Corporate Finance, Module 16, “Debt Policy”

Readings for the Fourteenth Edition (2022) of the Brealey, Myers, Allen, and Edmans text

(The attached PDF file has better formatting.)

The sections in this posting are for the *fourteenth* edition of the Brealey, Myers, Allen, and Edmans text. You may also use the seventh through thirteenth editions; final exam problems can be answered from any edition.

{The Brealey, Myers, Allen, and Edmans 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.}

Read Section 16-1 “Financial leverage and shareholder value.” The central topic of this module is summarized as “Modigliani and Miller proved that market value does not depend on capital structure in perfect, frictionless financial markets. … the total value of outstanding debt and equity depends on the value of the firm’s real assets, operations, and growth opportunities, but not on the proportions of debt and equity.”

Read Section 16-2 “Modigliani and Miller’s Proposition 1.” Understand financial leverage and the simple tables used to explain Modigliani and Miller’s Proposition 1. The textbook summarizes this as “a law of conservation of value. The value of an asset is preserved regardless of the nature of the claims against it. Thus, Proposition 1: Firm value is determined on the left-hand side of the balance sheet by real assets—not by the proportions of debt and equity securities issued to buy the assets.” The Macbeth Spot Removers Example of Proposition 1 on pages 464-465 is easy to follow. Be sure you can replicates table 16.3 (page 465) for other input data.

Read Section 16-3 “Leverage and expected returns: MM’s Proposition 2.” Know equation 16.1 at the bottom of page 466 and equation 16.2 on page 467. Financial Leverage has offsetting effects on expected return and risk, leading to no change in wealth.

Read the subsection “Leverage and the Cost of Equity” on pages 468-470. The arithmetic in Section 16-3 is used in final exam problems. You must derive the cost of equity capital or the cost of debt capital in several modules of this course.

Read the subsection “How Changing Capital Structure Affects the Equity Beta” on pages 470-471. Know equations 16.3 and 16.4; for perfect capital markets, the final exam will ask you to derive

- R_A or R_E from the other
- β_A or β_E from the other

Read Section 16-4 “No Magic in Financial Leverage.” You will not be tested on the Basel requirements for banks in “Does MM Apply to Banks?” or the similar capital requirements for insurers (Solvency II).

Read Section 16-5 “A Final Word on the Cost of Capital.” Know the after-tax weighted-average cost of capital or WACC on page 476, which you must use for final exam problems.

Review problems 1, 2, 4, 5, 6, 8, 9, 10, 11, 12, 13, 17, 20, 21, and 22; the final exam asks similar problems.

The *key takeaways* summarize the important formulas in this module.

Illustrative test questions, problems, and homework assignments are shown separately on the discussion forum.