

Excel Modeling in Corporate Finance

FIFTH EDITION





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EXCEL[®] MODELING IN CORPORATE FINANCE *Fifth Edition*

Global Edition

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PEARSON

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CONTENTS

Preface	8
Fifth Edition Changes	8
Ready-To-Build Spreadsheets	8
What is Unique about This Book	11
Conventions Used in This Book	12
Craig's Challenge	14
Excel TM Modeling Books	14
Suggestions for Faculty Members	14
Acknowledgments	15
About The Author	17

PART 1 TIME VALUE OF MONEY....18

Chapter 1 Single Cash Flow	18
1.1 Present Value	18
1.2 Future Value	19
Problems	20
Chapter 2 Annuity	21
2.1 Present Value	21
2.2 Future Value	22
2.3 System of Four Annuity Variables	23
Problems	24
Chapter 3 NPV Using Constant Discounting	25
3.1 Nominal Rate	25
3.2 Real Rate	
Problems	27
Chapter 4 NPV Using General Discounting	
4.1 Nominal Rate	
4.2 Real Rate	
Problems	32
Chapter 5 Loan Amortization	
5.1 Basics	
5.2 Sensitivity Analysis	34
Problems	
Chapter 6 Lease Vs. Buy	37
6.1 Car	
6.2 Corporate	
Problems	

Chapter 7 Bond Valuation	40
7.1 Annual Payments	40
7.2 EAR, APR, and Foreign Currencies	41
7.3 Duration and Convexity	

7.4 Price Sensitivity	48
7.5 System of Five Bond Variables	50
Problems	51
Chapter 8 Estimating the Cost of Capital	54
8.1 Static CAPM Using Fama-MacBeth Method	54
8.2 APT or Intertemporal CAPM Using Fama-McBeth Method	
Problems	63
Chapter 9 Stock Valuation	64
9.1 Dividend Discount Model	64
Problems	65
Chapter 10 Firm and Project Valuation	66
10.1 Cash Flows for Five Equivalent Methods	66
10.2 Adjusted Present Value	69
10.3 Free Cash Flow To Equity	70
10.4 Free Cash Flow to the Firm	71
10.5 Dividend Discount Model	72
10.6 Residual Income	73
10.7 Five Equivalent Methods	74
Problems	83
Appendix: Reconciling the Residual Income Method with Other	
Approaches to Valuing Firms or Projects	84
Chapter 11 The Yield Curve	90
11.1 Obtaining It From Treasury Bills and Strips	90
11.2 Using It To Price A Coupon Bond	91
11.3 Using It To Determine Forward Rates	92
Problems	93
Chapter 12 US Yield Curve Dynamics	94
12.1 Dynamic Chart	94
Problems	

PART 3 CAPITAL STRUCTURE......101

Chapter 13 Capital Structure	
13.1 Modigliani-Miller With No Taxes	
13.2 Modigliani-Miller With Corporate Taxes	
13.3 Trade-off Model: Tax Shield vs. Distress Cost	
Problems	107

PART 4 CAPITAL BUDGETING......108

Chapter 14 Project NPV	
14.1 Basics	
14.2 Forecasting Cash Flows	
14.3 Working Capital	
14.4 Sensitivity Analysis	
Problems	
Chapter 15 Cost-Reducing Project	
15.1 Basics	
15.2 Sensitivity Analysis	
Problems	122

Chapter 16 Break-Even Analysis	
16.1 Based On Accounting Profit	
16.2 Based On NPV	
Problems	130
Problems	130

PART 5 FINANCIAL PLANNING131

Chapter 17 Corporate Financial Planning	131
17.1 Actual	131
17.2 Forecast	134
17.3 Cash Flow	138
17.4 Ratios	140
17.5 Sensitivity	142
17.6 Full-Scale Estimation	143
Problems	149
Chapter 18 Du Pont System Of Ratio Analysis	152
18.1 Basics	152
Problems	153
Chapter 19 Life-Cycle Financial Planning	154
19.1 Taxable Vs. Traditional Vs. Roth Savings	154
19.2 Basic Life-Cycle Planning	156
19.3 Full-Scale Life-Cycle Planning	158
Problems	165

Chapter 20 International Parity	166
20.1 System of Four Parity Conditions	166
20.2 Estimating Future Exchange Rates	168
Problems	169

Chapter 21 Binomial Option Pricing	
21.1 Estimating Volatility	
21.2 Single Period	171
21.3 Multi-Period	174
21.4 Risk Neutral	
21.5 Average of N and N-1	
21.6 Convergence to Normal	
21.7 American With Discrete Dividends	
21.8 Full-Scale	
Problems	194
Chapter 22 Real Options	
22.1 Option To Abandon	
22.2 Option to Expand	197

22.3 Option to Contract	
22.4 Option To Choose	
22.5 Compound Option	
Problems	
Chapter 23 Black-Scholes Option Pricing	206
23.1 Basics	
23.2 Continuous Dividend	
23.3 Implied Volatility	
Problems	
Chapter 24 Debt And Equity Valuation	215
24.1 Two Methods	
24.2 Impact of Risk	
Problems	

Chapter 25 Useful Excel Tricks	
25.1 Quickly Delete The Instructions and Arrows	
25.2 Freeze Panes	
25.3 Spin Buttons and the Developer Tab	
25.4 Option Buttons and Group Boxes	
25.5 Scroll Bar	
25.6 Install Solver or the Analysis ToolPak	
25.7 Format Painter	224
25.8 Conditional Formatting	
25.9 Fill Handle	
25.10 2-D Scatter Chart	
25.11 3-D Surface Chart	

DOWNLOADABLE CONTENTS

- 🔁 Excel Modeling in Corporate Finance Fifth Edition.pdf
- Ready-To-Build spreadsheets available in both XLSX

and XLS file formats:

- Ch 01 Single Cash Flow Ready-To-Build.xlsx
- Ch 02 Annuity Ready-To-Build.xlsx
- Ch 03 NPV Using Constant Discounting Ready-To-Build.xlsx
- Ch 04 NPV Using General Discounting Ready-To-Build.xlsx
- Main Ch 05 Loan Amortization Ready-To-Build.xlsx
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- Ch 14 Project NPV Ready-To-Build.xlsx
- Ch 15 Cost-Reducing Project Ready-To-Build.xlsx

- Ch 16 Break-Even Analysis Ready-To-Build.xlsx
- Ch 17 Corporate Financial Planning Ready-To-Build.xlsx
- Ch 18 Du Pont System of Ratio Analysis Ready-To-Build.xlsx
- Ch 19 Life-Cycle Financial Planning Ready-To-Build.xlsx
- Ch 20 International Parity Ready-To-Build.xlsx
- Ch 21 Binomial Option Pricing Ready-To-Build.xlsx
- Ch 22 Real Options Ready-To-Build.xlsx
- Ch 23 Black-Scholes Option Pricing Ready-To-Build.xlsx
- Ch 24 Debt and Equity Valuation Ready-To-Build.xlsx

Preface

For more than 30 years, since the emergence of Lotus 1-2-3 and Microsoft ExcelTM in the 1980s, spreadsheet models have been the dominant vehicles for finance professionals in the business world to implement their financial knowledge. Yet even today, most Corporate Finance textbooks have very limited coverage of how to build Excel models. This book fills that gap. It teaches students how to build financial models in Excel. It provides step-by-step instructions so that students can build models themselves (active learning), rather than being handed already-completed spreadsheets (passive learning). It progresses from simple examples to practical, real-world applications. It spans nearly all quantitative models in corporate finance, including nearly all niche areas of corporate finance.

