

Corporate Finance, Module 16, “Debt Policy”

Required reading:

(The attached PDF file has better formatting.)

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{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.}

Read the boxed introduction on page 465. The central topic of this module is summarized as “Modigliani and Miller, who showed that dividend policy doesn’t matter in perfect capital markets, also showed that financing decisions don’t matter in perfect markets.”

Read section 17.1, “The Effect of Leverage in a Competitive Tax Free Economy,” on pages 465-471, focusing on the sub-section “Enter Modigliani and Miller” on pages 467-468. Make sure you can replicate Table 17.3 on page 471; the final exam questions are similar to the data in this table.

Read section 17.2, “How Leverage Affects Returns,” on pages 472-475. Focus on four relations in this section: the relations for

- R_A on page 472
- R_E on page 473
- β_A on page 475
- β_E on page 475

They are all the same equation, re-arranged to solve for different variables. You will use these equations to solve final exam questions on returns and betas.

Skip section 17.3, “The Traditional Position,” on pages 476-481. You must know the weighted average cost of capital, which is discussed on page 476, but this relation is discussed elsewhere in the text and there is nothing that you must know from this section.

Read the summary on page 482 until the line “... has no effect on firm value”; skip the rest of the summary.