Index

Abandonment option
 agency problems, 827, 843
 asset structure, 840–843
 balance sheet, 823
 capital budgeting, 825
 case studies, 652–657
 Compustat data, 831
 empirical testing, 823, 828, 835
 European and American, 825
 exercising, 845
 exit value, 824, 828
 financial distress, 843–845
 hysteresis, 165
 put option, 296
 PVCF calculations, 847, 849
 sample selection, 833–835
 sensitivity tests, 845–848
 sequential decision, 661n
 theory and predictions, 825–828
Abandonment value
 capital budgeting, 295
 cash flows, 297
 equation, 850
 investor, 175, 823
 numerical examples, 301
 payout ratios, 297
 problem, 296–299
 project life, 295
 salvage, 299, 305, 308
 sensitivity analysis, 302
 solution procedure, 299
Accounting
 multinationals, 758–760
 value-relevant, 823
Across-country options, 745, 748
Acquisitions. *See* Strategic acquisitions
Adjusted discount rates, 175
Aircraft industry, 273, 421
Airlines, ticket pricing, 465
American options, 707, 825
Analyst forecasts, future earnings, 824, 829
Approximation techniques, 575–582
 binomial, 575, 578
 errors and convergence, 580
 finite difference, 577
 Monte Carlo simulation, 575
 option valuation, 571
 principles, 572–574
 stability, 578, 581
Arbitrage
 basic concepts, 176n
 oil reserves, 781
Asia, global sourcing, 743
Asset pricing
 equilibrium model, 3
 investment timing, 256
 standard model, 259
 stochastic, 256–258
Assets. *See also* Abandonment option
 cash flows, 601
 financial, 668, 670
 flexibility, 668
 managing, 704
 market value, 842
 nonfinancial, 668, 670
 physical, 299
 replacement value, 851
 return variance, 387
 structure, 840–843
At-the-money options, 373

Bad news principle, 163, 169
Balance sheet, abandonment option, 823
Barraquand-Martineau model, Monte Carlo simulation, 614, 616
Berger, P. G., 823
Beta risk. *See also* Volatility
 abandonment option, 830
 asset pricing, 139
 real options, 4
Binomial approximation
 call options, 591
 computer costs, 587
 option valuation, 584
Biotechnology firms, volatility, 68
Bjerksund, P., 689
Black-Scholes model, option pricing, 409, 560, 583
Bonds
 call options, 30
 corporate, 2, 559
Book value
 abandonment option, 828
 asset classes, 824, 841
 excess, 835, 851n
Break-even price, uncertain investments, 700
Brealey-Myers Second Law, 26
Brennan, M. J., 135, 335, 559
Brennan-Schwartz model, option valuation, 614–618
Brownian motion
 correlated, 2242
 geometric, 240, 254
Budgeting. *See* Capital budgeting
Building valuation, 807–811
 business and commercial, 808, 815
 empirical results, 807–811
 industrial and residential, 810, 815
 land prices, 721
 market prices, 817
 observation errors, 811–813

Building valuation (cont.)
option pricing, 8–7–811
size and price, 721, 820n
uncertain investment, 727
zoning categories, 807, 820n
Buy-and-hold strategy, 519, 525
Bystander strategy, 519

Call options, 583–590
American, 583
binomial approximation, 591
Black-Scholes model, 583
computer costs, 587, 589
dividends, 584–590
European, 583
exercising, 310n, 368
expansion, 380n
futures contracts, 648
irreversible, 200
oil reserves, 780
pricing models, 780
vs. real options, 82, 98n
solution techniques, 30
strategic investment, 453
valuing, 37, 98n, 559, 583
volatility, 68
Capacity choice
dynamics, 326
firm valuation, 313, 316
incremental, 233–236
irreversible, 313
real options, 313
simple model, 316–324
utilization, 326
Capital
abandonment option, 831
expenditures, 831
firm-specific, 313
marginal value, 332n
market returns, 25, 32n
opportunity cost, 20
staged financing, 127
timing commitment, 41
Capital asset pricing model (CAPM), 49, 139
Capital budgeting
abandonment option, 295, 825
dissatisfaction, 47
empirical issues, 438
general model, 422–427
growth option, 33
interrelated projects, 419–421
long-range planning, 44
managerial flexibility, 59
natural resources, 135, 335
optimal investment, 432–438
options approach, 79, 103
practical implementation, 438
process, 493n
real options, 93, 419, 687n
strategic, 21, 36, 87
techniques, 5
urgency of decision, 89
Capital investments
oil reserves, 72
options approach, 61–76
strategic, 6
volatility, 68
uncertainty, 70
CAPM, 49, 139
Cash flow. *See also* Discounted cash flow
abandonment option, 297
asset value, 601
binomial technique, 551
estimating, 28
forecasting, 27, 297
interrelated projects, 423
jumps in, 261–263
past-dependent, 601
Poisson-Wiener process, 261
proportional, 379n
risk premiums, 601
valuation model, 338, 341
CCA, 51, 59, 82
Childs, P. D., 419
CIM, 528
Claims. *See* Contingent claims; Real asset claims
Closed-end funds, 22
Commitment
growth options, 509
real options, 383
strategic value, 383, 455
Commodities
cash flow, 1
convenience yield, 136, 338
pricing models, 13n, 75, 333n
production and demand, 265
spot prices, 147
volatility, 75, 238
Competition
capital budgeting, 419–421
commitment, 451
contrarian, 459–467
Cournot-type, 456
flexibility, 451
industry dynamics, 169–172
interrelated projects, 419
monopoly game, 462, 469, 472
Nash-Cournot model, 461, 469, 472

