

Detailed Contents

PART 1 INTRODUCTION 33

Chapter 1 The Corporation and Financial Markets 34

- 1.1 The Four Types of Firms 35
 - Sole Proprietorships 35
 - Partnerships 36
 - Limited Liability Companies 37
 - Corporations 37
 - Tax Implications for Corporate Entities 38

- Corporate Taxation Around the World 39

1.2 Ownership Versus Control of Corporations 39

- The Corporate Management Team 39

- **INTERVIEW with** David Viniar 40

- The Financial Manager 41

- **FINANCE IN TIMES OF DISRUPTION**

- The Dodd-Frank Act 42

- The Goal of the Firm 42

- The Firm and Society 42

- Ethics and Incentives within Corporations 43

- Shareholder versus Stakeholder Value 43

- **FINANCE IN TIMES OF DISRUPTION**

- The Dodd-Frank Act on Corporate Compensation 44

- Citizens United v. Federal Election Commission 45

- Airlines in Bankruptcy 46

1.3 The Stock Market 46

- Primary and Secondary Stock Markets 47

- Traditional Trading Venues 47

- **INTERVIEW with** Adena T. Friedman 48

- New Competition and Market Changes 49

- Dark Pools 50

1.4 Fintech: Finance and Technology 51

- Telecommunications 51

- Security and Verification 51

- Automation of Banking Services 52

- Big Data and Machine Learning 52

- Competition 53

- Key Points and Equations 53 ■ Key

- Terms 54 ■ Further Reading 55 ■

- Problems 55

Chapter 2 Introduction to Financial Statement Analysis 59

2.1 Firms' Disclosure of Financial Information 60

- Preparation of Financial Statements 60

- International Financial Reporting Standards 60

- **INTERVIEW with** Ruth Porat 61

- Types of Financial Statements 62

2.2 The Balance Sheet 62

- Assets 63

- Liabilities 64

- Stockholders' Equity 65

- Market Value Versus Book Value 65

- Enterprise Value 66

2.3 The Income Statement 66

- Earnings Calculations 67

2.4 The Statement of Cash Flows 68

- Operating Activity 69

- Investment Activity 70

- Financing Activity 70

2.5 Other Financial Statement Information 71

- Statement of Stockholders' Equity 71

- Management Discussion and Analysis 72

- Notes to the Financial Statements 72

2.6 Financial Statement Analysis 73

- Profitability Ratios 73

- Liquidity Ratios 74

- Working Capital Ratios 75

- Interest Coverage Ratios 76

- Leverage Ratios 77

- Valuation Ratios 79

- **COMMON MISTAKE** Mismatched Ratios 79

- Operating Returns 80

- The DuPont Identity 82

2.7 Financial Reporting in Practice 84

- Enron 84

- WorldCom 84

- Sarbanes-Oxley Act 85

- **FINANCE IN TIMES OF DISRUPTION**

- Bernard Madoff's Ponzi Scheme 86

- Dodd-Frank Act 86

- Foreign Regulation: Wirecard 86

- Key Points and Equations 87 ■ Key

- Terms 89 ■ Further Reading 90 ■

- Problems 90 ■ Data Case 96

Chapter 3 Financial Decision Making and the Law of One Price 99

3.1 Valuing Decisions 100

Analyzing Costs and Benefits 100

Using Market Prices to Determine Cash Values 101

- When Competitive Market Prices Are Not Available 103

3.2 Interest Rates and the Time Value of Money 103

The Time Value of Money 103

The Interest Rate: An Exchange Rate Across Time 103

3.3 Present Value and the NPV Decision Rule 106

Net Present Value 106

The NPV Decision Rule 107

NPV and Cash Needs 109

3.4 Arbitrage and the Law of One Price 110

Arbitrage 110

Law of One Price 111

3.5 No-Arbitrage and Security Prices 111

Valuing a Security with the Law of One Price 111

- An Old Joke 115

The NPV of Trading Securities and Firm Decision Making 115

Valuing a Portfolio 116

- **FINANCE IN TIMES OF DISRUPTION** Liquidity and the Informational Role of Prices 117

