

Corporate Finance, Module 10, "Positive Net Present Values"

Corporate finance module 10: Readings for Eleventh Edition

(The attached PDF file has better formatting.)

The page numbers here are for the *eleventh* edition of Brealey and Myers. You may also use the seventh, eighth, ninth, or tenth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the eleventh edition.

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Module 10 reviews some financial items often overlooked by budding entrepreneurs. One sometimes hears that a business will succeed if it meets an unfilled demand, so entrepreneurs should concentrate on finding these unfilled demands. At some business schools, this is a mantra: students are *trained* to find these unfilled demands.

This perspective considers only the demand side; it ignores the supply side. Brealey and Myers say: "Look first to market values." Not only must there be an unfilled demand, but you must have some advantage over potential competitors in filling the demand.

Illustration: Suppose an actuary vacations one summer at a new resort. There are no insurance agents in the new resort, and the actuary tells his company that they should build an agency there and market their products. But the actuary has considered only the demand side, not the supply side. If the resort is in an area where the company does not now sell insurance, its peer companies can probably provide insurance more cheaply. The company may have a slight advantage if it gets its agent first into the area, but it is at a disadvantage in keeping profitable business from moving to competitors who can service the town more cheaply. The market is not always right. But unless you have an advantage over your competitors, be wary.

Question: The business sections of *Time* and other news-magazines describe entrepreneurs who find unfilled demands and make high profits by filling them.

Answer: Brealey and Myers would say that the perspective is only half right. To succeed, a firm must fill a consumer demand. But unless it has a competitive advantage it won't make money. For every entrepreneur who finds an unfilled demand and makes high profits, there are half a dozen entrepreneurs who find unfilled demands and go broke.

Question: You make it sound as though one needs special training that others don't have to succeed. But entrepreneurs don't need PhD's to succeed. Many PhD's are poor, and many successful entrepreneurs don't even have college degrees.

Answer: Most graduate programs don't teach useful business skills. They train students to write theses; this may be useful to future authors, but it is useless for business.

Read sections 11.1, 11.2, and 11.3. These are stories and examples. Brealey and Myers build the theory from the examples, which are quite good. The final exam gives scenarios similar to those in the textbook and asks about financing and production decisions.

Imagine that you are setting up a new insurer. Using the principles in this chapter, under what conditions might you expect the insurer to be profitable?

You can skip the Warren Buffett sidebar on pages 287. It's fun to read, but nothing on the final exam tests these pages.

Read the summary on page 288.

Review problems 1 and 2 on page 289; problems 8 and 10 on page 290; and problems 13, 14, and 15 on page 291.

You can skip the mini-case on Ecsy-Cola on pages 293-294.