numerical calculations, 171
option pricing, 517–519
real options, 383
reciprocating, 459–467
Stackelberg leadership, 464, 469, 472
strategic acquisitions, 405
strategic options, 112
technological innovations, 517–519
tough or accommodating, 456, 458
Competitive strategies
critical demand zones, 481–487
effects, 467–481
goodwill, 479–481
modeling, 459–467
monopoly outcome, 483
Nash model, 483
numerical examples, 467
offensive and inoffensive, 458
proprietary and shared, 474, 482
Stackelberg model, 483
two-stage game, 460
Competitive options, 8–10
Compound options, 186
Geske-Johnson method, 543–551
interproject, 86, 89
valuing, 275, 649
Compulsive strategy, technological innovation, 518, 524
Computer-integrated manufacturing (CIM), 528
Computer costs, option valuation, 585, 587, 589
Computers, hardware and software, 571
Conglomerates, 22
Construction. *See also* Building valuation
default options, 126
flexibility value, 288
Consulting firms, strategic planning, 21
Contingent claims
Black-Scholes equation, 560
finite differences, 559
jump processes, 559–569
pricing methods, 559–569
riskless arbitrage, 562
valuing, 297, 319, 330
Contingent claims analysis (CCA), 51, 59, 82
Contraction options, 118, 193
Contrarian competition, 456
critical demand zones, 486
modeling strategies, 462–465
project values, 472
proprietary and shared, 490
Stackelberg leader, 494n
strategic investment, 477, 490
Convenience yield
commodities, 136
futures prices, 2, 11
net margin, 218
Convertible bonds, 30, 559
Copper mines
hysteresis effect, 229
Monte Carlo simulation, 614
real options, 143
timing option, 349
valuation, 146, 347
Copper prices, 348
convenience yield, 143
volatility, 75
Corporate bonds
default risk, 2
pricing, 2
valuation, 559
Corporations. *See also* Firms; *specific names*
financial strategy, 21
growth options, 8
resource allocation, 45
Cortazar, G., 601
Costs
Kolmogorov equation, 740
mean and variance, 740
uncertainty, 3
CPU, 585
Critical demand zones, competitive strategies, 481–487
Crude oil distiller, abandonment option, 652–657
Cumulative volatility, 387

DCF. *See* Discounted cash flow
Decision-making, major insights, 658
Decision tree analysis (DTA)
capital budgeting, 59, 79
contingent claims, 129n
generic example, 49
real options, 5
Default option, oil company, 117, 126
Deferrable options
capital budgeting, 89, 95
natural resources, 379n
oil company, 117, 123
sensitivity analysis, 378
Delayed investments, 200
Demand shocks, 177n
Developed property, Williams model, 820n
Diffusion processes, option valuation, 572
Discontinued operations, 7
Discount rates
computing, 259–261
project value, 660n
risk-adjusted, 1, 310n
selecting, 64

Discounted cash flow (DCF)
capital budgeting, 80
classical model, 137–140
criticism, 47
forecasting, 27
formula, 20
limitations, 6, 29, 107
major insights, 658
offshore leases, 775
option value vs, 785
real options, 5, 103
strategic planning, 20
traditional techniques, 49
Discrete transition probability, flexibility option, 678
Discretionary investments, 6
Disinvestment, 65, 165
Diversification, flexibility option, 410–414
Divestiture option, strategic acquisitions, 406, 414
Dividends. *See also* Cash flow
binomial technique, 551
call options, 584–590
liquidating, 846
option value, 583
put options, 592–595
Dixit, A. K., 61, 153
Drift equations, 3, 260
DTA. *See* Decision tree analysis
Dual-fuel steam boiler, 663–675
DCF techniques, 664
flexibility value, 663–675
simple formula, 664–666
Dual funds, valuing, 559
Dynamic programming, 187, 213, 242