- Arbitrage in Markets 118

Where Do We Go from Here? 119

Key Points and Equations 120 ■ Key

Terms 121 ■ Further Reading 121 ■

Problems 121 ■ Data Case 125

Appendix The Price of Risk 126

Risky Versus Risk-Free Cash Flows 126

Arbitrage with Transactions Costs 131

PART 2 TIME, MONEY, AND INTEREST RATES 135

Chapter 4 The Time Value of Money 136

4.1 The Timeline 137

4.2 The Three Rules of Time Travel 138

Rule 1: Comparing and Combining Values 138

Rule 2: Moving Cash Flows Forward in Time 139

Rule 3: Moving Cash Flows Back in Time 140

- Rule of 72 141

Applying the Rules of Time Travel 142

4.3 Valuing a Stream of Cash Flows 144

4.4 Calculating the Net Present Value 146

- **USING EXCEL** Calculating Present Values in Excel 148

4.5 Perpetuities and Annuities 149

Perpetuities 149

- Historical Examples of Perpetuities 149

Annuities 151

- **COMMON MISTAKE** Discounting One Too Many Times 151

■ Formula for an Annuity Due 154
Growing Cash Flows 155

4.6 Using an Annuity Spreadsheet or Calculator 159

- Annuity Calculator 161

4.7 Non-Annual Cash Flows 162

4.8 Solving for the Cash Payments 163

4.9 The Internal Rate of Return 166

- **USING EXCEL** Excel's IRR Function 169

Key Points and Equations 170 ■ Key

Terms 171 ■ Further Reading 172 ■

Problems 172 ■ Data Case 178

Appendix Solving for the Number of Periods 179

Chapter 5 Interest Rates 181

5.1 Interest Rate Quotes and Adjustments 182

The Effective Annual Rate 182

- **COMMON MISTAKE** Using the Wrong Discount Rate in the Annuity Formula 183

Annual Percentage Rates 184

5.2 Application: Discount Rates and Loans 186

5.3 The Determinants of Interest Rates 187

- **FINANCE IN TIMES OF DISRUPTION** Teaser Rates and Subprime Loans 188

Inflation and Real Versus Nominal Rates 188

Investment and Interest Rate Policy 190

The Yield Curve and Discount Rates 191

The Yield Curve and the Economy 192

- **COMMON MISTAKE** Using the Annuity Formula When Discount Rates Vary by Maturity 192

- **INTERVIEW with** Dr. Janet Yellen 194

5.4 Risk and Taxes 195

Risk and Interest Rates 196

After-Tax Interest Rates 197

5.5	The Opportunity Cost of Capital	198		
	■ COMMON MISTAKE States Dig a Multi-Trillion Dollar Hole by Discounting at the Wrong Rate	199		
	Key Points and Equations	200	■	Key Terms
	201	■	Further Reading	201
	■	Problems	201	■
	■	Data Case	206	
Appendix	Continuous Rates and Cash Flows	207		
	Discount Rates for a Continuously Compounded APR	207	■	
	Continuously Arriving Cash Flows	207		
Chapter 6	Valuing Bonds	209		
6.1	Bond Cash Flows, Prices, and Yields	210		
	Bond Terminology	210		
	Zero-Coupon Bonds	210		
	■ FINANCE IN TIMES OF DISRUPTION			
	Negative Bond Yields	212		
	Coupon Bonds	213		
6.2	Dynamic Behavior of Bond Prices	215		
	Discounts and Premiums	215		
	Time and Bond Prices	216		
	Interest Rate Changes and Bond Prices	218		
	■ Clean and Dirty Prices for Coupon Bonds	219		
6.3	The Yield Curve and Bond Arbitrage	221		
	Replicating a Coupon Bond	221		
	Valuing a Coupon Bond Using Zero-Coupon Yields	222		
	Coupon Bond Yields	223		
	Treasury Yield Curves	224		
6.4	Corporate Bonds	224		
	Corporate Bond Yields	225		
	■ Are Treasuries Really Default-Free Securities?	225		
	Bond Ratings	227		
	Corporate Yield Curves	228		
6.5	Sovereign Bonds	228		
	■ FINANCE IN TIMES OF DISRUPTION The Credit Crisis and Bond Yields	229		
	■ FINANCE IN TIMES OF DISRUPTION European Sovereign Debt Yields: A Puzzle	231		
	■ INTERVIEW with Carmen M. Reinhart	232		
	Key Points and Equations	233	■	Key Terms
	234	■	Further Reading	235
	■	Problems	235	■
	■	Data Case	239	■
	■	Case Study	240	
Appendix	Forward Interest Rates	242		
	Computing Forward Rates	242		
	Computing Bond Yields from Forward Rates	243		
	Forward Rates and Future Interest Rates	244		
PART 3 VALUING PROJECTS AND FIRMS 247				
Chapter 7	Investment Decision Rules	248		
7.1	NPV and Stand-Alone Projects	249		
	Applying the NPV Rule	249		
	The NPV Profile and IRR	249		
	Alternative Rules Versus the NPV Rule	250		
	■ INTERVIEW with Dick Grannis	251		
7.2	The Internal Rate of Return Rule	252		
	Applying the IRR Rule	252		
	Pitfall #1: Delayed Investments	252		
	Pitfall #2: Multiple IRRs	253		
	■ COMMON MISTAKE IRR Versus the IRR Rule	255		
	Pitfall #3: Nonexistent IRR	255		
7.3	The Payback Rule	256		
	Applying the Payback Rule	256		
	Payback Rule Pitfalls in Practice	257		
	■ Why Do Rules Other Than the NPV Rule Persist?	258		
7.4	Choosing between Projects	258		
	NPV Rule and Mutually Exclusive Investments	258		
	IRR Rule and Mutually Exclusive Investments	259		
	The Incremental IRR	260		
	■ COMMON MISTAKE Manipulating the IRR with Financing	261		
	■ When Can Returns Be Compared?	263		
7.5	Project Selection with Resource Constraints	263		
	Evaluating Projects with Different Resource Requirements	263		
	Profitability Index	264		
	Shortcomings of the Profitability Index	266		
	Key Points and Equations	266	■	Key Terms
	267	■	Further Reading	267
	■	Problems	267	■
	■	Data Case	273	
Appendix	Computing the NPV Profile Using Excel's Data Table Function	274		

