Re: B-32, lines 16-18

Dr. Vilbert states, "Specifically, the price of the stock that underlies the DCF method will equal PV(Dividends) + PV(Option to Default), where PV is the prevent value of the quantity in parentheses."

(a) Please explain what is meant by the "option to default."

Response:

Dr. Vilbert's Appendix B page B-31 line 23 through page B-32 line 5 discusses the option to default. Technically, the "option to default" is the shareholders' right to default on debt instead of using personal assets to pay the bondholders. The option to default is valuable because the value of the firm's assets may be less than the value of the debt at the time it is necessary to pay bondholders, yet equity holders do not have to dip into their personal assets to pay off bondholders. Equity is worth the greater of (1) the market value of the assets minus the face value of the outstanding debt, and (2) zero. Debt is worth the lesser of (1) its face value, and (2) the market value of assets (the effects of intermediate interest rate fluctuations aside).

Re: B-32, lines 16-18

(b) Please provide documented support for this definition of the price of a stock.

Response:

See, for example, Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance*, 6th Ed., New York: Irwin McGraw-Hill (2000) at Section 20.2.