Chapter 14: Additional Problems

1. Assume that Krafty Foods and Whole Cheese have identical assets that will pay off either \$200 million or \$300 million a year from today. Krafty is funded with equity that has a market value of \$240 million, but Whole Cheese is funded with bonds that mature for \$220 million one year from today and with equity. The market value of Whole Cheese bonds is \$190 million and of its equity is \$40 million. If markets are perfect, what set of transactions today will generate an arbitrage profit for you? Show that the conditions of arbitrage are met regardless of whether the firms' assets end up begin worth \$200 million or \$300 million. Notes: 1) calculations required, 2) use "+" for inflows and "–" for outflows.