My goal is simply to *change finance education from limited treatment of the most basic Excel models to comprehensive treatment of both simple and sophisticated Excel models.* This change will better prepare students for their future business careers. It will increase student evaluations of teacher performance by enabling more practical, real-world content and by allowing a more hands-on, active learning pedagogy.

Fifth Edition Changes

The Fifth Edition adds great new corporate finance content:

- Real options, including project valuation with abandonment options, expansion options, contraction options, chooser options, and compound options
- Lease vs. buy decisions, including car and corporate applications
- Taxable vs. traditional vs. Roth savings plans

All of the real-world data, including financial statements, bond prices, the yield curve, asset returns, exchange rates, and options prices, have been updated.

Ready-To-Build Spreadsheets

This product includes **Ready-To-Build spreadsheets**, which can be downloaded from www.pearsonglobaleditions.com/Holden. The spreadsheets are available in both "**XLSX**" and "**XLS**" file formats. By default, the screen shots and instructions in the book are based on **Excel 2013**. For the items explained in this book, there are no significant differences relative to Excel 2010. There are few places where there are differences relative to Excel 2007. In those instances "Excel 2007 Equivalent" boxes have been added in the margin to explain how to do the equivalent step in Excel 2007.

The instruction boxes on the Ready-To-Build spreadsheets are *bitmapped images* so that the formulas cannot just be copied to the spreadsheet. Both the instruction boxes and arrows are *objects*, so that they can easily be deleted when the spreadsheet is complete. Just select the boxes and arrows and press delete. This leaves a clean spreadsheet for future use.

Ready-To-Build Spreadsheets for every chapter provide:



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20 Interest Experise 37.00 37.00 37.00 37.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 30.00 \$20.20 \$217.00 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.20 \$217.21 \$183.00 \$50.00 \$60.00 <td>20</td> <td>Interest Expanse</td> <td></td> <td></td> <td>\$100.00 ¢7.50</td> <td>1</td> <td>\$195.00 \$7.66</td> <td></td> <td>\$215.00 \$7.90</td> <td>ΨZ</td> <td>£25.00</td> <td>φ245.00 ¢9.10</td> <td></td> <td>\$305.00 ¢2.25</td>	20	Interest Expanse			\$100.00 ¢7.50	1	\$195.00 \$7.66		\$215.00 \$7.90	ΨZ	£25.00	φ245.00 ¢9.10		\$305.00 ¢2.25
21 Lainings Defore Tax 917.2.0 3217.6.3 3217.6.3 3237.5.3 3230.50 3220.7.3 23 Earnings \$103.50 \$112.41 \$124.32 \$130.23 \$142.14 \$178.65 24 Add Back Depreciation \$103.50 \$112.41 \$124.32 \$130.23 \$142.14 \$178.65 25 Cash Flow from Operations \$163.50 \$112.41 \$124.32 \$130.23 \$202.14 \$238.05 26 Add Back Depreciation \$163.50 \$172.41 \$184.32 \$190.23 \$202.14 \$238.05 26 New Invest in Plant and Equipment \$163.50 \$172.41 \$184.32 \$190.23 \$200.14 \$238.05 27 New Invest in Working Capital \$170.00 \$(\$60.00) ÷ \$(\$60.00) ÷ \$(\$1	20	Earnings Before Tax		-	\$1.30 \$172.50	1	\$7.00 \$187.35		\$7.00 \$207.20	¢2	97.95 017.05	\$0.10		\$0.25 \$296.75
21 Costson	22				.\$69.00	-	\$7/.9/		\$82.88	φ2 φ	86.82	\$94.76		\$118.70
24 Add Back Depreciation 260.00 \$6	23	Farnings			\$103.50		\$112.41		\$124.32	\$1	130.23	\$142.14		\$178.05
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26 Order to more prediction Order to more prediction Order to more prediction 27 New Invest in Plant and Equipment (\$60.00) ÷ (\$60.00) ÷ (\$60.00) ÷ (\$60.00) ÷ (\$60.00) ÷ (\$60.00) ÷ (\$10.00) ÷ (\$10.00) ÷ (\$10.00) \$50.00 29 New Invest in Working Capital (\$70.00) (\$70.00) (\$70.00) (\$70.00) (\$70.00) (\$70.00) (\$70.00) (\$70.00) (\$10.2500 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 (\$10.2500 • \$10.741 \$119.32 \$125.23 \$137.14 \$149.30 20 New Borrowing (Repayment) \$55.00 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 ÷ \$5.00 ± \$13.75 \$149.30 36 = Dividends \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 \$149.30 36 = Dividends \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 37 (\$6) Earnings Before Tax · Taxes (9) If Include Infinite Horizon = Yes, Then -Infinite Horizon Growth Rate * Boorwing(T+1) 38 (\$0) Earnings Hore Tax - Taxes (10) Sum of Investments Cash Flow to Caput(T) 41 (7) Depreciation (10) Sum of Investments Cash Flows the Working Capital(T+1) 42 (13) Free Cash Flow to Equity Enter =C34 and copy (12) Cash Flow from Operations + Cash Flow from Investments Enter =C23+C30+C32 and copy across 41 (13) Free Cash Flow to Equity Enter =C34 and copy (12) Cash Flow from Operations + Cash Flow from Investments Enter =C25+C30+C32 and copy across 41<	25	Cash Flow from Operations		1	\$163.50		\$172.41		\$184.32	\$1	190.23	\$202.14	<u> </u>	\$238.05
27 New Invest in Plant and Equipment (60.00)	26			11	11		• •••			÷.	00.20	Q202.11		\$200.00
28 After-Tax Salvage Value	27	New Invest in Plant and Equipment		H	(\$60.00)	÷	(\$60.00)	÷	(\$60.00)	÷ (\$	60.00)	(\$60.00)		(\$92.50)
29 New Invest in Working Capital 1 \$10.00) (\$10.250) 31 Stanta Stanta (\$5.00 \$5.00 \$5.00 \$5.00 \$13.75 32 New Borrowing (Repayment) Stanta \$119.32 \$125.23 \$137.14 \$149.30 35 = Dividends \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 36 [5) (Earnings Before Tax) * (Tax Rate) \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 36 [6) Earnings Before Tax - Taxes \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 37 [6) Earnings Before Tax - Taxes \$90.50 \$107.41	28	After-Tax Salvage Value		1	li (Y		Y			\$0.00		1
30 Cash Flows from Investments (\$70.00) </td <td>29</td> <td>New Invest in Working Capital</td> <td></td> <td>÷</td> <td>(\$10.00)</td> <td>÷</td> <td>(\$10.00)</td> <td>÷</td> <td>(\$10.00)</td> <td>÷ (\$</td> <td>610.00)</td> <td>(\$10.00)</td> <td>÷</td> <td>(\$10.00)</td>	29	New Invest in Working Capital		÷	(\$10.00)	÷	(\$10.00)	÷	(\$10.00)	÷ (\$	610.00)	(\$10.00)	÷	(\$10.00)
31 New Borrowing (Repayment) 55.00 \$5.00 \$5.00 \$5.00 \$5.00 \$5.00 \$13.75 33 Free Cash Flow to Equity (FCFE) \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 36 (5) (Earnings Before Tax) * (Tax Rate) (9) If Include Infinite Horizon = Yes, Then -Infinite Horizon Growth Rate * Book Value of Equity(T) . Gross Earnings(T+1) . New Invest in Working Capital(T+1) 41 (7) Depreciation Enter =C18 and copy across (10) Sum of Investments (11) If Include Infinite Horizon = Yes, 44 (8) Earnings + Depreciation (10) Sum of Investments (11) If Include Infinite Horizon = Yes, 45 Enter =C23+C24 and copy across (10) Sum of Investments (11) If Include Infinite Horizon = Yes, 46 Then Infinite Horizon Growth Rate * Debt(T) Else 0 Enter =IF(C10=1,B9*G80,0) Enter =IF(C10=1,B9*G80,0) Enter =IF(C10=1,B9*G80,0) Enter =C25+C30+C32 and copy across Inter =C25+C30+C32 and copy across Enter =C25+C30+C32 and copy across Enter =C25+C30+C32 and copy across Inter	30	Cash Flows from Investments		T	(\$70.00)		(\$70.00)		(\$70.00)	(\$	\$70.00)	(\$70.00)		(\$102.50)
32 New Borrowing (Repayment) \$5.00 ÷ \$5.00 is 10.20 higher there is the tend in the tend is the tend	31			1	1 1									
33 34 Free Cash Flow to Equity (FCFE) 35 36 37 38 39 39 (6) (Earnings Before Tax) * (Tax Rate) Enter = C21*SB\$6 and copy across 39 39 (6) Earnings Before Tax - Taxes Enter = C21-C22 and copy across 30 31 41 (7) Depreciation Enter = C23+C24 and copy across 42 (8) Earnings + Depreciation Enter = C23+C24 and copy across 44 (8) Earnings + Depreciation Enter = C23+C24 and copy across 44 (13) Free Cash Flow to Equity Enter = C34 and copy (12) Cash Flow from Operations + Cash Flow from Investments + New Borrowing (Repayment) Enter = C25+C30+C32 and copy across	32	New Borrowing (Repayment)		-	\$5.00	±	\$5.00	÷	\$5.00	÷	\$5.00	\$5.00		\$13.75
34 Free Cash Flow to Equity (FCFE) \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 35 = Dividends \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 36 (5) (Earnings Before Tax) * (Tax Rate) Enter =C21*\$58\$6 and copy across (9) If Include Infinite Horizon = Yes, Then -Infinite Horizon Growth Rate * Book Value of Equity(T) - Gross Earnings(T+1) 39 (6) Earnings Before Tax - Taxes Enter =C21-C22 and copy across - Gross Earnings(T+1) - New Invest in Working Capital(T+1) 41 (7) Depreciation Enter =C18 and copy across (10) Sum of Investments Cash Flows (11) If Include Infinite Horizon = Yes, Then Infinite Horizon Growth Rate * Debt(T) 44 (8) Earnings + Depreciation Enter =C23+C24 and copy across (10) Sum of Investments Cash Flows (11) If Include Infinite Horizon = Yes, Then Infinite Horizon Growth Rate * Debt(T) 45 Enter =C23+C24 and copy across (12) Cash Flow from Operations + Cash Flow from Investments Enter =C34 and copy (12) Cash Flow from Operations + Cash Flow from Investments + New Borrowing (Repayment) Enter =C25+C30+C32 and copy across (13) Free Cash Flow to Equity Enter =C25+C30+C32 and copy across	33				i i	\								
35 = Dividends \$98.50 \$107.41 \$119.32 \$125.23 \$137.14 \$149.30 36 (5) (Earnings Before Tax) * (Tax Rate) Enter =C21*\$B\$6 and copy across (9) If Include Infinite Horizon = Yes, Then -Infinite Horizon Growth Rate * Book Value of Equity(T) - Gross Earnings(T+1) (9) If Include Infinite Horizon = Yes, Then -Infinite Horizon Growth Rate * Book Value of Equity(T) 39 (6) Earnings Before Tax - Taxes Enter =C21-C22 and copy across (9) If Include Infinite Horizon Growth Rate * Book Value of Equity(T) 40 (7) Depreciation Enter =C18 and copy across (10) Sum of Investments Cash Flows Enter =C23+C24 and copy across (10) Sum of Investments Enter =C23+C24 and copy across 44 (8) Earnings + Depreciation Enter =C23+C24 and copy across (11) If Include Infinite Horizon = Yes, Then Infinite Horizon = Yes, Then Infinite Horizon Growth Rate * Debt(T) Else 0 47 (13) Free Cash Flow to Equity Enter =C34 and copy (12) Cash Flow from Operations + Cash Flow from Investments + New Borrowing (Repayment) Enter =C25+C30+C32 and copy across 51 (12) Cash Flow from Operations + Cash Flow from Investments Enter =C25+C30+C32 and copy across	34	Free Cash Flow to Equity (FCFE)			\$98.50	1	\$107.41		\$119.32	\$1	125.23	\$137.14		\$149.30
36 37 38 39 40 40 40 41 42 44 4 4 4 4 4 4 4 4 4 4 4 4 4 4 4	35	= Dividends			\$98.50	1	\$107.41		\$119.32	\$1	125.23	\$137.14		\$149.30
37 Enter = C21*\$B\$6 and copy across 38 (6) Earnings Before Tax - Taxes Enter = C21-C22 and copy across 40 (7) Depreciation Enter = C18 and copy across 41 (7) Depreciation Enter = C18 and copy across 43 (8) Earnings + Depreciation Enter = C23+C24 and copy across 44 (8) Earnings + Depreciation Enter = C23+C24 and copy across 45 Enter = C23+C24 and copy across 46 (10) Sum of Investments Cash Flows Enter 47 (13) Free Cash Flow to Equity Enter = C34 and copy 48 (12) Cash Flow from Operations + Cash Flow from Investments + New Borrowing (Repayment) Enter = C25+C30+C32 and copy across 51 (12) Cash Flow from Operations + Cash Flow from Investments + New Borrowing (Repayment) Enter = C25+C30+C32 and copy across	36	(5) (Earnings Before Tax) * (Tax Ba	ite)	1	11				(9) If Incl	ude In	nfinite H	lorizon = Yes		
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	51				Enter	-02	0+030+03	iz a	na copy a	cross				