Chapter 8	Fundamentals of Capital Budgeting	275
8.1	Forecasting Earnings	276
	Revenue and Cost Estimates	276
	Incremental Earnings Forecast	277
	Indirect Effects on Incremental Earnings	279
	■ COMMON MISTAKE The Opportunity Cost of an Idle Asset	280
	Sunk Costs and Incremental Earnings	281
	■ COMMON MISTAKE The Sunk Cost Fallacy	281
	Real-World Complexities	282
8.2	Determining Free Cash Flow and NPV	283
	Calculating Free Cash Flow from Earnings	283
	Calculating Free Cash Flow Directly	285
	Calculating the NPV	286
	■ USING EXCEL Capital Budgeting Using Excel	287
8.3	Choosing among Alternatives	288
	Evaluating Manufacturing Alternatives	288
	Comparing Free Cash Flows for Cisco's Alternatives	289
8.4	Further Adjustments to Free Cash Flow	289
	■ INTERVIEW with David Holland	294
8.5	Analyzing the Project	295
	Break-Even Analysis	295
	■ COMMON MISTAKE Corporate Tax Rates and Investment	296
	Sensitivity Analysis	296
	■ USING EXCEL Project Analysis Using Excel	298
	Scenario Analysis	299
	Key Points and Equations	301
	■ Key Terms	302
	■ Further Reading	302
	■ Problems	303
	■ Data Case	309
Appendix	MACRS Depreciation	311

Chapter 9 Valuing Stocks 313

9.1	The Dividend-Discount Model	314
	A One-Year Investor	314
	Dividend Yields, Capital Gains, and Total Returns	315
	■ The Mechanics of a Short Sale	316
	A Multiyear Investor	317
	The Dividend-Discount Model Equation	318
9.2	Applying the Dividend-Discount Model	318
	Constant Dividend Growth	318

	Dividends Versus Investment and Growth	319
	■ John Burr Williams's <i>Theory of Investment Value</i>	320
	Changing Growth Rates	322
	Limitations of the Dividend-Discount Model	324
9.3	Total Payout and Free Cash Flow Valuation Models	324
	Share Repurchases and the Total Payout Model	324
	The Discounted Free Cash Flow Model	326
9.4	Valuation Based on Comparable Firms	330
	Valuation Multiples	330
	Limitations of Multiples	332
	Comparison with Discounted Cash Flow Methods	333
	Stock Valuation Techniques: The Final Word	334
	■ Kenneth Cole Productions—What Happened?	335
	■ Cryptocurrencies and Price Bubbles	336
	■ INTERVIEW with Susan Athey	338
9.5	Information, Competition, and Stock Prices	339
	Information in Stock Prices	339
	Competition and Efficient Markets	340
	Lessons for Investors and Corporate Managers	342
	■ INTERVIEW with Fahmi Quadir	344
	The Efficient Markets Hypothesis Versus No Arbitrage	345
	Key Points and Equations	345
	■ Key Terms	347
	■ Further Reading	347
	■ Problems	348
	■ Data Case	353

PART 4 RISK AND RETURN 355

Chapter 10 Capital Markets and the Pricing of Risk 356

10.1	Risk and Return: Insights from 96 Years of Investor History	357
10.2	Common Measures of Risk and Return	360
	Probability Distributions	360
	Expected Return	360
	Variance and Standard Deviation	361
10.3	Historical Returns of Stocks and Bonds	363
	Computing Historical Returns	363
	Average Annual Returns	365