Early investing, growth options, 40
Economic policy, investment behavior, 236–238
Economy, uncertain investments, 691
Ekern, S., 689
Electric utilities, 74
Embedded options, 517, 531
Energy prices, recession, 246n
Energy projects, put options, 12
Environmental pollution, 12, 115
Equity value, percentage change, 851
Escrow accounts, investment costs, 379n
Excess book value, 835, 851n
Exchange option, 518
Exchange rates
critical, 766n
hysteresis, 752
imports, 65, 153
multinationals, 758
Ornstein-Uhlembeck process, 766
plant location, 9
threshold values, 757
trade deficits, 229
Ex-dividend date, 588
Exercise price, 636
call options, 200
option value, 588, 590
put options, 594
Exit value
abandonment option, 836
asset classes, 824, 826
estimating, 828
excess, 826, 850
market price, 841
Expansion options, 118, 124, 193
Expiration date, 588, 636
Expiring investments, 89
Expiring options, 702
Exports
exchange rates, 162
hysteresis, 756
Exotic options, 624

Factory. *See also* Building valuation
time-to-build, 275–279
valuation, 333n
Finance theory, 19
analysis limitations, 23
asset flexibility, 668
cash flow, 20
criticism, 23
decision-making, 637
misuse, 24
planning process, 31
problems, 27
relevance, 19–21
strategic planning, 19–23
Financial options
irreversibility, 204–206
vs. real options, 713n
Finite difference methods
computer costs, 587, 589
contingent claims, 559–569
explicit and implicit, 560, 584
forward and backward, 597n
option valuation, 563–568
Firms. *See also* Corporations; *specific names*
abandonment option, 835–843
capacity choice, 313, 316
irreversible investment, 313
optimal capacity, 322–324
option valuation, 840–843
sensitivity analysis, 325
valuing, 313, 324, 326

Flexibility option
cancellation, 681
competition, 383
costless switching, 673
decision tree, 666
discrete transition, 678
diversification, 410–414
dual-fuel steam boiler, 663
expansion, 681
general model, 666–670
natural resources, 681
product and process, 195
real options, 179
risk adjustment, 668–670
salvage and deferral, 681, 685
sensitivity analysis, 683
simple formula, 664–666
strategic acquisitions, 406
types, 681
valuation, 663–675
Foreign exchange, market volatility, 749
Foreign investment, real options, 12, 115, 745
Foreign trade, hysteresis, 677n
Frictionless markets, real estate, 731n
Future investments
Black-Scholes formula, 698
call options, 33
uncertainty, 697–699
Futures contracts, 1, 648
Futures prices
applications, 623
convenience yield, 2, 11
spot prices, 2
stochastic model, 340
theory, 623

Game theory, competitive interaction, 87
Gas prices, 664, 673
Geological uncertainty, 3
Geske, R., 571
Geske-Johnson method, compound options, 543–551
Global manufacturing
flexibility factor, 750
heuristic rules, 757–761
hysteresis, 756
location and scheduling, 746
multinationals, 743, 746
operating procedures, 757–761
planning models, 746
plant location, 764
relative cost, 749
shifting production, 746
sourcing, 752, 762
wage rates, 748
within-country options, 745, 756
volatility, 76
Global warming, 12, 115
Gold, spot prices, 142, 148
Gold mines
real options, 140–143
valuation, 2, 146
Goods prices, flexibility option, 670
Goodwill, 479, 756
Government
regulation, 12, 67
subsidies, 114
Grenadier, S. R., 517
Growth options, 33–45
benchmark model, 501–503
call options, 34
capital budgeting, 33
case studies, 646–652
characteristics, 42
corporate, 8, 120
early investing, 40
exercising, 515n
expiring, 43
framework, 42
monopoly investment, 501
multinationals, 756
new perspective, 44
oil company, 120, 124
planning situation, 647
pricing formula, 409, 417n
proprietary and shared, 39, 43
real options, 105
selected companies, 35
simple and compound, 43
strategic acquisitions, 406–410
valuing, 12, 37, 327, 332n, 409

Harvard Business School, 45, 761
Hedging, 577, 602
Heuristic rules, global manufacturing, 757–761
Hurdle rates, 153, 176n, 820n
Hysteresis
abandonment option, 165
Dixit model, 229
exchange rates, 752
flexibility option, 663, 667
foreign trade, 677n
global manufacturing, 756
investment, 153, 167
multiple options, 110
prevalence, 229
real options, 7, 153
sunk costs, 227–230