Spin buttons, option buttons, and graphs facilitate visual, interactive learning

Many spreadsheets use real-world data

	A	В	С	D	E	F	G	Н	I	J
1	CORPORATE FINA		PLANN	ING	Full-Sc	ale Estir	nation			
2	Nike, Inc.	5/31/2010	5/31/2011	5/31/2012	5/31/2013	5/31/2014	5/31/2015	5/31/2016	Ave. %	
3	Financial Plan	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast	of Sales	
4	Key Assumptions								(1) Fore	cast kev
5	Sales Growth Rate		5.8%	16.0%	8.5%	9.0%	10.0%	11.0%	assum	ptions
6	Tax Rate	24.2%	24.1%	25.0%	24.7%	24.0%	24.0%	24.0%	Enter	forecast
7	Int Rate on Short-Term Debt	0.12%	0.04%	0.09%	0.05%	0.10%	0.15%	0.20%	values	in the
8	Int Rate on Long-Term Debt	1.17%	0.71%	0.39%	0.58%	0.70%	0.80%	0.90%	range	F5:H10
9	Dividend Payout Rate	26.9%	26.3%	28.8%	29.1%	28.0%	29.0%	30.0%	(aone	for you)
10	Price / Earnings	18.4	18.6	21.6	22.2	21.0	21.0	21.0		
11			(2) 0			0 I D				
12		(2) Gros	s Margin - 5 	SG&AE + NO	n-Op Inc - De	epreciation				
13	Income Statement (Mil.			+D19-D20 al	55					
14	Sales	\$19,014.0	\$20,117.0	\$23,331.0	\$25,313.0	\$27,591.2	\$30,350.3	\$33,688.8		
15	Cost of Goods Sold	\$10,213.6	\$10,975.0	\$13,183.0	\$14,279.0	\$15,236.4	\$16,760.0	\$18,603.6		
16	Gross Margin	\$8,800.4	\$9,202.0	\$10,148.0	\$11,034.0	\$12,354.8	\$13,590.3	\$15,085.2		
17			/							
18	Selling, Gen & Adm Expenses	\$6,326.4	\$6,361.0	\$7,051.0	\$7,766.0	\$8,677.0	\$9,544.7	\$10,594.6		
19	Non-Operating Income	\$42.9	\$21.0	(\$58.0)	\$18.0	\$10.5	\$11.6	\$12.8		
20	Depreciation	\$0.0	\$0.0	\$14.0	\$14.0	\$8.0	\$8.7	\$9.7		
21	EBIT	\$2,516.9	\$2,862.0	\$3,025.0	\$3,272.0	\$3,680.4	\$4,048.4	\$4,493.7		
22										
23	Interest Expense	\$0.0	\$0.0	\$0.0	\$0.0	\$8.53	\$2.93	\$3.51		
24	Taxes	\$610.2	\$690.0	\$756.0	\$808.0	\$881.2	\$970.9	\$1,077.7		
25	Extraordinary Items	\$0.0	\$39.0	\$46.0	(\$21.0)	\$21.2	\$23.4	\$25.9		
26	Net Income	\$1,906.7	\$2,133.0	\$2,223.0	\$2,485.0	\$2,769.3	\$3,051.2	\$3,386.6		
27	Shares Outstanding (Millions)	968.0	936.0	916.0	894.0	894.0	894.0	894.0		
28	Earnings Per Share	\$1.97	\$2.28	\$2.43	\$2.78	\$3.10	\$3.41	\$3.79		

What is Unique about This Book

There are many features which distinguish this book from any other:

- Plain Vanilla Excel. Other books on the market emphasize teaching students programming using Visual Basic for Applications (VBA) or using macros. By contrast, this book does nearly everything in plain vanilla Excel. Although programming is liked by a minority of students, it is seriously disliked by the majority. Excel has the advantage of being a very intuitive, user-friendly environment that is comprehensible to all. It is fully capable of handling a wide range of applications, including quite sophisticated ones. Further, the only assumption is that your students already know the basics of Excel, such as entering formulas in a cell and copying formulas from one cell to another. All other features of Excel (such as built-in functions, Data Tables, Solver, etc.) are explained as they are used.
- **Build from Simple Examples to Practical, Real-World Applications.** The general approach is to start with a simple example and build up to a practical,

real-world application. In many chapters, the previous Excel model is carried forward to the next, more complex model. For example, the chapter on binomial option pricing carries forward Excel models as follows: (a.) singleperiod model with replicating portfolio, (b.) eight-period model with replicating portfolio, (c.) eight-period model with risk-neutral probabilities, (d.) eight-period model with risk-neutral probabilities for American or European options with discrete dividends, (e.) full-scale, fifty-period model with risk-neutral probabilities for American or European options with discrete dividends. Whenever possible, this book builds up to full-scale, practical applications using real data. Students are excited to learn practical applications that they can actually use in their future jobs. Employers are excited to hire students with Excel modeling skills, who can be more quickly productive.

- Supplement for All Popular Corporate Finance Textbooks. This book is a supplement to be combined with a primary textbook. This means that you can keep using whatever textbook you like best. You don't have to switch. It also means that you can take an incremental approach to incorporating Excel modeling. You can start modestly and build up from there.
- A Change in Content, Too. Excel modeling is not merely a new medium, but an opportunity to cover some unique content items which require computer support to be feasible. For example, the full-scale estimation Excel model in Corporate Financial Planning uses three years of historical 10K data on Nike, Inc. (including every line of their income statement, balance sheet, and cash flow statement), constructs a complete financial system (including linked financial ratios), and projects these financial statements three years into the future. The chapter on Estimating the Cost of Capital uses 10 years of monthly returns for individual stocks, U.S. Fama-French portfolios, and country ETFs to estimate the cost of capital using the Static CAPM based on the Fama-MacBeth method and to estimate the cost of capital using the APT or Intertemporal CAPM based on the Fama-MacBeth method. The Excel model to estimate firm valuation or project valuation demonstrates the equivalence of the Free Cash Flow To Equity, Free Cash Flow to the Firm, Residual Income, Dividend Discount Model, and the Adjusted Present Value technique, not just in the perpetuity case covered by some textbooks, but for a fully general two-stage project with an arbitrary set of cash flows over an explicit forecast horizon, followed by an infinite horizon growing perpetuity. As a practical matter, all of these sophisticated applications require Excel.