	The Variance and Volatility of Returns	367			
	Estimation Error: Using Past Returns to Predict the Future	368			
	■ Arithmetic Average Returns Versus Compound Annual Returns	370			
10.4	The Historical Tradeoff Between Risk and Return	370			
	The Returns of Large Portfolios	371			
	The Returns of Individual Stocks	372			
10.5	Common Versus Independent Risk	373			
	Theft Versus Earthquake Insurance: An Example	373			
	The Role of Diversification	374			
10.6	Diversification in Stock Portfolios	375			
	Firm-Specific Versus Systematic Risk	376			
	No Arbitrage and the Risk Premium	377			
	■ FINANCE IN TIMES OF DISRUPTION				
	Diversification Benefits During Market Crashes	379			
	■ COMMON MISTAKE A Fallacy of Long-Run Diversification	380			
10.7	Measuring Systematic Risk	381			
	Identifying Systematic Risk: The Market Portfolio	381			
	Sensitivity to Systematic Risk: Beta	381			
10.8	Beta and the Cost of Capital	384			
	Estimating the Risk Premium	384			
	■ COMMON MISTAKE Beta Versus Volatility	384			
	The Capital Asset Pricing Model	386			
	Key Points and Equations	386	■ Key Terms	388	■ Further Reading
			388	■ Problems	388
			■ Data Case	393	
Chapter 11	Optimal Portfolio Choice and the Capital Asset Pricing Model	395			
11.1	The Expected Return of a Portfolio	396			
11.2	The Volatility of a Two-Stock Portfolio	397			
	Combining Risks	397			
	Determining Covariance and Correlation	398			
	■ COMMON MISTAKE Computing Variance, Covariance, and Correlation in Excel	400			
	Computing a Portfolio's Variance and Volatility	401			
11.3	The Volatility of a Large Portfolio	403			
	Large Portfolio Variance	403			
	Diversification with an Equally Weighted Portfolio	404			
	■ INTERVIEW with Anne Martin	406			
	Diversification with General Portfolios	407			
11.4	Risk Versus Return: Choosing an Efficient Portfolio	407			
	Efficient Portfolios with Two Stocks	408			
	The Effect of Correlation	410			
	Short Sales	411			
	Efficient Portfolios with Many Stocks	412			
	■ NOBEL PRIZE Harry Markowitz and James Tobin	413			
11.5	Risk-Free Saving and Borrowing	415			
	Investing in Risk-Free Securities	415			
	Borrowing and Buying Stocks on Margin	416			
	Identifying the Tangent Portfolio	417			
11.6	The Efficient Portfolio and Required Returns	419			
	Portfolio Improvement: Beta and the Required Return	419			
	Expected Returns and the Efficient Portfolio	421			
11.7	The Capital Asset Pricing Model	423			
	The CAPM Assumptions	423			
	Supply, Demand, and the Efficiency of the Market Portfolio	424			
	Optimal Investing: The Capital Market Line	424			
11.8	Determining the Risk Premium	425			
	Market Risk and Beta	425			
	■ NOBEL PRIZE William Sharpe on the CAPM	427			
	The Security Market Line	428			
	Beta of a Portfolio	428			
	Summary of the Capital Asset Pricing Model	430			
	Key Points and Equations	430	■ Key Terms	433	■ Further Reading
			433	■ Problems	434
			■ Data Case	440	
Appendix	The CAPM with Differing Interest Rates	442			
	The Efficient Frontier with Differing Saving and Borrowing Rates	442			
	The Security Market Line with Differing Interest Rates	442			
Chapter 12	Estimating the Cost of Capital	445			
12.1	The Equity Cost of Capital	446			
12.2	The Market Portfolio	447			
	Constructing the Market Portfolio	447			
	Market Indexes	447			
	■ Value-Weighted Portfolios and Rebalancing	448			
	The Market Risk Premium	449			

- 14.2 Modigliani-Miller I: Leverage, Arbitrage, and Firm Value 531**
 MM and the Law of One Price 531
 Homemade Leverage 531
 ■ MM and the Real World 532
 The Market Value Balance Sheet 533
 Application: A Leveraged Recapitalization 534
- 14.3 Modigliani-Miller II: Leverage, Risk, and the Cost of Capital 536**
 Leverage and the Equity Cost of Capital 536
 Capital Budgeting and the Weighted Average Cost of Capital 537
 ■ **COMMON MISTAKE** Is Debt Better Than Equity? 540
 Computing the WACC with Multiple Securities 540
 Levered and Unlevered Betas 540
 ■ **NOBEL PRIZE** Franco Modigliani and Merton Miller 542
- 14.4 Capital Structure Fallacies 543**
 Leverage and Earnings per Share 543
 ■ **FINANCE IN TIMES OF DISRUPTION** Bank Capital Regulation and the ROE Fallacy 545
 Equity Issuances and Dilution 546
- 14.5 MM: Beyond the Propositions 547**
 Key Points and Equations 548 ■ Key Terms 549 ■ Further Reading 549 ■ Problems 550
- Chapter 15 Debt and Taxes 555**
- 15.1 The Interest Tax Deduction 556**
- 15.2 Valuing the Interest Tax Shield 558**
 The Interest Tax Shield and Firm Value 558
 ■ Pizza and Taxes 559
 The Interest Tax Shield with Permanent Debt 559
 The Weighted Average Cost of Capital with Taxes 560
 ■ The Repatriation Tax: Why Some Cash-Rich Firms Borrowed 561
 The Interest Tax Shield with a Target Debt-Equity Ratio 562
- 15.3 Recapitalizing to Capture the Tax Shield 564**
 The Tax Benefit 564
 The Share Repurchase 565
 No Arbitrage Pricing 565
 Analyzing the Recap: The Market Value Balance Sheet 566
- 15.4 Personal Taxes 567**
 Including Personal Taxes in the Interest Tax Shield 567
 Determining the Actual Tax Advantage of Debt 570
 Valuing the Interest Tax Shield with Personal Taxes 571
 ■ **COMMON MISTAKE** How to Save for Retirement 572
- 15.5 Optimal Capital Structure with Taxes 573**
 Do Firms Prefer Debt? 573
 Limits to the Tax Benefit of Debt 576
 Growth and Debt 577
 ■ **INTERVIEW with** Andrew Balson 578
 Other Tax Shields 579
 The Low Leverage Puzzle 579
 ■ Employee Stock Options 581
 Key Points and Equations 581 ■ Key Terms 582 ■ Further Reading 582 ■ Problems 583 ■ Data Case 587
- Chapter 16 Financial Distress, Managerial Incentives, and Information 589**
- 16.1 Default and Bankruptcy in a Perfect Market 590**
 Armin Industries: Leverage and the Risk of Default 590
 Bankruptcy and Capital Structure 591
- 16.2 The Costs of Bankruptcy and Financial Distress 592**
 The Bankruptcy Code 593
 Direct Costs of Bankruptcy 593
 Indirect Costs of Financial Distress 594
 ■ **FINANCE IN TIMES OF DISRUPTION** The Chrysler Prepack 597
- 16.3 Financial Distress Costs and Firm Value 598**
 Armin Industries: The Impact of Financial Distress Costs 598
 Who Pays for Financial Distress Costs? 598
- 16.4 Optimal Capital Structure: The Tradeoff Theory 600**
 The Present Value of Financial Distress Costs 600
 Optimal Leverage 601
- 16.5 Exploiting Debt Holders: The Agency Costs of Leverage 603**
 Excessive Risk-Taking and Asset Substitution 603
 Debt Overhang and Under-Investment 604

