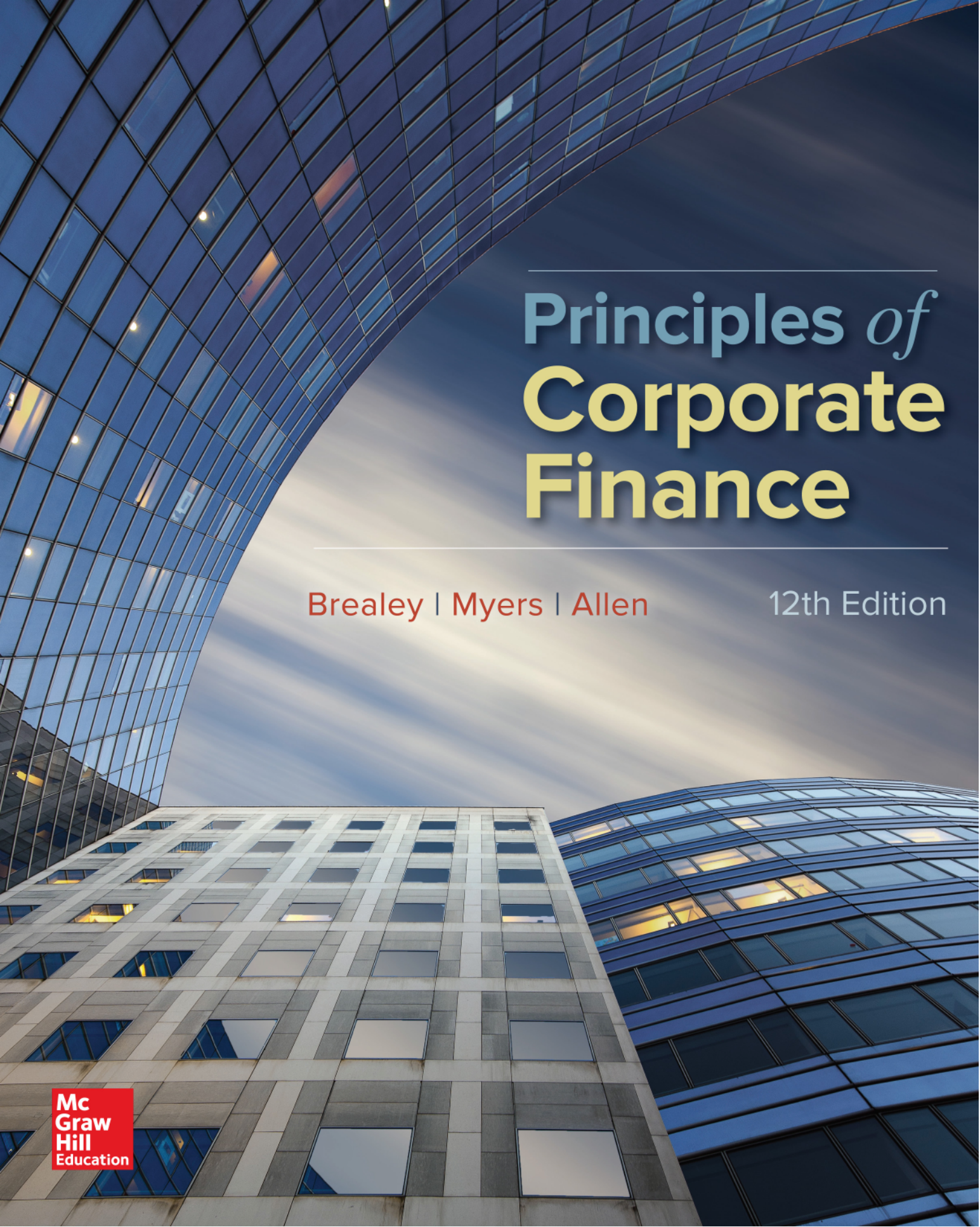

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Principles *of* Corporate Finance