Conventions Used in This Book

This book uses a number of conventions.

• **Time Goes Across the Columns and Variables Go Down the Rows.** When something happens over time, I let each column represent a period of time. For example, in life-cycle financial planning, date 0 is in column B, date 1 is in column C, date 2 is in column D, etc. Each row represents a different

variable, which is usually labeled in column A. This manner of organizing Excel models is common because it is how financial statements are organized.

- Color Coding. A standard color scheme is used to clarify the structure of the Excel models. The Ready-To-Build spreadsheets available for download use:

 (1) yellow shading for input values, (2) no shading (i.e. white) for throughput formulas, and (3) green shading for final results ("the bottom line"). A few Excel models include choice variables with blue shading.
- **The Timeline Technique.** The most natural technique for discounting cash flows in an Excel model is the timeline technique, where each column corresponds to a period of time. As an example, see the section labeled "Bond Price using a Timeline" in the figure below.



• Using as Many Different Techniques as Possible. In the figure above, the bond price is calculated using as many different techniques as possible. Specifically, it is calculated three ways: (1) discounting each cash flow on a time line, (2) using the closed-form formula, and (3) using Excel's PV function. This approach makes the point that all three techniques are equivalent. This approach also develops skill at double-checking these calculations, which is a very important method for avoiding errors in practice.

• Symbolic Notation is Self-Contained. Every spreadsheet that contains symbolic notation in the instruction boxes is self-contained (i.e., all symbolic notation is defined on the spreadsheet).

Craig's Challenge

I challenge the reader of this book to dramatically improve your finance education by personally constructing all of the Excel models in this book. This will take you about 10–20 hours depending on your current Excel modeling skills. Let me assure you that it will be an excellent investment. You will:

- gain a practical understanding of the core concepts of Corporate Finance
- develop hands-on, Excel modeling skills
- build an entire suite of finance applications, which you fully understand

When you complete this challenge, I invite you to e-mail me at <u>cholden@indiana.edu</u> to share the good news. Please tell me your name, school, (prospective) graduation year, and which Excel modeling book you completed. I will add you to a web-based honor roll at:

http://www.excelmodeling.com/honor-roll.htm

We can celebrate together!

ExcelTM Modeling Books

This book is one of two *Excel Modeling* books by Craig W. Holden, published by Pearson. The other book is *Excel Modeling in Investments*. Both books teach value-added skills in constructing financial models in Excel. Complete information about my *Excel Modeling* books is available at my web site:

http://www.excelmodeling.com

If you have any suggestions or corrections, please e-mail them to me at **cholden@indiana.edu**. I will consider your suggestions and will implement any corrections in the next edition.

Suggestions for Faculty Members

There is no single best way to use *Excel Modeling in Corporate Finance*. There are as many different techniques as there are different styles and philosophies of teaching. You need to discover what works best for you. Let me highlight several possibilities:

1. **Out-of-class individual projects with help.** This is a technique that I have used and it works well. I require completion of several short Excel modeling

projects of every individual student in the class. To provide help, I schedule special "help lab" sessions in a computer lab during which time I and my graduate assistant are available to answer questions while students do each assignment in about an hour. Typically about half the questions are Excel questions and half are finance questions. I have always graded such projects, but an alternative approach would be to treat them as ungraded homework.

- 2. **Out-of-class individual projects without help.** Another technique is to assign Excel modeling projects for individual students to do on their own out of class. One instructor assigns seven Excel modeling projects at the beginning of the semester and has individual students turn in all seven completed Excel models for grading at the end of the semester. At the end of each chapter are problems that can be assigned with or without help. Faculty members can download the completed Excel models and answers to end-of-chapter problems at <u>http://www.pearsonglobaleditions.com/Holden</u>. See your local Pearson representative to gain access.
- 3. **Out-of-class group projects.** A technique that I have used for the last fifteen years is to require students to do big Excel modeling projects in groups. I have students write a report to a hypothetical boss that intuitively explains their method of analysis, key assumptions, and key results.
- 4. **In-class reinforcement of key concepts.** The class session is scheduled in a computer lab or students are asked to bring their laptop computers to class. I explain a key concept in words and equations. Then I turn to a 10–15 minute segment in which students open a Ready-To-Build spreadsheet and build the Excel model in real-time in the class. This provides real-time, hands-on reinforcement of a key concept. This technique can be done often throughout the semester.
- 5. **In-class demonstration of Excel modeling.** The instructor can perform an in-class demonstration of how to build Excel models. Typically, only a small portion of the total Excel model would be demonstrated.
- 6. In-class demonstration of key relationships using Spin Buttons, Option Buttons, and Charts. The instructor can dynamically illustrate comparative statics or dynamic properties over time using visual, interactive elements. For example, one spreadsheet provides a "movie" of 43 years of U.S. term structure dynamics. Another spreadsheet provides an interactive graph of the sensitivity of bond prices to changes in the coupon rate, yield-to-maturity, number of payments/year, and face value.

I'm sure I haven't exhausted the list of potential teaching techniques. Feel free to send an e-mail to <u>cholden@indiana.edu</u> to let me know novel ways in which you use this book.

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Craig W. Holden is a Professor of Finance at the Kelley School of Business at Indiana University. His M.B.A. and Ph.D. are from the Anderson School at UCLA. He is the winner of many teaching and research awards, including a Fama/DFA Prize. His research on market microstructure has been published in leading academic journals. He has written *Excel Modeling in Investments* and *Excel Modeling in Corporate Finance*. The Fifth Editions in English are published by Pearson and there are International, Chinese, and Italian editions. He has chaired 20 dissertations, been a member or chair of 58 dissertations, serves as the

Secretary-Treasurer of the *Society for Financial Studies*, serves as an associate editor of the *Journal of Financial Markets*, and serves on the program committees of the *Western Finance Association* and the *European Finance Association*. He chaired the department undergraduate committee for thirteen years, chaired the department doctoral committee for four years, chaired three different schoolwide committees for a combination of six years, and currently serves for a third year on the campus tenure advisory committee. He has led several major curriculum innovations in the finance department. More information is available at Craig's home page: www.kelley.iu.edu/cholden.

