

Contents

Introductory Remarks	vii
I Introduction to Finance	
1 Finance	3
1.1 What is Finance?	3
1.2 Corporate Finance	3
1.3 Financial Markets	4
2 Axioms of Modern Corporate Finance	7
2.1 The Axioms	7
2.1.1 Financial Markets are Competitive	7
2.1.2 Value Additivity	8
2.1.3 No Free Lunches	8
2.1.4 The Efficient Markets Hypothesis	8
3 On Value Additivity	9
3.1 Value Additivity	9
3.2 The Value of the Firm	9
3.3 A Couple of Brain Teasers	10
4 On the Efficient Markets Hypothesis	13
4.1 The Idea	13
4.2 Traditional Formulation of the Efficient Markets Hypothesis	14
4.3 What Information?	14
4.4 What Does “Correctly Reflected” Mean?	15
4.4.1 Rational Learning	15
4.4.2 Unbiased Beliefs	16
4.4.3 Adding Compensation for Waiting and Risk	16
4.5 Empirical Evidence	17
4.6 Some Implications of the Efficient Markets Hypothesis	17
4.6.1 One Cannot Time the Market	17

4.6.2	Average Returns in Excess of the Risk Free Rate are Solely Determined by Risk	18
4.6.3	Expected Returns Can Vary Over Time	18

II Basic Finance

5	Present Value	23
5.1	Definition of Present Value	23
5.2	Pricing in Markets for Dated Riskfree Cash Flows	25
5.3	Interest Rates	25
5.4	Term Structure of Interest Rates	27
5.5	Net Present Value	28
5.6	Capital Budgeting	28
5.7	Perpetuities	29
5.8	Annuities	30
5.9	Compound Interest	31
5.10	Valuing Fixed Income Securities	32
5.11	Valuing Equities	33
5.12	Risky Cash flows	34
6	Capital Budgeting	39
6.1	Capital Budgeting	39
6.2	Evaluating Projects Using NPV	40
6.2.1	Calculation of NPV	40
6.2.2	Only Cash Flows	41
6.2.3	Accountants	41
6.2.4	After Tax Cash Flows	41
6.2.5	What are Relevant Cash Flows?	41
6.2.6	Inflation	42
6.2.7	Projects with Different Life Lengths	43
6.3	Alternative Valuation Methods	43
6.3.1	Payback Period	43
6.3.2	Internal Rate of Return	44
6.3.3	Profitability Index	47
6.3.4	Accounting Measures of Return	48
6.4	Some Fancy Acronyms	48
6.4.1	EVA (Economic Value Added)	48
6.4.2	MVA (Market Value Added)	48
6.4.3	TSR (Total Shareholder Return)	49
7	Valuation under Uncertainty: The CAPM	53
7.1	Asset Pricing Theory	53
7.2	Portfolio Returns	54
7.3	Diversifiable and Nondiversifiable Risk	55
7.4	The Set of Efficient Portfolios	56

7.5	The Possibility Set with a Risk Free Security	57
7.6	The Capital Asset Pricing Model	57
7.7	Using CAPM for Pricing	59
7.8	Using CAPM for Capital Budgeting	60
7.9	Empirical Evidence	61
7.10	Experimental Evidence	61
7.11	The Arbitrage Pricing Theory	62
7.12	When the CAPM Would Fail	62
III Multiperiod Pricing and Derivatives		
8	Valuing Risky Cash Flows	69
8.1	Valuation of Dated, Risky Cash Flows	69
8.2	States	70
8.3	States and Digital Options	70
8.4	Expectations and Digital Options	72
8.5	Trees	74
8.6	Summarizing	74
9	Introduction to Derivatives	77
9.1	Derivatives	77
9.2	Definitions	78
9.3	Option Cashflows	79
9.4	Bounds on Option Prices	81
9.4.1	Positivity	81
9.4.2	Simple Upper Bounds	81
9.4.3	European Call Lower Bound	82
9.4.4	Should American Options be Exercised Early?	84
9.5	Put–Call Parity	84
9.6	Wrapping Up	86
10	Pricing Derivatives	89
10.1	Pricing Risky Cash Flows	89
10.2	Pricing Derivatives	90
10.3	Interpreting Equity as an Option	92
11	Pricing of Multiperiod, Risky Investments	97
11.1	Multiple States	97
11.2	Getting to Two States by Adding Time Steps	98
11.3	A Real-Life Example: Pricing an MCI Call Option	100
11.4	General Strategy	104