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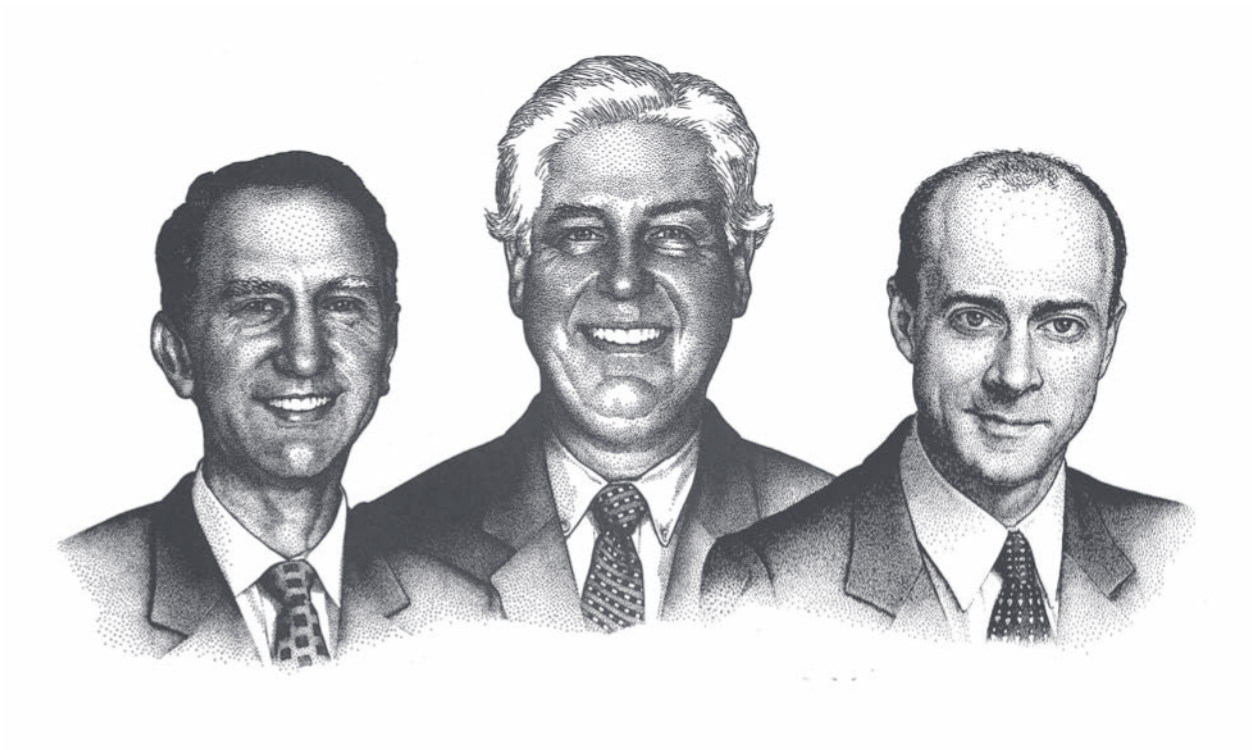
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For Maureen McGuire Myers
1941–2014

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Preface

This book describes the theory and practice of corporate finance. We hardly need to explain why financial managers have to master the practical aspects of their job, but we should spell out why down-to-earth managers need to bother with theory.

Managers learn from experience how to cope with routine problems. But the best managers are also able to respond to change. To do so you need more than time-honored rules of thumb; you must understand *why* companies and financial markets behave the way they do. In other words, you need a *theory* of finance.

Does that sound intimidating? It shouldn't. Good theory helps you to grasp what is going on in the world around you. It helps you to ask the right questions when times change and new problems need to be analyzed. It also tells you which things you do *not* need to worry about. Throughout this book we show how managers use financial theory to solve practical problems.

Of course, the theory presented in this book is not perfect and complete—no theory is. There are some famous controversies where financial economists cannot agree. We have not glossed over these disagreements. We set out the arguments for each side and tell you where we stand.

Much of this book is concerned with understanding what financial managers do and why. But we also say what financial managers *should* do to increase company value. Where theory suggests that financial managers are making mistakes, we say so, while admitting that there may be hidden reasons for their actions. In brief, we have tried to be fair but to pull no punches.

This book may be your first view of the world of modern finance theory. If so, you will read first for new ideas, for an understanding of how finance theory translates into practice, and occasionally, we hope, for entertainment. But eventually you will be in a position to make financial decisions, not just study them. At that point you can turn to this book as a reference and guide.

Changes in the Twelfth Edition

We are proud of the success of previous editions of *Principles,* and we have done our best to make the twelfth edition even better.

Users of previous editions of this book will not find dramatic changes in either the material or the ordering of topics, but throughout we have tried to make the book more up-to-date and easier to read. In many cases, the changes consist of some updated data here and a new example there. Often these additions reflect some recent development in the financial markets or company practice. For instance, you will find brief references to peer-to-peer lending (Chapter 14), crowdfunding (Chapter 15), and tax inversion (Chapter 31).

In other cases, we have removed clutter that has accumulated over successive editions. For example, we have pruned our discussion of market efficiency in Chapter 13, both to make it simpler and also more up-to-date. Behavioral economists often stress the importance of investor sentiment in determining stock prices. We have therefore expanded our discussion of behavioral finance to cover the role of sentiment, which we illustrate with a chart of the varying levels of investor optimism and pessimism. The discussions of short-term financial planning and working capital in Chapters 29 and 30 provide another instance where some rewriting has helped to simplify and remove overlap.