PART 1 TIME VALUE OF MONEY

Chapter 1 Single Cash Flow

1.1 Present Value

Problem. A single cash flow of \$1,000.00 will be received in 5 periods. For this cash flow, the appropriate discount rate / period is 6.0%. What is the present value of this single cash flow?

Solution Strategy. We will calculate the present value of this single cash flow in three equivalent ways. First, we will calculate the present value using a time line, where each column corresponds to a period of calendar time. Second, we use a formula for the present value. Third, we use Excel's **PV** function for the present value.

Excel 2013

FIGURE 1.1 Excel Model for Single Cash Flow - Present Value.

	A	В	С	D	E	F	G	Н	1	J
1	SINGLE CASH FLOW	Present	Value							
2										
3	Inputs			S	ingle C	ash Flov	w - Pres	ent ۱	Value	
4	Single Cash Flow	\$1,000.00	20	\$1,400.00 \$1,200.00						
5	Discount Rate / Period	▲●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●●<	6	\$1,000.00				•		
6	Number of Periods	• 5	5	\$800.00 \$600.00					• Cash Flow	/s
7				¢ 400.00						
8				\$400.00					Present V	alue
9				\$200.00	-					
10				\$0.00		1	, ,			
11					0 1	2 3	3 4	5		
12						Period				
13										
14	Present Value using a Time Line									
15	Period	0	1	2	3	4	5			
16	Cash Flows						x \$1,000.00			
17	Present Value						\$747.26			
18			(1) The si	nalo cash flor	v occurs in t	ho final pori				
19	Present Value using the Formula		Enter =	R4	w occurs in t	ne inai pend				
20	Present Value	\$747.26	Entor	54						
21			(2) (0	Cash Flow) / ((1+Discount	Rate/Period	l) ^ Period)	L		
22	Present Value using the PV Funct	ion	L E	nter =G16/((1	I+\$B\$5)^G1	5)				
23	Present Value	\$747.26								
24		Ţ	(3) (Cash	Flow) / ((1 +	Discount Ra	te/Period) ^	Period)			
25		i	Enter =	-B4/((1+B5)^	86)					
26	(4) DV/D	i Dete (Det	ad Name	(Deriede 0	Olarda Oral					
27	(4) -PV(Disco	VINT Rate / Perio	oa, number o	or Periods, U,	Single Cash	I FIOW)				
28	EnterP	(03,00,0,04)								
29										

The Present Value of this Single Cash Flow is \$747.26. Notice you get the same answer all three ways: using the time line, using the formula, or using the PV function!

1.2 Future Value

Problem. A single cash flow of \$747.26 is available now (in period 0). For this cash flow, the appropriate discount rate / period is 6.0%. What is the period 5 future value of this single cash flow?

Solution Strategy. We will calculate the future value of the single cash flow in three equivalent ways. First, we will calculate the future value using a time line, where each column corresponds to a period of calendar time. Second, we use a formula for the future value. Third, we use Excel's **FV** function for the future value.

Excel 2013

FIGURE 1.2 Excel Model for Single Cash Flow - Future Value.



The Future Value of this Single Cash Flow is \$1,000.00. Notice you get the same answer all three ways: using the time line, using the formula, or using the FV function!

Comparing Present Value and Future Value, we see that they are opposite operations. That is, one operation "undoes" the other. The Present Value of \$1,000.00 in period 5 is \$747.26 in period 0. The Future Value of \$747.26 in period 0 is \$1,000.00 in period 5.

Problems

- 1. A single cash flow of \$1,723.48 will be received in 6 periods. For this cash flow, the appropriate discount rate / period is 6.8%. What is the present value of this single cash flow?
- A single cash flow of \$1,032.47 is available now (in period 0). For this cash flow, the appropriate discount rate / period is 2.9%. What is the period 5 future value of this single cash flow?

Chapter 2 Annuity

2.1 Present Value

Problem. An annuity pays \$80.00 each period for 5 periods. For these cash flows, the appropriate discount rate / period is 6.0%. What is the present value of this annuity?

Solution Strategy. We will calculate the present value of this annuity in three equivalent ways. First, we will calculate the present value using a time line, where each column corresponds to a period of calendar time. Second, we use a formula for the present value. Third, we use Excel's **PV** function for the present value.

Excel 2013

FIGURE 2.1 Excel Model for Annuity - Present Value.



The Present Value of this Annuity is \$336.99. Notice you get the same answer all three ways: using the time line, using the formula, or using the PV function.

2.2 Future Value

Problem. An annuity pays \$80.00 each period for 5 periods. For these cash flows, the appropriate discount rate / period is 6.0%. What is the period 5 future value of this annuity?

Solution Strategy. We will calculate the future value of this annuity in three equivalent ways. First, we will calculate the future value using a time line, where each column corresponds to a period of calendar time. Second, we use a formula for the future value. Third, we use Excel's **FV** function for the future value.

Excel 2013

FIGURE 2.2 Excel Model for Annuity - Future Value.

	A	В	С	D	E	F	G	Н	1	J
1	ANNUITY	Future	Value							
2										
3	Inputs					Annuit	ty			
4	Payment	\$80.00	8	\$140.00						
				\$120.00	-			_		
5	Discount Rate / Period	• 6.0%	6	\$100.00						
	Biododant Hato / Fonod		Ű	\$80.00					Cash Elau	
c	Number of Desireda	8,	~	000.00	_			TI		15
7	Number of Periods	<u> </u>	5	\$60.00						
8				\$40.00					Future Va	lue of
9				\$20.00				— L	Each Cash	Flow
10				\$0.00						
11					0 1	2 3	4	5		
12						Period				
13						T CHOU				
14	Annuity Future Value using a Tin	ne Line								
15	Period	0	1	2	3	4	5			
16	Cash Flows		\$80.00	\$80.00	\$80.00	\$80.00	\$80.00			
17	Future Value of Each Cash Flow		\$101.00	\$95.28	\$89.89	\$84.80	\$80.00			
18	Future Value		T	\backslash			\$450.97			
19			(1) Cash Flow E	Each Period	= Payment	1			
20	Annuity Future Value using the F	ormula		Enter =\$B\$	4 and copy a	cross		\		
21	Future Value	\$450.97						1		
22			(2) (Ca	sh Flow) * (1	+ Discount F	Rate/Period)		1		
23	Annuity Future Value using the F	V Function	\^(([Number of Pe	eriods) - (Curi	rent Period))				
24	Future value	\$450.97		er - C 16 (1+\$	000)~(0001:	5-C 15) and C	copy across			
20			1	(3) \$	Sum of all the	e Future Valu	ie of Cash Fl	ows		
20			1	Ē	Enter =SUM(C17:G17)				
28			(4) (De	wmont) * ///1	+ Discourt	Data/Daried)				
29			(4) (Pa ^(N	umber of Per	iods)) - 1) / (Discount Rat	te/Period)			
30			Ent	er =B4*(((1+E	35)^B6)-1)/B	5				
31										
32		(5) -FV(Dis	count Rate /	Period, Num	ber of Period	ls, Payment,	0)			
33		Enter =-	rv(D0,D0,B	4,0)						

The Future Value of this Annuity is \$450.97. Notice you get the same answer all three ways: using the time line, using the formula, or using the FV function.

