Chapter 14 – Example 1

Assume markets are perfect and that Geralt Inc. has assets that will generate cash flows of either $100 million or $300 million a year from today.

a. What are the possible payoffs to Geralt's investors if it has only issued equity and no debt?

b. What are the possible payoffs to Geralt's investors if Geralt has issued debt that matures for $100 million a year from today in addition to its equity?

c. What are the possible payoffs to Geralt's investors if Geralt has issued debt that matures for $150 million a year from today in addition to its equity?

d. What conclusions can we draw about the rates of return on the bonds in parts "b" and "c"?