IBM, 37, 530
Immediate development, uncertain investment, 695–697
Imperfect competition, strategic growth, 503–507
Imports, exchange rates, 65, 153
Incremental investments
  basic models, 234
  Bertola model, 234
  capacity choice, 233–236
  dynamic model, 234
  Manne model, 234
  Pindyck model, 234
  stochastic models, 236
  technology choice, 235
Industry
  competitive dynamics, 169–172
  real options, 452–459
  volatility, 68
Inflation
  land prices, 730
  treatment, 25
Input costs, uncertain investments, 734
Institutional Brokers Estimate System (IBES), 833
Insurance contracts, 624
Interest rates
  growth options, 38
  investments, 236
Interproject options, 47, 86
Interrelated projects
  capital budgeting, 419–421
  cash flows, 423, 448n
  derivations and proofs, 443–445
  distribution-free, 422–427
  empirical issues, 438
  general model, 422–427
  implementation, 438
  normally distributed case, 427
  optimal investment, 432–438
  parallel and sequential, 422, 427, 439
  real options, 419–421
  valuation models, 440–443
In-the-money options, 374, 414
Intraproject options, 85, 89
Inventory, convenience yield, 356n
Investments. *See also* Capital investments; Uncertain investments
  abandonment option, 175, 823
  anticipated, 315
  asset price, 256–258
  bang-bang solution, 279
  base case, 283
  Bellman equation, 243
  call options, 161
  capital budgeting, 432–438
  characteristics, 215, 273
  competitive dynamics, 169, 457
  decision-making, 47, 61, 221, 273, 432
  delayed, 200
  discount rates, 259–261
  deferring, 53–55
  economic policy, 236–238
  extensions and qualifications, 163
  firm-specific, 199
  foreign, 12, 115, 745
  hurdle rates, 153
  hysteresis, 153
  industry-specific, 199
  interest rates, 236
  interrelated projects, 432–438
  irreversible, 66, 199
  lumpy, 329
  market value, 276, 279
  Marshallian trigger, 156, 161
  monopolist decision, 265–267
  natural resources, 135, 335, 679
  noneconomic applications, 173
  numerical examples, 263–265
  opportunity, 28, 214, 360
  optional policy, 159, 315
  optimal rule, 215
  option interactions, 359
  option pricing, 517–519
  parameters, 263
  price uncertainty, 689
  problem solving, 211–213
  project value, 217–221
  real options, 1, 153, 199, 335
  sequential, 230–233
  technological innovations, 517
  theory, 153
  time to build, 273–275
  timing, 154, 209, 214, 243, 256
  triggers, 159
  United States and Japan, 168
  valuation model, 338–344
  waiting, 154, 253
Irreversible investments, 199–202
  basic models, 209, 736
  capacity choice, 313, 316
  financial options, 204–206
  firm valuation, 313
  interest rates, 236
  MacDonald-Siegel model, 209
  option models, 269n
  real options, 199, 313
  simulation models, 238
  stochastic process, 208, 225, 239

trade reforms, 237
two-period example, 202–208
Ito's lemma, investment timing, 212, 241

Japan
exchange rates, 229
investments, 168
production switching, 767n
Jump processes
contingent claims, 559
mean and variance, 569
option valuation, 572

Kemna, A. G., 641
Kester, W. C., 33
Kogut, B., 743
Kolmogorov equation, cost model, 740
Kulatilaka, N., 179, 499, 663, 743

Labor
markets, 167
training, 626
Laggard strategy, technological innovation, 519, 525
Land
development, 11, 114
empirical tests, 813–818
real options, 11, 114
transactions, 803–806
value, 813–818
Land prices
applications, 728
building activity, 727
comparative statics, 724
extensions, 728
inflation, 730
numerical example, 723
options, 803
timing model, 804–806
uncertainty, 719–721
valuation techniques, 720, 722
Latent assets, 447n
Leapfrog strategy, technological innovation, 518, 525
Leasing, option valuation, 11, 30, 114
Lewent, J., 633
Licensing, strategic option, 396
Log-transformed binomial technique
adjustments and applications, 551–554
algorithm structure, 541–543
comparative analysis, 543–551
flow chart, 542
multiple options, 539
risk-neutral probability, 555
stability and consistency, 550
theoretical design, 540
London Stock Exchange, 779
Luehrman, T. A., 385

MacDonald-Siegel model, irreversible investments, 209
Majd, S., 273, 295
Managerial flexibility
asymmetry, 48, 80
generic example, 48
NPV analysis, 80, 361
operating options, 53
real options, 359
simple examples, 53
special case, 703
uncertain investments, 703
valuation, 47–59
Managerial options, 295, 309n
Manne model, incremental investing, 235
Manufacturing. *See also* Global manufacturing
flexibility, 11, 114
scientific, 633–639
Marginal cost
investment, 320
measuring, 328
pricing, 333n
unit capacity, 318
Market value
abandonment option, 826, 836
exit value, 836, 841
investments, 276, 279
manufacturing firm, 330
Marshall trigger, investments, 156, 161
Mason, S. P., 47
Merck
option analysis, 636
real options, 11
scientific management, 633
Merton, R. C., 623
Mesh ratio, approximation techniques, 578
Microprocessors, 534n
Migration strategy
adoption behavior, 525, 534
equilibrium argument, 522
likelihood and speed, 524, 527
optional investment, 521–524
probability analysis, 533
technological innovation, 518, 524
Mines and mining
boundary conditions, 145
Brennan-Schwartz model, 614–618
cash flows, 145
exhaustion, 145