2.3 System of Four Annuity Variables

Problem. There is a tight connection between all of the inputs and output to annuity valuation. Indeed, they form a system of four annuity variables: (1) Payment, (2) Discount Rate / Period, (3) Number of Periods, and (4) Present Value. Given any three of these variables, find the fourth variable.

Solution Strategy. Given any three of these variable, we will use as many equivalent ways of solving for the fourth variable as possible. The Annuity – Present Value spreadsheet solves for the present value using a Timeline, a formula, and the **PV** function. Building on that spreadsheet, add the Payment using the formula and **PMT** function. Then add the Discount Rate / Period using the **RATE** function. Then add the Number of Periods, using the **NPER** function.

Excel 2013 FIGURE 2.3 Excel Model for Annuity - System of Four Annuity Variables.

	A	В	С	D	E	F	G	Н	1	J
1	ANNUITY	System	of Fou	r Annuit	y Varial	bles				
2										
3	Inputs									
4	Payment	▲\$80.00	8	\$140.00	_	Annu	ity			
5	Discount Rate / Period	▲●●6.0%	6	\$120.00						
6	Number of Periods	5	5	\$100.00 \$80.00		8	• •	-	• Cash Flow	/s
7	Present Value	▲ ▼ \$336.99	6	\$60.00 \$40.00					Present V	alue of
8				\$20.00				L	Each Cash	Flow
10				\$0.00	0 1	2	3 4			
12						- Perio	1	-		
13										
14	Annuity Present Value using a Time Li	ine								
15	Period	0	1	2	3	4	5			
16	Cash Flows		\$80.00	\$80.00	\$80.00	\$80.00	\$80.00			
17	Present Value of Each Cash Flow		\$75.47	\$71.20	\$67.17	\$63.37	\$59.78			
18	Present Value	\$336.99								
19									_	
20	Annuity Present Value using the Form	ula	(1)) Copy the Ar	nuity formul	as from Sh	eet 2.1	_		
21	Present Value	\$336.99		Copy the ra	inge B16:G2	4 from She	et 2.1 to the ra	ange B	16:G24	
22			10					_		
23	Annuity Present Value using the PV Fu	inction	1(2) Payment to	rmula is:	//1 L Diana	unt Data/Dari			
24	Present Value	\$336.99		 Present \ (Present \ (Number \ 	of Periods)))	((T + Disco	t Rate/Period))		
25				Enter =B7/0	(1-((1+B5)^(-	B6)))/B5)	r tater enou)	<i>.</i>		
26				Enter Brite	(1 ((1.86)) (00))),00)				
27	Payment		13) Payment fu	nction is:					
28	Payment using the Formula	\$80.00	10	=PMT(Disco	ount Rate / P	eriod. Num	ber of Periods	sPres	sent Value.	0).
29	Payment using the PMT Function	\$80.004		Enter = PMT	(B5,B6,-B7,	D)		.,	,	·
30			_			,				
31	Discount Rate / Period		(4) Rate function	on is:					
32	Discount Rate / Per using the RATE Func	6.0%		=RATE(Nur	nber of Perio	ods, Payme	nt, -Present V	alue, O).	
33				Enter =RAT	E(B6,B4,-B7	(,0)				
34	Number of Periods		-						_	
35	Num of Periods using the NPER Function	5	(5)) Number of I	Periods funct	tion is:	De De			
36				=NPER(Dis	COUNT RATE /	Period, Pay	ment, -Prese	nt valu	ie, U).	
37				Liller -MPE	R(D5,D4,-D/	,0)				

We see that the system of four annuity variables is internally consistent. The four outputs in rows 13 through 32 (Present Value = \$336.99, Payment = \$80.00, Discount Rate / Period = 6.0%, and Number of Periods = 5) are identical to the four inputs in rows 4 through 7. Thus, any of the four annuity variables can be calculated from the other three in a fully consistent manner.

Problems

- An annuity pays \$132.38 each period for 5 periods. For these cash flows, the appropriate discount rate / period is 3.5%. What is the present value of this annuity?
- 2) An annuity pays \$63.92 each period for 4 periods. For these cash flows, the appropriate discount rate / period is 9.1%. What is the period 5 future value of this annuity?
- 3) Consider a system of four annuity variables.
 - (a) An annuity pays \$63.00 each period for 3 periods. For these cash flows, the appropriate discount rate / period is 8.0%. What is the present value of this annuity?
 - (b) An annuity pays each period for 11 periods, the appropriate discount rate / period is 6.0%, and the present value is \$192.38. What is the payment each period?
 - (c) An annuity pays \$183.00 each period for 14 periods, and the present value is \$463.94. What is the discount rate / period of this annuity?
 - (d) An annuity pays \$30.00 each period, the appropriate discount rate / period is 7.6%, and the present value is \$218.49. What is the number of periods?

Chapter 3 NPV Using Constant Discounting

3.1 Nominal Rate

Problem. A project requires a current investment of \$100.00 and yields future expected cash flows of \$21.00, \$34.00, \$40.00, \$33.00, and \$17.00 in periods 1 through 5, respectively. All figures are in thousands of dollars. For these expected cash flows, the appropriate nominal discount rate is 8.0%. What is the net present value of this project?

Solution Strategy. We will calculate the net present value of this project in two equivalent ways. First, we will calculate the net present value using a time line, where each column corresponds to a period of calendar time. Second, we use Excel's **NPV** function for the net present value.

Excel 2013 FIGURE 3.1 NPV Using Constant Discounting – Nominal Rate.