Some important topics get more emphasis than in previous editions. For example, recent events have highlighted the need for ethical behavior. We therefore expanded our discussion of ethical issues in Chapter 1. There is a tendency to focus on blatantly illegal activities as examples of unethical behavior, but for most companies the difficult and important decisions are those that involve gray areas. So we illustrate with a discussion of three gray areas—aggressive tax avoidance, asset stripping, and short selling. We also highlight a key question: Does unethical activity simply result from a few bad apples, or is it more likely the result of a business culture that condones poor behavior?

Another issue that deserved more emphasis is hidden leverage. We introduce this topic in Chapter 14. We return to it in Chapter 17, with the example of Reeby Sports' equipment purchase and a new mini-case, and again in Chapters 18 and 22, when we discuss the leverage created by growth options.

In the last edition, we added digital extensions through our Beyond the Page features, or apps as we call them. This extra material can allow us to escape from some of the constraints of the printed page by providing more explanation for readers who need it and additional material for those who would like to dig deeper. The Beyond the Page features include extra examples and spreadsheet programs, as well as some interesting anecdotes.

There are now over 150 of these apps, including many new ones in this edition. They are all seamlessly available with a click on the e-versions of the book, but they are also readily accessible from the traditional hard copy of the text through the shortcut URLs. Check out **mhhe.com/brealey12e** to learn more.

Examples of these applications include:

- **Chapter 2** Do you need to learn how to use a financial calculator? The Beyond the Page financial calculator application shows how to do so.
- **Chapter 3** Would you like to calculate a bond's duration, see how it predicts the effect of small interest rate changes on bond price, calculate the duration of a common stock, or learn how to measure convexity? The duration application for Figure 3.2 allows you to do so.
- **Chapter 5** Want more practice in valuing annuities? There is an application that provides worked examples and hands-on practice.
- **Chapter 9** How about measuring the betas of the Fama-French three-factor model for U.S. stocks? The Beyond the Page beta estimation application does this.
- **Chapter 14** Ever wondered why Google split its stock into A and C shares? An app provides the answer.
- **Chapter 15** There was not space in the chapter to include a real IPO prospectus, but you can go Beyond the Page to view Twitter's prospectus.
- **Chapter 19** The book briefly describes the flow-to-equity method for valuing businesses, but using the method can be tricky. We provide an application that guides you through the procedure.
- **Chapter 20** The Black-Scholes Beyond the Page application provides an option calculator. It also shows how to estimate the option's sensitivity to changes in the inputs and how to measure an option's risk.
- **Chapter 28** Would you like to view the most recent financial statements for different U.S. companies and calculate their financial ratios? There is an application that will do this for you.

We believe that the opportunity to add additional content and applications such as these will increasingly widen the type of material that can be made available and help the reader to decide how deeply he or she wishes to explore a topic.

We realize the importance that instructors place on having access to a comprehensive and accurate set of questions and answers. Therefore, much of the effort in creating this new edition has gone into improving the set of assignments and ensuring that the answers to these assignments are error-free. We have added to the end-of-chapter questions in the text, but the principal additions are available online through McGraw-Hill's Connect.

Making Learning Easier

Each chapter of the book includes an introductory preview, a summary, and an annotated list of suggested further reading. The list of possible candidates for further reading is now voluminous. Rather than trying to include every important article, we largely list survey articles or general books. We give more specific references in footnotes.

Each chapter is followed by a set of basic problems, intermediate problems on both numerical and conceptual topics, and a few challenge problems. Answers to the odd-numbered basic problems appear in the Appendix at the end of the book.

We included a Finance on the Web section in chapters where it makes sense to do so. This section now houses a number of Web Projects, along with new Data Analysis problems. These exercises seek to familiarize the reader with some useful websites and to explain how to download and process data from the Web.

The book also contains 13 end-of-chapter Mini-Cases. These include specific questions to guide the case analyses. Answers to the mini-cases are available to instructors on the book's website.

Spreadsheet programs such as Excel are tailor-made for many financial calculations. Several chapters include boxes that introduce the most useful financial functions and provide some short practice questions. We show how to use the Excel function key to locate the function and then enter the data. We think that this approach is much simpler than trying to remember the formula for each function.

We conclude the book with a glossary of financial terms.

The 34 chapters in this book are divided into 11 parts. Parts 1 to 3 cover valuation and capital investment decisions, including portfolio theory, asset pricing models, and the cost of capital. Parts 4 to 8 cover payout policy, capital structure, options (including real options), corporate debt, and risk management. Part 9 covers financial analysis, planning, and working-capital management. Part 10 covers mergers and acquisitions, corporate restructuring, and corporate governance around the world. Part 11 concludes.

We realize that instructors will wish to select topics and may prefer a different sequence. We have therefore written chapters so that topics can be introduced in several logical orders. For example, there should be no difficulty in reading the chapters on financial analysis and planning before the chapters on valuation and capital investment.

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