Mines and mining (cont.)
flexibility option, 413
infinite resource, 344–347
inventory size, 350
investment decision, 349–351
Monte Carlo simulation, 614
opening and closing, 346
operating decisions, 145
output rates, 354
premature abandonment, 145
real options, 144, 679
time-to-build, 273
valuation model, 338–34
Monopoly investment
benchmark model, 501
decision-making, 265–267
growth option, 501–503
net profit, 501, 503, 513n
Monte Carol simulation
mine problem, 614–618
model extensions, 617
option valuation, 575–577
state variables, 613
Mortgage pricing, valuation model, 814
Multinational companies
accounting practices, 758–760
exchange rates, 758
foreign subsidiaries, 743
global manufacturing, 743, 746
growth options, 756
heuristic rules, 757–761
managerial discretion, 745
natural resources, 679
network activity, 745
operating flexibility, 743
option valuation, 743–746
real options, 679
Multiple options
heuristic rules, 544
interdependent, 110
numerical techniques, 539, 544
research and development, 552
valuation, 539
Multiple real options
assumptions, 362–365
binomial model, 553, 362
interactions, 359
numerical technique, 370–377
opportunity, 360–365
project description, 360
specification, 362–365
valuation, 359
Multiplicative binomial model, options analysis, 539, 555
Mutual funds, options strategy, 628n
Myers, S. C., 19, 295

Nash-Cournot model, competition, 461, 469, 472
Natural resources. *See also* Mines and mining
base case analysis, 681–683
convenience yield, 338
infinite case, 344–347
investment, 135, 335, 614, 679
Miller-Upton model, 337
project description, 679–681
real options, 11, 113, 135, 335, 679
stochastic models, 335
valuation model, 338–344
Nested options, business strategy, 396–401
Net present value (NPV)
capital budgeting, 59, 80, 419
dissatisfaction, 47
expanded and passive, 93, 80, 103, 362
growth options, 37
hurdle rates, 65
irreversible investments, 203, 313
limitations, 487
managerial flexibility, 80, 361
positive and negative, 9, 24
probability distribution, 81, 98n
real options, 103
strategic planning, 19, 23, 454
timing option, 643
volatility effect, 509
New York Stock Exchange, 779
Nonadditive options, 365–369
Nonfinancial assets, flexibility option, 669
Noninventory items, book value, 852n
NPV. *See* Net present value
Nuclear power plants
cancellation, 741n
critical capacity, 739
operating costs, 742n
uncertainty, 736–739
Numerical techniques
binomial techniques, 539, 544
accuracy and efficiency, 592
applications, 551–554
alternative, 543, 609
approximation, 571
binomial, 539
comparison, 582, 609
computer costs, 598n
finite difference, 544–551, 559
Johnson method, 544
jump processes, 559–569
multiple options, 539
option valuation, 10, 556n, 571, 601

Parkinson method, 544
quadratic approximation, 544
real options, 4
stability and consistency, 550
types, 10, 582
Whaley method, 544

Ofek, E., 823
Offshore leases
comparison, 784, 794
data sources, 786
DCF approach, 775, 798n
depreciation allowance, 799n
developed and undeveloped, 774, 780
development costs, 777, 797n
economics, 774
empirical results, 786–796
exploration, 776, 784, 788, 795
extraction stage, 778
field size, 799n
government auctions, 72
industry bids, 791
investment timing, 784
market value, 798n
option value, 773
real asset claims, 773
relinquishment, 790, 799n
reserves, 787
royalties and taxes, 799n
stage characteristics, 776
technology, 774
timing investment, 795
tract valuation, 775–785
valuation equation, 787–791
variance estimates, 788
Oil and gas industry
abandonment option, 652–657
capital investment, 72
development cost, 713n
field valuation, 706
lease value, 7, 11
Norway, 714n
offshore projects, 642–646
options approach, 72
real options, 11
refinery, 652–657
reserves, 72
sequential investment, 232
timing option, 642–646
Oligopoly, 164
Operating options, 314
capital markets, 329
combinations, 371
managerial flexibility, 53
multinationals, 743, 746
types, 57
valuing, 137, 359, 362
Opportunity
capital cost, 20, 27, 201
investment, 28, 263
numerical examples, 263
stochastic process, 258, 268
valuing, 85
Opposite-type options, 368
Option interactions
exercise times, 372
expanding, 373
investment valuation, 359
nonadditivity, 365–369
usual properties, 376
Option pricing
arbitrage, 2, 109
basic models, 6
binomial technique, 208
Black-Scholes equation, 409, 560, 583
building values, 807–811
competition, 465, 479, 517
dynamic models, 712n
empirical results, 803, 807
equilibrium argument, 522
goodwill, 479–481
investment opportunity, 401, 517
land values, 813–818
major insights, 657
market and transfer, 760
model and assumptions, 519–521
Monte Carlo simulation, 615, 618
multinationals, 760
no-arbitrage hedge, 97n
numerical examples, 705–710
pioneer venture, 647
real assets, 803, 807
reciprocating strategy, 465–467
risk-neutral, 2
spanning assumption, 210
strategy, 521–524
technology, 517, 623
theory, 623–628
timing problem, 209, 804
uncertain investments, 689–691
wait and see, 689–691
Option space, 387
maybe and probably, 389
now and never, 389
value metrics, 387
Option valuation
accuracy and efficiency, 592
alternative techniques, 571

