dividends 603
    - The Benchmark Case* 603
    - Popular Trading Range* 604
  - Reverse Splits 604
- 17.9 Summary and Conclusions** 605

## **PART 7 Short-Term Financial Planning and Management**

### **CHAPTER 18**

#### **SHORT-TERM FINANCE AND PLANNING 612**

##### **18.1 Tracing Cash and Net Working Capital 613**

##### **18.2 The Operating Cycle and the Cash Cycle 614**

Defining the Operating and Cash Cycles 615

*The Operating Cycle 615*

*The Cash Cycle 615*

The Operating Cycle and the Firm's Organizational Chart 616

Calculating the Operating and Cash Cycles 617

*The Operating Cycle 617*

*The Cash Cycle 618*

Interpreting the Cash Cycle 619

##### **18.3 Some Aspects of Short-Term Financial Policy 620**

The Size of the Firm's Investment in Current Assets 620

Alternative Financing Policies for Current Assets 621

*An Ideal Case 623*

*Different Policies for Financing Current Assets 623*

Which Financing Policy Is Best? 625

Current Assets and Liabilities in Practice 626

##### **18.4 The Cash Budget 627**

Sales and Cash Collections 627

Cash Outflows 628

The Cash Balance 628

##### **18.5 Short-Term Borrowing 630**

Unsecured Loans 630

*Compensating Balances 630*

*Cost of a Compensating Balance 630*

*Letters of Credit 631*

Secured Loans 631

*Accounts Receivable Financing 631*

*Inventory Loans 632*

Other Sources 633

##### **18.6 A Short-Term Financial Plan 633**

##### **18.7 Summary and Conclusions 634**

### **CHAPTER 19**

#### **CASH AND LIQUIDITY MANAGEMENT 646**

##### **19.1 Reasons for Holding Cash 647**

The Speculative and Precautionary Motives 647

The Transaction Motive 647

Compensating Balances 647

Costs of Holding Cash 647

Cash Management versus Liquidity Management 648

##### **19.2 Understanding Float 648**

Disbursement Float 648

Collection Float and Net Float 649

Float Management 650

*Measuring Float 650*

*Some Details 651*

*Cost of the Float 652*

*Ethical and Legal Questions 653*

Electronic Data Interchange and Check 21: The End of Float? 654

##### **19.3 Cash Collection and Concentration 655**

Components of Collection Time 655

Cash Collection 655

Lockboxes 655

Cash Concentration 657

Accelerating Collections: An Example 658

##### **19.4 Managing Cash Disbursements 659**

Increasing Disbursement Float 660

Controlling Disbursements 660

*Zero-Balance Accounts 660*

*Controlled Disbursement Accounts 661*

##### **19.5 Investing Idle Cash 661**

Temporary Cash Surpluses 661

*Seasonal or Cyclical Activities 661*

*Planned or Possible Expenditures 661*

Characteristics of Short-Term Securities 662

*Maturity 662*

*Default Risk 662*

*Marketability 662*

*Taxes 663*

Some Different Types of Money Market Securities 663

##### **19.6 Summary and Conclusions 664**

### **CHAPTER 20**

#### **CREDIT AND INVENTORY MANAGEMENT 679**

##### **20.1 Credit and Receivables 679**

Components of Credit Policy 680

The Cash Flows from Granting Credit 680

The Investment in Receivables 681

##### **20.2 Terms of the Sale 681**

The Basic Form 681

The Credit Period 682

*The Invoice Date 682*

*Length of the Credit Period 682*

Cash Discounts 683

*Cost of the Credit 684*

*Trade Discounts 684*

*The Cash Discount and the ACP 684*

Credit Instruments 685

##### **20.3 Analyzing Credit Policy 685**

Credit Policy Effects 685

Evaluating a Proposed Credit Policy 686

*NPV of Switching Policies 686*

*A Break-Even Application 688*



- 20.4 Optimal Credit Policy** 688
  - The Total Credit Cost Curve 688
  - Organizing the Credit Function 689
- 20.5 Credit Analysis** 690
  - When Should Credit Be Granted? 690
    - A One-Time Sale* 690
    - Repeat Business* 691
  - Credit Information 692
  - Credit Evaluation and Scoring 692
- 20.6 Collection Policy** 693
  - Monitoring Receivables 693
  - Collection Effort 694
- 20.7 Inventory Management** 694
  - The Financial Manager and Inventory Policy 694
  - Inventory Types 695

