Chapter 14 – Example 2

Assume that markets are perfect and that Kratos and Faye have identical assets that will generate identical cash flows a year from today (at which point both firms will pay out all cash and cease operations). The market value of Kratos's outstanding stock is $100,000. Faye's debt matures for $30,000 a year from today and promises a 4% return. The market value of Faye's stock is $60,000. Note: in answering all parts, use a "+" for inflows and a "-" for outflows.

a. Given this information, what set of transactions today will generate an arbitrage profit? What is your profit today from this transaction?

b. Show that the conditions of arbitrage are met if Kratos and Faye's assets generate net cash flow of $110,000 a year from today. Be sure to identify the source of all cash flows.

c. Show that the conditions of arbitrage are met if Kratos and Faye's assets generate net cash flow of $25,000 a year from today. Be sure to identify the source of all cash flows.