■ FINANCE IN TIMES OF DISRUPTION

Bailouts, Distress Costs, and Debt Overhang 605

Agency Costs and the Value of Leverage 606

The Leverage Ratchet Effect 607

Debt Maturity and Covenants 608

■ Why Do Firms Go Bankrupt? 609

16.6 Motivating Managers: The Agency Benefits of Leverage 609

Concentration of Ownership 610

Reduction of Wasteful Investment 610

■ Excessive Perks and Corporate Scandals 611

■ FINANCE IN TIMES OF DISRUPTION

Moral Hazard, Bailouts, and the Appeal of Leverage 612

Leverage and Commitment 612

■ NOBEL PRIZE Contract Theory 613

16.7 Agency Costs and the Tradeoff Theory 613

The Optimal Debt Level 614

Debt Levels in Practice 615

16.8 Asymmetric Information and Capital Structure 615

Leverage as a Credible Signal 615

Issuing Equity and Adverse Selection 617

■ NOBEL PRIZE Markets with Asymmetric Information and Adverse Selection 619

Implications for Equity Issuance 619

Implications for Capital Structure 620

■ NOBEL PRIZE The Cost of Bank Runs 623

16.9 Capital Structure: The Bottom Line 623

Key Points and Equations 624 ■ Key Terms 626 ■ Further Reading 626 ■ Problems 627