Option valuation (cont.)
approximation, 571
bionomial trees, 603
Black-Scholes equation, 574
Brennan-Schwartz model, 614–618
comparisons, 791–794
computer costs, 585, 598n, 605
conditions, 744
DCF approach, 785
diffusion process, 572
empirical results, 786–796
equilibrium model, 778
finite difference, 606
importance, 162
investment rules, 267
maturity, 607
Monte Carlo simulation, 575, 609
multinationals, 743–746
numerical techniques, 582
offshore leases, 773
premiums, 816, 821n
principles, 572–574
real asset claims, 773
risk-neutral technique, 777
strategic acquisitions, 405
time-dependent, 745
uncertain investments, 744
variance and expiration, 795
volatility, 652
Options. *See also specific options*
acquiring, 31
additivity, 183, 364, 380n
asymmetry diagram, 38
capital investment, 61–76
classification, 91–93
competition effect, 87
conceptual approach, 17, 79
contracts, 636
creating, 63, 72
deferring, 53–55
exclusive ownership, 87
exercising, 31, 71, 368
expanding, 56, 83, 104
initiating, 98n
interaction, 105
killing, 62, 201
Merck analysis, 636
operating strategy, 91–93
opposite-type, 367
premiums, 803
real vs. financial, 745
strategic factors, 31
switching, 83, 98n, 105, 183
types, 627
underinvestment, 17
value components, 91–93
Ornstein-Uhlembeck process, exchange rates, 766
Ott, S. H., 419
Out-of-the-money options, 37, 368, 379n

Paddock, J. L., 773
Paper industry, flexibility option, 413
Parallel projects
capital budgeting, 422, 427
cash flows, 437
covariance effects, 435
empirical issues, 438
implementation, 438
investment strategy, 433–438
program value, 427
valuation model, 440
Partial differential equation (PDE), 4, 308
Payoff functions, monopoly investment, 501, 513n
Payout ratios, abandonment option, 297, 305
PDE, 4, 308
Perfect markets, securities pricing, 1
Periodicals industry, strategic acquisitions, 408
Perotti, E. C., 499
Personal computers, 530
Petrochemical plant, time-to-build investment, 273
Petroleum. *See* Oil and gas industry
Pharmaceutical industry, scientific management, 633–639
Pindyck, R. S., 61, 199, 273, 313, 733
Pindyck model, incremental investing, 234
Pioneer venture
capital and production, 650
growth option, 646–652
option pricing, 646
stand-alone project, 646
valuing, 12
Plants
exchange rates, 9
location, 9
closings, 12
valuing, 12
Poisson-Wiener process, cash flows, 261
Portfolio strategy
real options, 385
self-financing, 336, 356n
Pollution, real options, 12, 115
Present value of expected cash flow (PVCF)
empirical results, 837
proxies, 829–833
sample selection, 834
sensitivity tests, 845
theory and predictions, 826
Printing industry, strategic acquisitions, 415

Probability measures, risk-adjusted, 1
Production
  Cobb-Douglas function, 265
  demand, 265–267
  flexibility option, 412, 418n
  hysteresis, 756
  investment, 265–267
  shadow value, 741n
  technology, 295
  temporary shutdown, 83
  uncertainty, 3
Production shifting
  continuous-time, 763
  costless, 747
  flexibility factor, 755
  global manufacturing, 746
  heuristic rules, 757–761
  hysteresis, 756
  model uncertainty, 748
  numerical example, 753
  principal results, 754
  stochastic models, 746
Profits, incremental, 315
Projects. *See also* Parallel projects
  abandonment option, 295
  classification, 84–87
  contracting, 56
  cutoff value, 284–287
  deferring, 53–55
  evaluation, 43
  flexible and rigid, 179
  infinite, 244n
  interdependent, 58
  investments, 217–221
  partial, 419
  payout rates, 282
  rigid technology, 182
  risk factor, 37
  salvage value, 85
  scrapping, 256, 259
  sensitivity analysis, 377
  stand-alone, 646
  valuing, 128n, 219, 243
Property tax rates, 341
Proprietary investment
  capital budgeting, 87
  critical demand zones, 482
  inoffensive strategy, 480
  negative effect, 480
  numerical example, 468
  offensive strategy, 471–473
  option strategy, 87
  research and development, 471
  strategic effect, 478
Provance model, flexibility option, 671
Put options
  American, 592
  binomial approximation, 592
  Black-Scholes equation, 544
  computer costs, 594, 596
  dividends, 592–595
  energy projects, 12
  exercising, 368, 574
  numerical techniques, 544–551, 571, 592
  salvage value, 8
  scrapping, 245n
  solution techniques, 30
  theory and applications, 624
  valuation techniques, 592–595
PVCF. *See* Present value of expected cash flow

