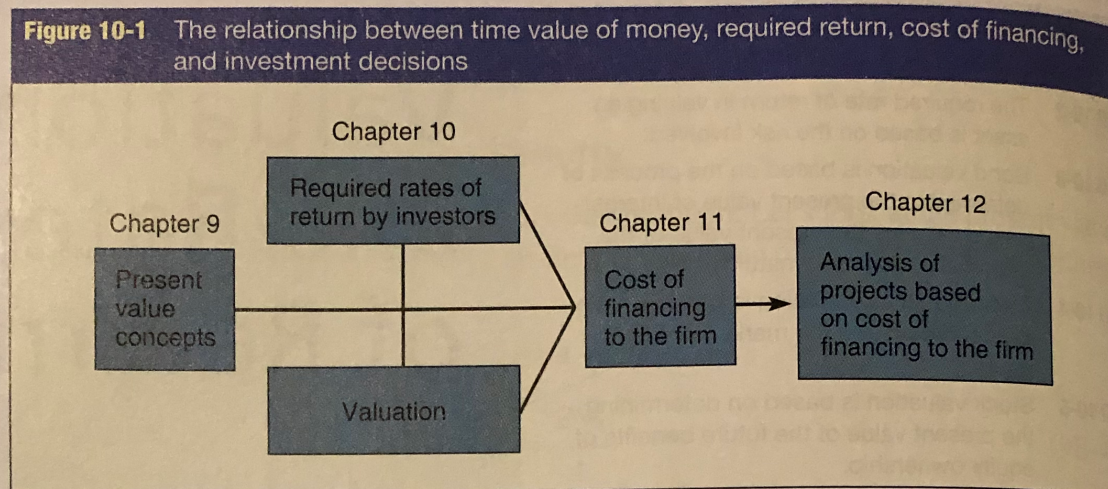


The cost of corporate financing (capital) is subsequently used in analyzing whether a project is acceptable for investment. These relationships are depicted in Figure 10-1.



Valuation Concepts

The valuation of a financial asset is based on determining the present value of future cash flows. Thus we need to know the value of future cash flows and the discount rate to be applied to the future cash flows to determine the current value.

The market-determined **required rate of return**, which is the discount rate, depends on the market's perceived level of risk associated with the individual security. Also important is the idea that required rates of return are competitively determined among the many companies seeking financial capital. For example, Microsoft, due to its low financial risk, relatively high return, and strong market position, is likely to raise debt capital at a significantly lower cost than can United Airlines, a firm with high financial risk. This implies that investors are willing to accept low return for low risk, and vice versa. The market allocates capital to companies based on risk, efficiency, and expected returns—which are based to a large degree on past performance. The reward to the financial manager for efficient use of capital in the past is a lower required return for investors than that of competing companies that did not manage their financial resources as well.

Throughout the balance of this chapter, we apply concepts of valuation to corporate bonds, preferred stock, and common stock. Although we describe the basic characteristics of each form of security as part of the valuation process, extended discussion of each security is deferred until later chapters.

Valuation of Bonds

As previously stated, the value of a financial asset is based on the concept of the present value of future cash flows. Let's apply this approach to bond valuation. A bond provides an annuity stream of interest payments and a \$1,000 principal payment at maturity.¹ These cash flows are discounted at Y , the yield to maturity. The value of Y is determined in the bond market and represents the required rate of return for bonds of a given risk and maturity. More will be said about the concept of yield to maturity in the next section.

¹The assumption is that the bond has a \$1,000 par value. If the par value is higher or lower, then this value would be discounted to the present from the maturity date.