- Inventory Costs 695
- 20.8 Inventory Management Techniques** 696
  - The ABC Approach 696
  - The Economic Order Quantity Model 696
    - Inventory Depletion* 698
    - The Carrying Costs* 698
    - The Restocking Costs* 698
    - The Total Costs* 699
  - Extensions to the EOQ Model 701
    - Safety Stocks* 701
    - Reorder Points* 701
  - Managing Derived-Demand Inventories 701
    - Materials Requirements Planning* 701
    - Just-in-Time Inventory* 703
- 20.9 Summary and Conclusions** 703

## PART 8: Topics in Corporate Finance

### CHAPTER 21

- INTERNATIONAL CORPORATE FINANCE** 717
- 21.1 Terminology** 718
- 21.2 Foreign Exchange Markets and Exchange Rates** 719
  - Exchange Rates 720
    - Exchange Rate Quotations* 720
    - Cross-Rates and Triangle Arbitrage* 720
    - Types of Transactions* 723
- 21.3 Purchasing Power Parity** 724
  - Absolute Purchasing Power Parity 724
  - Relative Purchasing Power Parity 726
    - The Basic Idea* 726
    - The Result* 726
    - Currency Appreciation and Depreciation* 727
- 21.4 Interest Rate Parity, Unbiased Forward Rates, and the International Fisher Effect** 728
  - Covered Interest Arbitrage 728
  - Interest Rate Parity 729
    - Forward Rates and Future Spot Rates 730
  - Putting It All Together 730
    - Uncovered Interest Parity* 731
    - The International Fisher Effect* 731
- 21.5 International Capital Budgeting** 732
  - Method 1: The Home Currency Approach 732
  - Method 2: The Foreign Currency Approach 733
  - Unremitted Cash Flows 734
- 21.6 Exchange Rate Risk** 734
  - Short-Run Exposure 734
  - Long-Run Exposure 735
  - Translation Exposure 736
  - Managing Exchange Rate Risk 737
- 21.7 Political Risk** 737
  - The Tax Cuts and Jobs Act of 2017 737
  - Managing Political Risk 738
- 21.8 Summary and Conclusions** 739

### CHAPTER 22

- BEHAVIORAL FINANCE: IMPLICATIONS FOR FINANCIAL MANAGEMENT** 746
- 22.1 Introduction to Behavioral Finance** 747
- 22.2 Biases** 747
  - Overconfidence 747
  - Overoptimism 748
  - Confirmation Bias 748
- 22.3 Framing Effects** 749
  - Loss Aversion 749
  - House Money 750
- 22.4 Heuristics** 752
  - The Affect Heuristic 752
  - The Representativeness Heuristic 753
  - Representativeness and Randomness 753
  - The Gambler's Fallacy 754
- 22.5 Behavioral Finance and Market Efficiency** 755
  - Limits to Arbitrage 756
    - The 3Com/Palm Mispricing* 756
    - The Royal Dutch/Shell Price Ratio* 757
  - Bubbles and Crashes 758
    - The Crash of 1929* 758
    - The Crash of October 1987* 759
    - The Nikkei Crash* 761
    - The "Dot-Com" Bubble and Crash* 761
- 22.6 Market Efficiency and the Performance of Professional Money Managers** 763
- 22.7 Summary and Conclusions** 766

### CHAPTER 23

- ENTERPRISE RISK MANAGEMENT** 769
- 23.1 Insurance** 770
- 23.2 Managing Financial Risk** 772