	A	В	С	D	E	F	G	Н		J	
1	NPV USING CONST	ANT DIS	COUNT	FING	Nomin	al Rate)				
2	(in thousands of \$)					ing Cor	actant [licco	unting		
3				\$60.00	VPV US	ing coi	ISLAILL L	JISCO	unung		
4	Inputs			¢40.00							
				Ş40.00	_	<u>_</u>	Ď 📍				
5				\$20.00				<u> </u>			
				\$0.00							
6				(\$20.00)				i			
7				(\$40.00)					Cash Flow	NS	
8	Outputs			(\$60.00)							
9	Nominal Discount Rate	8.0%		(\$00.00)					Present V	/alue of	
10		0.070		(\$80.00)					Each Cas	h Flow	
10				(\$100.00)	•						
11				(\$120.00)							
12					0 1	2	3 4	5			
13						Perio	bd				
14	Net Present Value using a Time I	ine									
15	Period	0	1	2	3	3 4	5				
16	Cash Flows	(\$100.00)	\$21.00	\$34.00	\$40.00	\$33.00	\$17.00				
17	Present Value of Each Cash Flow	(\$100.00)	\$19.44	\$29.15	\$31.75	\$24.26	\$11.57				
18	Net Present Value	\$16. <u>1</u> 7									
19			(2)	(Cash Flow) / (1 + Disc	count Rate)	^ Period)				
20	Net Present Value using the NPV	Function		Enter =B16	/((1+\$B\$9)	^B15) and c	opy across				
21	Net Present Value	\$16.17	(3)	Sum of all t	he Present	Value of Ca	sh Flows				
22				Enter =SUN	I(B17:G17)	value of Ga	511110113				
23											
24			(4)	(Current Inv	estment) +	NPV(Disco	unt Rate, Fu	iture Ca	sh Flows)		
26				Enter =B16+NPV(B9,C16:G16)							

The Net Present Value of this project is \$16.17. Notice you get the same answer both ways: using the time line or using the NPV function.

3.2 Real Rate

Problem. A project requires a current investment of \$100.00 and yields future expected cash flows of \$21.00, \$34.00, \$40.00, \$33.00, and \$17.00 in periods 1 through 5, respectively. All figures are in thousands of dollars. The inflation rate is 3.0%. For these expected cash flows, the appropriate Real Discount Rate is 4.854%. What is the net present value of this project?

Solution Strategy. We begin by calculating the (nominal) discount rate from the inflation rate and the real discount rate. The rest of the net present value calculation is the same as the Net Present Value - Constant Discount Rate Excel model.

Excel 2013

FIGURE 3.2 NPV Using Constant Discounting – Real Rate.



The inflation rate of 3.0% and the real discount rate of 4.854%, combine to yield a nominal discount rate of 8.0%, which is the same as before. Therefore, the Net Present Value of this project is \$16.17, which is the same as before.

Problems

- 1. A project requires a current investment of \$179.32 and yields future expected cash flows of \$35.19, \$63.11, \$88.54, \$82.83, and \$68.21 in periods 1 through 5, respectively. All figures are in thousands of dollars. For these expected cash flows, the appropriate discount rate is 5.3%. What is the net present value of this project?
- A project requires a current investment of \$107.39 and yields future expected cash flows of \$48.31, \$58.53, \$82.80, \$106.31, and \$62.18 in periods 1 through 5, respectively. All figures are in thousands of dollars. The inflation rate is 3.7%. For these expected cash flows, the appropriate Real Discount Rate is 7.6%. What is the net present value of this project?

Chapter 4 NPV Using General Discounting

4.1 Nominal Rate

Problem. A project requires a current investment of \$100.00 and yields future expected cash flows of \$21.00, \$34.00, \$40.00, \$33.00, and \$17.00 in periods 1 through 5, respectively. All figures are in thousands of dollars. For these expected cash flows, the appropriate nominal discount rates are 8.0% in period 1, 7.6% in period 2, 7.3% in period 3, 7.0% in period 4, and 7.0% in period 5. What is the net present value of this project?

Solution Strategy. We will calculate the Net Present Value of this project using a Time Line. This is the *only* possible way to calculate the project NPV in the general case where the discount rate changes over time. Excel's **NPV** function cannot be used because it is limited to the special case of a constant discount rate. There is no simple formula for NPV, short of typing in a term for each cash flow.

Excel 2013

FIGURE 4.1 NPV Using General Discounting – Nominal Rate.



The Net Present Value of this project is \$17.42.

4.2 Real Rate

Problem. A project requires a current investment of \$100.00 and yields future expected cash flows of \$21.00, \$34.00, \$40.00, \$33.00, and \$17.00 in periods 1 through 5, respectively. All figures are in thousands of dollars. The forecasted inflation rate is 3.0% in period 1, 2.8% in period 2, 2.5% in period 3, 2.2% in period 4, and 2.0% in period 5. For these expected cash flows, the appropriate REAL discount rate is 4.854% in period 1, 4.669% in period 2, 4.683% in period 3, 4.697% in period 4, and 4.902% in period 5. What is the net present value of this project?

Solution Strategy. We begin by calculating the (nominal) discount rate for each period from the inflation rate in each period and corresponding real discount rate. The rest of the net present value calculation is the same as the Net Present Value - General Discount Rate Excel model.

Excel 2013

FIGURE 4.2 NPV Using General Discounting – Real Rate.

	A	B	C	D	E	F	G	H		J
1	NPV USING GENER	RAL D IS	соинті	NG	Real Ra	ate				
2	(in thousands of \$)									
3			JPV Usi	ng Gené	eral Disc	countin	ø			
4		\$60.00				countin	Ъ			
5		\$40.00								
6		\$40.00		_	ŏ 🕴	L				
7		\$20.00				- <u>e</u>				
8		\$0.00				Ť				
9		(620.00)								
10		(\$20.00)					😑 Cash Flov	vs		
11		(\$40.00)								
12		(\$60.00)					Present \	/alue of		
13		(\$80.00)					Each Cas	h Flow		
14		(0.000)	1							
15		(\$100.00)								
16		(\$120.00)		1						
1/			0 1	2	3	4 5				
18				Peri	od					
19	•									
20	Inputs									
21	Period	0	1	2	3	4	5			Add to All Periods
22	Inflation Rate		▲ 3.0%	2.8%	▲2.5%	2.2%	2.0%			• 0.0%
23	Real Discount Rate		▲ ▼ 4.854%	▲ ▼ 4.669%	▲ ▼ 4.683%	▲ ▼ 4.697%	▲ ▼ 4.902%			▲●●0.0%
24										
25	Outputs									
26	Period	0	1	2	3	4	5			
27	Nominal Discount Rate		8.0%	7.6%	7.3%	7.0%	7.0%			
28			$(1) (1 \pm \ln \theta)$	ation Date) *	(1 + Roal Di	scount Date) - 1			
29			Enter =	(1+C22)*(1+	(14) (23)-1 and c	CODV ACTOSS				
30			Enter	(1.022) (1.	025) T and e	opy across				
31	Net Present Value using a Time	Line								
32	Period	0	1	2	3	4	5		L	
33	Cash Flows	(\$100.00)	\$21.00	\$34.00	\$40.00	\$33.00	\$17.00			
34	Cumulative Discount Factor	0.0%	8.0%	16.2%	24.7%	33.4%	42.8%			
35	Present Value of Each Cash Flow	(\$100.00)	\$19.44	\$29.26	\$32.08	\$24.73	\$11.91			
36	Net Present Value	\$17.42								