12 Where to Get State Price Probabilities?	107
12.1 Implementation	107
12.2 Generating the Possible Future States	107
12.3 Now the State Price Probabilities	110
12.4 Pricing Call Options: The MCI Example Again	111
12.5 State Price Probabilities and True Probabilities	113
12.6 The Power of State Price Probabilities	114
13 Warrants	119
13.1 Definition	119
13.2 Firm Value and Warrants	119
13.3 Valuation	121
14 The Dynamic Hedge Argument	123
14.1 Pricing	123
14.2 Why State Prices Must be Equal	123
14.3 The Binomial Option Pricing Model	125
15 Multiple Periods in the Binomial Option Pricing Model	133
15.1 Multiple Periods	133
15.2 The Binomial Formula and the Black Scholes Model	137
15.3 Early Exercise of Puts in the Binomial Model	138
15.4 Adjusting for Dividends in the Binomial Model	139
15.5 Implementing the Binomial Option Formula	141
16 An Application: Pricing Corporate Bonds	145
16.1 Corporate Bonds	145
16.2 The Risky Part of Corporate Bonds	146
16.3 Risk Free Bonds with Put Options	147
16.4 Shareholder Incentives	150
16.5 A Solution: Convertible Bonds	152
16.6 Callable Convertible Bonds	154
IV Corporate Finance	
17 Are Capital Structure Decisions Relevant?	161
17.1 The Capital Structure Problem	161
17.2 The Capital Structure Problem when Assets are In Place	162
17.3 Shareholder Preferences for Firm Value	165
17.4 Implications for Cost of Equity Capital: MM II	166
17.5 What if Assets are not In Place?	168

18	Maybe Capital Structure Affects Firm Value After All?	173
18.1	Only Through Changes in Assets	173
18.2	Corporate Taxes	174
18.3	Bankruptcy Costs	176
18.4	Agency Costs	179
18.5	Personal Taxes	179
18.6	General Equilibrium Effects Restore Irrelevance	179
19	Valuation of Projects Financed Partly with Debt	185
19.1	Adjusting for Taxes	185
19.2	Three Strategies that have been Suggested	185
19.2.1	Adjusted Present Value (APV)	185
19.2.2	Flow to Equity	186
19.2.3	Weighted Average Cost of Capital	186
19.3	The General Principle: Net Present Value Again	187
20	And What About Dividends?	189
20.1	Dividends	189
20.2	The Miller and Modigliani Argument	190
20.3	Why Pay Dividends if only the IRS Gains?	190
20.3.1	Double Taxation	190
20.3.2	Individual Preferences for Capital Gains	191
20.4	Does the Market Agree?	191
20.4.1	The Ex-Day Drop	191
20.4.2	Looking Beyond the Border	192
20.4.3	The Evidence from Returns on Investment	192
20.5	Share Repurchases	192
20.6	So, Why do Firms Pay Dividends? The Signalling Hypothesis	193
20.7	Irrelevance Again	193

V Risk Management

21	Risk and Incentive Management	199
21.1	Hedging	199
21.2	Hedging with Readily Available Contracts	200
21.2.1	Forward and Futures Contracts	200
21.2.2	Pricing of Forward and Futures Contracts	200
21.2.3	Options	202
21.2.4	Other Derivatives	202
21.3	Synthetic Static Hedges	202
21.4	Synthetic Dynamic Hedges	203
21.5	The Metallgesellschaft Case	205
21.6	Value at Risk (VaR)	208
21.7	Should Corporations Hedge?	209
21.8	Managing Incentives	209

VI Summary of the Insights	
22 Fourteen Insights	217
VII Longer Examples	
23 Longer Examples	221
23.1 Determining the Maximum Bid on a Gold Mining License	221
23.2 Chippawhip	222
VIII Appendix	
A Notation and Formulas	233
A.1 Notation	233
A.2 Formulas	234
Bibliography	239
Index	245