Quantity competition
  contrarian strategy, 462–465
  proprietary and shared, 468
  research and development, 467
Quigg, L., 803

Rate of return, internal ranking, 25
Real asset claims
  empirical results, 786–796
  offshore leases, 773
  option valuation, 773
Real estate
  divestiture, 415
  flexibility, 413
  Seattle market, 806, 808
Real options. *See also specific options*
  acquisitions, 115
  advantages, 4
  American, 611–618
  applications, 113–115
  base case analysis, 681–683
  basic models, 6, 101
  binomial techniques, 6, 10, 603
  Black-Scholes equation, 602
  building valuation, 807–811
  capacity choice, 313
  capital budgeting, 93, 419, 687n
  case studies, 641
  classification, 90–93
  commitment, 451
  common types, 104
  competition, 383, 452
  conceptual approaches, 5, 82, 108
  criticism, 107
  DCF analysis, 682
  defining, 627
  empirical results, 12, 803, 807

Real options (cont.)
European, 602
examples, 116–126
expansion, 681
explanatory power, 12
financial options vs., 665
flexibility, 103–106
foreign investment, 115
foundations, 108
future research, 115
general model, 422–427
gold mines, 140, 422
government subsidies, 114
hysteresis, 153, 179
individual, 8
industrial organization, 452–459
interactions, 359
interrelated projects, 419–421
investment, 1, 153, 199, 273, 385
irreversibility, 199–202
land development, 114
lattice approach, 10
leasing, 114
literature, 5, 106, 823
main ideas, 1–5
major insights, 657–659
managerial flexibility, 359
manufacturing, 114
mining operations, 144–146
Monte Carlo methods, 4
multinationals, 745
multiple, 8, 359
natural resources, 113, 135, 335, 679
numerical methods, 4, 10, 111, 539, 601
oil company, 117–120
operating strategy, 91–93
portfolio management, 31, 385
pricing strategies, 689–691
project description, 679–681
research and development, 115
risk adjustment, 108
salvage and deferral, 681, 685
sensitivity analysis, 376, 683
separate valuation, 109
simulation methods, 601, 611
start-up ventures, 115
strategic acquisitions, 405
strategy and competition, 8–10
switching flexibility, 179
technological innovations, 517–519
timing, 642–646
types, 121, 627
uncertainty, 199–202
underinvestment, 107
valuation, 107, 116, 273, 601, 681
Reciprocating competition
critical demand zones, 488
equilibrium prices, 475
modeling strategies, 465
proprietary vs. shared, 484, 491
strategic investment, 491
Replacement investment, 419
Research and development
capital investment, 69
competitive strategies, 474
exclusive vs. shared, 495n
growth option, 120
investment decisions, 273
multiple options, 552
proprietary investment, 471
quantity competition, 467–469
real options, 115
shared investment, 473–479
strategic investment, 452
valuing, 12
Resources. *See* Natural resources
Restart option, 118, 193
Return on investment (ROI), 44
Rights, securities options, 34
Rigid technology, project valuation, 182
Risk. *See also* Beta risk
adjustment, 108, 668
aversion, 259
flexibility option, 668
Risk-neutral valuation, 108, 196n
Riskless arbitrage, 562
ROI, 44

Salvage value
abandoned options, 119, 194, 299
base case example, 302
put options, 8
uncertainty, 305–307
Schwartz, E. S., 1, 135, 335, 559
Scrapping projects, 256, 259
Securities options, 34
Separate options
abandoning, 370
contracting, 371
deferring, 370
switching, 371
valuing, 370
Sequential investments, 230–233
Majd-Pindyck model, 231
production decisions, 245n
random opportunities, 274, 291n