Chapter 17 Payout Policy 635

17.1 Distributions to Shareholders 636

Dividends 636

Share Repurchases 638

17.2 Comparison of Dividends and Share Repurchases 639

Alternative Policy 1: Pay Dividend with Excess Cash 639

Alternative Policy 2: Share Repurchase (No Dividend) 640

■ COMMON MISTAKE Repurchases and the Supply of Shares 642

Alternative Policy 3: High Dividend (Equity Issue) 642

Modigliani-Miller and Dividend Policy Irrelevance 643

■ COMMON MISTAKE The Bird in the Hand Fallacy 644

Dividend Policy with Perfect Capital Markets 644

17.3 The Tax Disadvantage of Dividends 644

Taxes on Dividends and Capital Gains 644

Optimal Dividend Policy with Taxes 646

17.4 Dividend Capture and Tax Clienteles 648

The Effective Dividend Tax Rate 648

Tax Differences Across Investors 649

Clientele Effects 650

■ INTERVIEW with John Connors 651

17.5 Payout Versus Retention of Cash 653

Retaining Cash with Perfect Capital Markets 654

Taxes and Cash Retention 655

Adjusting for Investor Taxes 656

Issuance and Distress Costs 657

Agency Costs of Retaining Cash 658

■ COMMON MISTAKE Mischaracterizing Buybacks 660

17.6 Signaling with Payout Policy 660

Dividend Smoothing 660

Dividend Signaling 661

■ Can a Dividend Cut be Good News? 662

Signaling and Share Repurchases 663

17.7 Stock Dividends, Splits, and Spin-Offs 665

Stock Dividends and Splits 665

Spin-Offs 666

■ Berkshire Hathaway's A & B Shares 667

Key Points and Equations 668 ■ Key

Terms 670 ■ Further Reading 670 ■

Problems 671 ■ Data Case 675

PART 6 ADVANCED VALUATION 677

Chapter 18 Capital Budgeting and Valuation with Leverage 678

18.1 Overview of Key Concepts 679

18.2 The Weighted Average Cost of Capital Method 680

■ INTERVIEW with Zane Rowe 681

Using the WACC to Value a Project 682

Summary of the WACC Method 683

Implementing a Constant Debt-Equity Ratio 684

18.3 The Adjusted Present Value Method 686

The Unlevered Value of the Project 686

Valuing the Interest Tax Shield 687

Summary of the APV Method 688

- 20.3 Put-Call Parity 774**
- 20.4 Factors Affecting Option Prices 777**
 Strike Price and Stock Price 777
 Arbitrage Bounds on Option Prices 777
 Option Prices and the Exercise Date 777
 Option Prices and Volatility 778
- 20.5 Exercising Options Early 779**
 Non-Dividend-Paying Stocks 779
 Dividend-Paying Stocks 781
- 20.6 Options and Corporate Finance 783**
 Equity as a Call Option 783
 Debt as an Option Portfolio 784
 Credit Default Swaps 784
- **FINANCE IN TIMES OF DISRUPTION**
 Credit Default Swaps 785
 Pricing Risky Debt 786
 Agency Conflicts 787
- Key Points and Equations 788 ■ Key Terms 789 ■ Further Reading 789 ■ Problems 789 ■ Data Case 794

Chapter 21 Option Valuation 795

- 21.1 The Binomial Option Pricing Model 796**
 A Two-State Single-Period Model 796
 The Binomial Pricing Formula 798
 A Multiperiod Model 799
 Making the Model Realistic 803
- 21.2 The Black-Scholes Option Pricing Model 804**
 The Black-Scholes Formula 804
 ■ **INTERVIEW with** Myron S. Scholes 805
 Implied Volatility 810
 ■ **FINANCE IN TIMES OF DISRUPTION** The VIX Index 811
 The Replicating Portfolio 812
- 21.3 Risk-Neutral Probabilities 814**
 A Risk-Neutral Two-State Model 814
 Implications of the Risk-Neutral World 814
 Risk-Neutral Probabilities and Option Pricing 815
- 21.4 Risk and Return of an Option 817**
- 21.5 Corporate Applications of Option Pricing 819**
 Beta of Risky Debt 819
 ■ **COMMON MISTAKE** Valuing Employee Stock Options 822
 ■ **NOBEL PRIZE** Pricing Financial Options 823
 Agency Costs of Debt 823

- Key Points and Equations 824 ■ Key Terms 826 ■ Further Reading 826 ■ Problems 826

Chapter 22 Real Options 831

- 22.1 Real Versus Financial Options 832**
- 22.2 Decision Tree Analysis 832**
 Representing Uncertainty 833
 Real Options 834
 Solving Decision Trees 834
- 22.3 The Option to Delay: Investment as a Call Option 835**
 An Investment Option 835
 Factors Affecting the Timing of Investment 838
 ■ Why Are There Empty Lots in Built-Up Areas of Big Cities? 839
 Investment Options and Firm Risk 840
 ■ **FINANCE IN TIMES OF DISRUPTION** Uncertainty, Investment, and the Option to Delay 841
- 22.4 Growth and Abandonment Options 842**
 Valuing Growth Potential 842
 ■ **Growth Options and COVID** 844
 The Option to Expand 844
 The Option to Abandon 845
 ■ **INTERVIEW with** Kenneth C. Frazier 846
- 22.5 Investments with Different Lives 848**
 ■ Equivalent Annual Benefit Method 849
- 22.6 Optimally Staging Investments 850**
- 22.7 Rules of Thumb 853**
 The Profitability Index Rule 854
 The Hurdle Rate Rule 854
 ■ The Option to Repay a Mortgage 856
- 22.8 Key Insights from Real Options 857**
 Key Points and Equations 857 ■ Key Terms 859 ■ Further Reading 859 ■ Problems 859

PART 8 LONG-TERM FINANCING 865

Chapter 23 Raising Equity Capital 866

- 23.1 Equity Financing for Private Companies 867**
 Sources of Funding 867
 ■ Crowdfunding: The Wave of the Future? 868
 ■ **INTERVIEW with** Kevin Laws 869
 Venture Capital Investing 872
 Venture Capital Financing Terms 874

