

Finance 323 Exam II Outline

This is an Outline of chapters 8 – 13 of the book. A good use for this outline is to look at the topics and see what you can say about them. For example: Can you define the terms? Can you describe how the concept is used? Can you think of an application? Can you find a problem in the appropriate chapter and solve it without help? Can you come up with a good question relating to the topic? Can you explain the idea and its use to someone else?

Chapter 8 NET PRESENT VALUE AND OTHER INVESTMENT CRITERIA

I. Net Present Value

- A. The Basic Idea
- B. Estimating Net Present Value

II. The Payback Rule

- A. Defining the Rule
- B. Analyzing the Rule
- C. Redeeming Qualities of the Rule
- D. Summary of the Rule

III. The Average Accounting Return

IV. The Internal Rate of Return

- A. Problems with the IRR
- B. Redeeming Qualities of the IRR

V. The Profitability Index

VI. The Practice of Capital Budgeting

Chapter 9 MAKING CAPITAL INVESTMENT DECISIONS

I. Project Cash Flows: A First Look

- A. Relevant Cash Flows
- B. The Stand-Alone Principle

II. Incremental Cash Flows

- A. Sunk Costs
- B. Opportunity Costs

- C. Side Effects
- D. Net Working Capital
- E. Financing Costs
- F. Other Issues

III. Pro Forma Financial Statements and Project Cash Flows

- A. Getting Started: Pro Forma Financial Statements
- B. Project Cash Flows
- C. Projected Total Cash Flow and Value
- D. The Tax Shield Approach

IV. More on Project Cash Flow

- A. A Closer Look at Net Working Capital
- B. Depreciation
- C. An Example: The Majestic Mulch and Compost Company (MMCC)

V. Evaluating NPV Estimates

- A. The Basic Problem
- B. Forecasting Risk
- C. Sources of Value

VI. Scenario and Other What-If Analyses

- A. Getting Started
- B. Scenario Analysis
- C. Sensitivity Analysis

VII. Additional Considerations in Capital Budgeting

- A. Managerial Options and Capital Budgeting
- B. Capital Rationing

Chapter 10 SOME LESSONS FROM CAPITAL MARKET HISTORY

I. Returns

- A. Dollar Returns
- B. Percentage Returns

II. The Historical Record

- A. A First Look

B. A Closer Look

III. Average Returns: The First Lesson

- A. Calculating Average Returns
- B. Average Returns: The Historical Record
- C. Risk Premiums
- D. The First Lesson

IV. The Variability of Returns: The Second Lesson

- A. Frequency Distributions and Variability
- B. The Historical Variance and Standard Deviation
- C. The Historical Record
- D. Normal Distribution
- E. The Second Lesson
- F. Using Capital Market History

V. More on Average Returns

- A. Arithmetic Versus Geometric Average
- B. Calculating Geometric Average Returns
- C. Arithmetic Average Return of Geometric Average Return?

VI. Capital Market Efficiency

- A. Price Behavior in an Efficient Market
- B. The Efficient Markets Hypothesis
- C. Some Common Misconceptions about the EMH
- D. The Forms of Market Efficiency

Chapter 11 RISK AND RETURN

I. Expected Returns and Variances

- A. Expected Return
- B. Calculating the Variance

II. Portfolios

- A. Portfolio Weights
- B. Portfolio Expected Returns
- C. Portfolio Variance

III. Announcements, Surprises, and Expected Returns

- A. Expected and Unexpected Returns
 - B. Announcements and News
- IV. Risk: Systematic and Unsystematic
- A. Systematic and Unsystematic Risk
 - B. Systematic and Unsystematic Components of Return
- V. Diversification and Portfolio Risk
- A. The Effect of Diversification: Another Lesson from Market History
 - B. The Principle of Diversification
 - C. Diversification and Unsystematic Risk
 - D. Diversification and Systematic Risk
- VI. Systematic Risk and Beta
- A. The Systematic Risk Principle
 - B. Measuring Systematic Risk
 - C. Portfolio Betas
- VII. The Security Market Line
- A. Beta and the Risk Premium
 - B. The Security Market Line
- VIII. The SML and the Cost of Capital: A Preview
- A. The Basic Idea
 - B. The Cost of Capital

Chapter 12 COST OF CAPITAL

- I. The Cost of Capital: Some Preliminaries
- A. Required Return versus Cost of Capital
 - B. Financial Policy and Cost of Capital
- II. The Cost of Equity
- A. The Dividend Growth Model Approach
 - B. The SML Approach
- III. The Costs of Debt and Preferred Stock

- A. The Cost of Debt
- B. The Cost of Preferred Stock

IV. The Weighted Average Cost of Capital

- A. The Capital Structure Weights
- B. Taxes and the Weighted Average Cost of Capital
- C. Solving the Warehouse Problem and Similar Capital Budgeting Problems
- D. Calculating the WACC for Eastman Chemical

V. Divisional And Project Costs of Capital

- A. The SML and the WACC
- B. Divisional Cost of Capital
- C. The Pure Play Approach
- D. The Subjective Approach

Chapter 13 LEVERAGE AND CAPITAL STRUCTURE

I. The Capital Structure Question

II. The Effect of Financial Leverage

- A. The Impact of Financial Leverage
- B. Corporate Borrowing and Homemade Leverage

III. Capital Structure and the Cost of Equity Capital

- A. M&M Proposition I: The Pie Model
- B. The Cost of Equity and Financial Leverage: M&M Proposition II
- C. Business and Financial Risk

IV. Corporate Taxes and Capital Structure

- A. The Interest Tax Shield
- B. Taxes and M&M Proposition I

V. Bankruptcy Costs

- A. Direct Bankruptcy Costs
- B. Indirect Bankruptcy Costs

VI. Optimal Capital Structure

- A. The Static Theory of Capital Structure
 - B. Optimal Capital Structure and the Cost of Capital
 - C. Capital Structure: Some Managerial Recommendations
- VII. Observed Capital Structures
- VIII. A Quick Look at the Bankruptcy Process
- A. Liquidation and Reorganization
 - B. Financial Management and the Bankruptcy Process
 - C. Agreements to Avoid Bankruptcy