The Risk Profile	772
Reducing Risk Exposure	772
Hedging Short-Run Exposure	774
Cash Flow Hedging: A Cautionary Note	774
Hedging Long-Term Exposure	775
Conclusion	775
<b>23.3 Hedging with Forward Contracts</b>	<b>776</b>
Forward Contracts: The Basics	776
The Payoff Profile	776
Hedging with Forwards	777
<i>A Caveat</i>	777
<i>Credit Risk</i>	778
<i>Forward Contracts in Practice</i>	778
<b>23.4 Hedging with Futures Contracts</b>	<b>778</b>
Trading in Futures	779
Futures Exchanges	779
Hedging with Futures	779
<b>23.5 Hedging with Swap Contracts</b>	<b>782</b>
Currency Swaps	782
Interest Rate Swaps	783
Commodity Swaps	783
The Swap Dealer	783
Interest Rate Swaps: An Example	784
<b>23.6 Hedging with Option Contracts</b>	<b>785</b>
Option Terminology	785
Options versus Forwards	785
Option Payoff Profiles	785
Option Hedging	786
Hedging Commodity Price Risk with Options	787
Hedging Exchange Rate Risk with Options	788
Hedging Interest Rate Risk with Options	788
<i>A Preliminary Note</i>	788
<i>Interest Rate Caps</i>	789
<i>Other Interest Rate Options</i>	789
Actual Use of Derivatives	789
<b>23.7 Summary and Conclusions</b>	<b>791</b>

## CHAPTER 24

### OPTIONS AND CORPORATE FINANCE 796

<b>24.1 Options: The Basics</b>	<b>797</b>
Puts and Calls	797
Stock Option Quotations	798
Option Payoffs	799
<b>24.2 Fundamentals of Option Valuation</b>	<b>802</b>
Value of a Call Option at Expiration	802
The Upper and Lower Bounds on a Call Option's Value	803
<i>The Upper Bound</i>	803
<i>The Lower Bound</i>	803
A Simple Model: Part I	805
<i>The Basic Approach</i>	805
<i>A More Complicated Case</i>	805
Four Factors Determining Option Values	806

<b>24.3 Valuing a Call Option</b>	<b>807</b>
A Simple Model: Part II	807
The Fifth Factor	808
A Closer Look	809
<b>24.4 Employee Stock Options</b>	<b>810</b>
ESO Features	811
ESO Repricing	811
ESO Backdating	812
<b>24.5 Equity as a Call Option on the Firm's Assets</b>	<b>813</b>
Case I: The Debt Is Risk-Free	813
Case II: The Debt Is Risky	814
<b>24.6 Options and Capital Budgeting</b>	<b>815</b>
The Investment Timing Decision	816
Managerial Options	817
<i>Contingency Planning</i>	818
<i>Options in Capital Budgeting: An Example</i>	819
<i>Strategic Options</i>	820
<i>Conclusion</i>	820
<b>24.7 Options and Corporate Securities</b>	<b>820</b>
Warrants	821
<i>The Difference between Warrants and Call Options</i>	821
<i>Earnings Dilution</i>	821
Convertible Bonds	822
<i>Features of a Convertible Bond</i>	822
<i>Value of a Convertible Bond</i>	822
Other Options	824
<i>The Call Provision on a Bond</i>	824
<i>Put Bonds</i>	824
<i>Insurance and Loan Guarantees</i>	825
<b>24.8 Summary and Conclusions</b>	<b>826</b>

## CHAPTER 25

### OPTION VALUATION 835

<b>25.1 Put-Call Parity</b>	<b>836</b>
Protective Puts	836
An Alternative Strategy	836
The Result	837
Continuous Compounding: A Refresher Course	838
<b>25.2 The Black-Scholes Option Pricing Model</b>	<b>841</b>
The Call Option Pricing Formula	841
Put Option Valuation	844
A Cautionary Note	845
<b>25.3 More about Black-Scholes</b>	<b>846</b>
Varying the Stock Price	846
Varying the Time to Expiration	849
Varying the Standard Deviation	851
Varying the Risk-Free Rate	851
Implied Standard Deviations	851
<b>25.4 Valuation of Equity and Debt in a Leveraged Firm</b>	<b>854</b>
Valuing the Equity in a Leveraged Firm	855
Options and the Valuation of Risky Bonds	856