- **COMMON MISTAKE** Misinterpreting Start-Up Valuations 874
 - From Launch to Liquidity 876
 - Exiting an Investment in a Private Company 878
 - 23.2 The Initial Public Offering 878**
 - Advantages and Disadvantages of Going Public 878
 - Types of Offerings 879
 - The Mechanics of an IPO 881
 - Google's IPO 881
 - An Alternative to the Traditional IPO: Spotify's Direct Listing 886
 - 23.3 IPO Puzzles 886**
 - Underpricing 886
 - Cyclicality and Recent Trends 889
 - **FINANCE IN TIMES OF DISRUPTION**
 - Worldwide IPO Deals in 2008–2009 890
 - Cost of an IPO 890
 - Long-Run Underperformance 891
 - 23.4 SPACs: A New Way to Go Public 892**
 - The SPAC Process 893
 - Analyzing a Deal 894
 - SPAC Performance 896
 - 23.5 The Seasoned Equity Offering 897**
 - The Mechanics of an SEO 897
 - Price Reaction 898
 - Issuance Costs 899
 - Key Points and Equations 900 ■ Key Terms 901 ■ Further Reading 902 ■ Problems 903 ■ Data Case 907
- Chapter 24 Debt Financing 909**
- 24.1 Corporate Debt 910**
 - Public Debt 910
 - Private Debt 914
 - 24.2 Other Types of Debt 915**
 - Sovereign Debt 915
 - Green Bonds 916
 - Municipal Bonds 917
 - Detroit's Art Museum at Risk 917
 - Asset-Backed Securities 918
 - **FINANCE IN TIMES OF DISRUPTION**
 - CDOs, Subprime Mortgages, and the Financial Crisis 918
 - 24.3 Bond Covenants 920**
 - 24.4 Repayment Provisions 921**
 - Call Provisions 921
 - New York City Calls Its Municipal Bonds 923
 - Sinking Funds 925
 - Convertible Provisions 925
 - Key Points and Equations 927 ■ Key Terms 928 ■ Further Reading 929 ■ Problems 929
- Chapter 25 Leasing 931**
- 25.1 The Basics of Leasing 932**
 - Examples of Lease Transactions 932
 - Lease Payments and Residual Values 933
 - Leases Versus Loans 934
 - Calculating Auto Lease Payments 935
 - End-of-Term Lease Options 935
 - Other Lease Provisions 937
 - 25.2 Accounting, Tax, and Legal Consequences of Leasing 937**
 - Lease Accounting 938
 - Operating Leases at Alaska Air Group 939
 - The Tax Treatment of Leases 940
 - Leases and Bankruptcy 941
 - Synthetic Leases 942
 - 25.3 The Leasing Decision 942**
 - Cash Flows for a True Tax Lease 943
 - Lease Versus Buy (An Unfair Comparison) 944
 - Lease Versus Borrow (The Right Comparison) 945
 - Evaluating a True Tax Lease 947
 - Evaluating a Non-Tax Lease 948
 - 25.4 Reasons for Leasing 948**
 - Valid Arguments for Leasing 949
 - **INTERVIEW with Mark Long** 952
 - Suspect Arguments for Leasing 953
 - Key Points and Equations 953 ■ Key Terms 954 ■ Further Reading 955 ■ Problems 955
- PART 9 SHORT-TERM FINANCING 959**
- Chapter 26 Working Capital Management 960**
- 26.1 Overview of Working Capital 961**
 - The Cash Cycle 961
 - Firm Value and Working Capital 963
 - 26.2 Trade Credit 964**
 - Trade Credit Terms 964
 - Trade Credit and Market Frictions 964
 - Managing Float 965

26.3	Receivables Management 966
	Determining the Credit Policy 966
	Monitoring Accounts Receivable 967
26.4	Payables Management 969
	Determining Accounts Payable Days Outstanding 969
	Stretching Accounts Payable 970
26.5	Inventory Management 970
	Benefits of Holding Inventory 971
	Costs of Holding Inventory 971
	■ FINANCE IN TIMES OF DISRUPTION
	Supply Chains during COVID-19 972
26.6	Cash Management 973
	Motivation for Holding Cash 973
	Alternative Investments 974
	■ FINANCE IN TIMES OF DISRUPTION
	Hoarding Cash 974
	Key Points and Equations 976 ■ Key Terms 977 ■ Further Reading 977 ■ Problems 978 ■ Data Case 981
Chapter 27	Short-Term Financial Planning 983
27.1	Forecasting Short-Term Financing Needs 984
	Seasonalities 984
	Negative Cash Flow Shocks 987
	Positive Cash Flow Shocks 988
27.2	The Matching Principle 989
	Permanent Working Capital 989
	Temporary Working Capital 989
	Financing Policy Choices 990
27.3	Short-Term Financing with Bank Loans 991
	Single, End-of-Period Payment Loan 991
	Line of Credit 991
	Bridge Loan 992
	Common Loan Stipulations and Fees 992
27.4	Short-Term Financing with Commercial Paper 994
	■ FINANCE IN TIMES OF DISRUPTION
	Short-Term Financing Costs during Crises 995
27.5	Short-Term Financing with Secured Financing 996
	Accounts Receivable as Collateral 996
	Inventory as Collateral 996
	■ A Seventeenth-Century Financing Solution 997
	■ Loan Guarantees: The Ex-Im Bank Controversy 998
	Sales as Collateral 999
	Key Points and Equations 1000 ■ Key Terms 1001 ■ Further Reading 1001 ■ Problems 1001

PART 10 SPECIAL TOPICS 1005

Chapter 28 Mergers and Acquisitions 1006

28.1 Background and Historical Trends 1007

Merger Waves 1007

Types of Mergers 1009

28.2 Market Reaction to a Takeover 1009

28.3 Reasons to Acquire 1010

Economies of Scale and Scope 1011

Vertical Integration 1011

Expertise 1011

Monopoly Gains 1012

Efficiency Gains 1012

Tax Savings from Operating Losses 1013

Diversification 1014

Earnings Growth 1014

Managerial Motives to Merge 1016

28.4 Valuation and the Takeover Process 1017

Valuation 1017

The Offer 1018

Merger "Arbitrage" 1019

Tax and Accounting Issues 1020

Board and Shareholder Approval 1021

28.5 Takeover Defenses 1022

Poison Pills 1022

Staggered Boards 1023

White Knights 1024

Golden Parachutes 1025

Recapitalization 1025

Other Defensive Strategies 1025

Regulatory Approval 1026

■ Weyerhaeuser's Hostile Bid for Willamette Industries 1026

28.6 Who Gets the Value Added from a Takeover? 1027

The Free Rider Problem 1027

Toeholds 1028

The Leveraged Buyout 1028

■ The Leveraged Buyout of RJR-Nabisco by KKR 1029

The Freezeout Merger 1031

Competition 1032

Key Points and Equations 1032 ■ Key

Terms 1034 ■ Further Reading 1034 ■

Problems 1034

Chapter 29 Corporate Governance 1037

29.1 Corporate Governance and Agency Costs 1038

29.2 Monitoring by the Board of Directors and Others 1039

Types of Directors 1039

- Board Independence 1039
 - **COMMON MISTAKE** “Celebrity” Boards 1041
 - Board Size and Performance 1041
 - Other Monitors 1041
 - 29.3 Compensation Policies 1042**
 - Stock and Options 1042
 - Pay and Performance Sensitivity 1042
 - 29.4 Managing Agency Conflict 1044**
 - Direct Action by Shareholders 1044
 - Shareholder Activism at *The New York Times* 1047
 - Management Entrenchment 1047
 - The Threat of Takeover 1048
 - 29.5 Regulation 1048**
 - The Sarbanes-Oxley Act 1048
 - **INTERVIEW with** Lawrence E. Harris 1049
 - The Cadbury Commission 1051
 - Dodd-Frank Act 1051
 - Insider Trading 1052
 - Martha Stewart and ImClone 1053
 - 29.6 Corporate Governance Around the World 1053**
 - Protection of Shareholder Rights 1053
 - Controlling Owners and Pyramids 1053
 - The Stakeholder Model 1056
 - Cross-Holdings 1056
 - 29.7 The Tradeoff of Corporate Governance 1057**
 - Key Points and Equations 1058 ■ Key Terms 1059 ■ Further Reading 1060 ■ Problems 1060
- Chapter 30 Risk Management 1061**
- 30.1 Insurance 1062**
 - The Role of Insurance: An Example 1062
 - Insurance Pricing in a Perfect Market 1062
 - The Value of Insurance 1064
 - The Costs of Insurance 1066
 - The Insurance Decision 1068
 - 30.2 Commodity Price Risk 1068**
 - Hedging with Vertical Integration and Storage 1069
 - Hedging with Long-Term Contracts 1069
 - Hedging with Futures Contracts 1071
 - **COMMON MISTAKE** Hedging Risk 1073
 - Differing Hedging Strategies 1074
 - Deciding to Hedge Commodity Price Risk 1074
 - **FINANCE IN TIMES OF DISRUPTION** Negative Oil Prices 1075
 - 30.3 Exchange Rate Risk 1075**
 - Exchange Rate Fluctuations 1075
 - Hedging with Forward Contracts 1077
 - Cash-and-Carry and the Pricing of Currency Forwards 1078
 - **FINANCE IN TIMES OF DISRUPTION** Arbitrage in Currency Markets? 1081
 - Hedging with Options 1082
 - 30.4 Interest Rate Risk 1085**
 - Interest Rate Risk Measurement: Duration 1086
 - Duration-Based Hedging 1087
 - The Savings and Loan Crisis 1091
 - Swap-Based Hedging 1091
 - Key Points and Equations 1095 ■ Key Terms 1097 ■ Further Reading 1097 ■ Problems 1098
- Chapter 31 International Corporate Finance 1103**
- 31.1 Internationally Integrated Capital Markets 1104**
 - 31.2 Valuation of Foreign Currency Cash Flows 1105**
 - WACC Valuation Method in Domestic Currency 1106
 - Using the Law of One Price as a Robustness Check 1108
 - 31.3 Valuation and International Taxation 1109**
 - The TCJA: A New Approach to International Taxation 1110
 - Harmonizing the Tax Treatment of Exports: GILTI and FDII 1110
 - Avoiding Base Erosion: BEAT 1112
 - 31.4 Internationally Segmented Capital Markets 1112**
 - Differential Access to Markets 1113
 - Macro-Level Distortions 1113
 - Implications 1114
 - 31.5 Capital Budgeting with Exchange Risk 1116**
 - **INTERVIEW with** Sally Johnson 1118
 - Key Points and Equations 1119 ■ Key Terms 1119 ■ Further Reading 1120 ■ Problems 1120 ■ Data Case 1122
- Glossary 1123**
- Index 1145**