**25.5 Options and Corporate Decisions: Some Applications** 857

Mergers and Diversification 857

Options and Capital Budgeting 859

**25.6 Summary and Conclusions** 861

## CHAPTER 26

### MERGERS AND ACQUISITIONS 869

**26.1 The Legal Forms of Acquisitions** 870

Merger or Consolidation 870

Acquisition of Stock 871

Acquisition of Assets 871

Acquisition Classifications 872

A Note about Takeovers 872

Alternatives to Merger 873

**26.2 Taxes and Acquisitions** 873

Determinants of Tax Status 873

Taxable versus Tax-Free Acquisitions 874

**26.3 Accounting for Acquisitions** 874

The Purchase Method 874

More about Goodwill 875

**26.4 Gains from Acquisitions** 876

Synergy 876

Revenue Enhancement 877

*Marketing Gains* 877

*Strategic Benefits* 877

*Increases in Market Power* 878

Cost Reductions 878

*Economies of Scale* 878

*Economies of Vertical Integration* 878

*Complementary Resources* 879

Lower Taxes 879

*Net Operating Losses* 879

*Unused Debt Capacity* 879

*Surplus Funds* 879

*Asset Write-Ups* 880

Reductions in Capital Needs 880

Avoiding Mistakes 880

A Note about Inefficient Management 881

**26.5 Some Financial Side Effects of Acquisitions** 881

EPS Growth 881

Diversification 882

**26.6 The Cost of an Acquisition** 883

Case I: Cash Acquisition 884

Case II: Stock Acquisition 884

Cash versus Common Stock 885

**26.7 Defensive Tactics** 886

The Corporate Charter 886

Repurchase and Standstill Agreements 886

Poison Pills and Share Rights Plans 886

Going Private and Leveraged Buyouts 888

Other Devices and Jargon of Corporate Takeovers 888

**26.8 Some Evidence on Acquisitions: Does M&A Pay?** 889

**26.9 Divestitures and Restructurings** 890

**26.10 Summary and Conclusions** 891

## CHAPTER 27

### LEASING 900

**27.1 Leases and Lease Types** 901

Leasing versus Buying 901

Operating Leases 902

Financial Leases 902

*Tax-Oriented Leases* 902

*Leveraged Leases* 903

*Sale and Leaseback Agreements* 903

**27.2 Accounting and Leasing** 903

**27.3 Taxes, the IRS, and Leases** 905

**27.4 The Cash Flows from Leasing** 905

The Incremental Cash Flows 906

A Note about Taxes 906

**27.5 Lease or Buy?** 907

A Preliminary Analysis 907

Three Potential Pitfalls 908

NPV Analysis 908

A Misconception 910

**27.6 A Leasing Paradox** 910

**27.7 Reasons for Leasing** 911

Good Reasons for Leasing 912

*Tax Advantages* 912

*A Reduction of Uncertainty* 913

*Lower Transactions Costs* 913

*Fewer Restrictions and Security Requirements* 913

Dubious Reasons for Leasing 913

*100 Percent Financing* 913

*Low Cost* 914

Other Reasons for Leasing 914

**27.8 Summary and Conclusions** 914

## APPENDIX A

### MATHEMATICAL TABLES A-1

## APPENDIX B

### KEY EQUATIONS B-1

## APPENDIX C

### ANSWERS TO SELECTED END-OF-CHAPTER PROBLEMS C-1

## APPENDIX D

### USING THE HP 10B AND TI BA II PLUS FINANCIAL CALCULATORS D-1

## INDEX I-1