Roberts-Weitzman model, 233
Sequential projects
capital budgeting, 422, 427
cash flows, 437
covariance effects, 435
development, 444
empirical issues, 438
implementation, 438, 444
investment strategy, 432
program value, 428–432
valuation model, 442
Shadow value, production, 741n
Shared investment
critical demand zones, 482
inoffensive strategy, 480
numerical example, 468
offensive strategy, 473
options strategy, 88, 94
research and development, 473
Shastri, K., 571
Shipping industry, real options, 12, 115
Shortfall, rate of return, 713n
Shutdown option, 118, 193
Siegel, D. R. 253, 773
Simple growth options, 43
Simulation. *See* Monte Carlo simulation
Simultaneous entry, growth options, 509–511
Smit, H. T., 451
Smith, J. L., 773
Smith, K. W., 405
Sourcing, global, 743, 752, 762
Space-time hyperplane, approximation techniques, 575
Spanning assumption, option pricing, 210, 317
Spot prices, commodities, 147, 691, 712n
Spreads, mean-preserving, 502, 506
Staged investments, 104
Start-up ventures, real options, 12, 115
Stock options, employee, 623
Stock prices, 636
option valuation, 586
stochastic variable, 597n
timing, 576
Stackelberg leader, competitive strategy, 464, 483, 494n
Stopping region, optional scrapping, 269
Strategic growth options, 499
commitment, 501–503
imperfect competition, 503–507
net gain function, 505, 507
sensitivity analysis, 508, 511
simultaneous entry, 509–511
systematic risk, 512
volatility effect, 509
Strategic investment
call options, 453
Cournot competition, 493n
pioneer venture, 493n
proprietary and shared, 456
real options, 451
Strategic options, 8–10
competition, 112
commitment, 451
dynamic approach, 395
gardening metaphor, 386
flexibility, 451
harvesting, 391–394
licensing, 396
types, 407
volatility, 387
Strategic planning
acquisitions, 406–410
analysis, 30
capital budgeting, 87, 419
consulting firms, 21
contrarian competition, 477, 490
DCF analysis, 20
diversification, 410–414
divestiture, 414–416
finance theory, 19–23
flexibility option, 410
growth options, 406–410
interrelated projects, 419–421
nested options, 396–401
option pricing, 517–519
real options, 383, 452
synergy gains, 415
technological innovations, 517
Strike price, flexibility option, 677n
Sunk costs
consumer spending, 230
hysteresis, 166, 227
irreversibility, 199
types, 227
Supply contracts in natural resources, 351–353
Swary, I., 823
Switching option. *See also* Production shifting
additivity, 183–185
compound interactions, 186
costs, 183–191
flexibility, 182–191
hysteresis, 192, 196
oil company, 119, 124
Synthetic options, 108
Systematic risk, growth options, 512

Tax issues, option pricing, 625
Tax rates, property, 341
Technological innovation
 adoption behavior, 525–531
 buy-and-hold, 519, 525
 bystander strategy, 519
 competition, 517–519
 current and future, 519, 522
 environment, 525–532
 flexibility, 182–191
 investment, 517–524
 intuitive model, 528
 migration strategy, 524
 model and assumptions, 519
 option pricing, 517–519
 path-dependent, 519
 strategic option, 396
 switching value, 182–191
 uncertainty, 3, 534n
Telecommunications industry, volatility, 68
Time-to-build investments
 aircraft manufacturing, 273
 dynamic programming, 282
 numerical example, 282–288
 option valuation, 273–275
Timing investments, 209–216
 asset price, 256–258
 risk neutral, 254
 value of waiting, 256
Timing options
 case studies, 642–646
 DCF analysis, 643
 offshore projects, 642
Titman, S., 719
Trade
 deficits, 229
 exchange rates, 229
 foreign, 677n
 reforms, 237
Triantis, A. J., 405, 419
Trigeorgis, L., 1, 47, 79, 103, 179, 359, 451, 539, 679
Twin security, 49, 109, 692
Two-period irreversible investment, 202–208
Two-stage game, competitive strategy, 460

Uncertain investments
 applications, 728
 abandonment option, 707
 asset value, 709
 break-even price, 700
 Brownian motion, 712
 commitment, 691, 694, 713n
 cost vs. payoff, 733–739
 expiration, 702
 fixed date, 711
 flexibility, 693, 702, 705
 future development, 697–699
 hysteresis, 153, 169
 immediate development, 695
 interest rates, 236
 irreversibility, 199–202
 land prices, 719–721
 managerial flexibility, 703
 nuclear power plant, 736–739
 numerical examples, 705–710
 perpetual opportunity, 710
 pricing strategies, 689–691
 project description, 692
 real options, 199–202
 salvage value, 305–307
 simulation models, 238
 timing development, 699–701
 two-period example, 208
 types, 734
 valuing, 700
Underinvestment, real options, 5, 17, 107
Undeveloped property, valuation equation, 805, 819n
United States
 investments, 168
 land prices, 719
 production, 764
 trade deficit, 230
United States Geological Survey (USGS), 786, 791
Upgrade option, 532
Urban land prices
 comparison, 724–727
 numerical example, 723
 uncertainty, 719–721
Urgency, capital budgeting, 89
Utility planning, options approach, 73

Vacant land
 comparative statics, 724
 derivative security, 722
 valuation methods, 720
Valuation grid, Monte Carlo simulation, 615
Value Line Investment Survey, 35
Value-to-cost option, 387
Venture capital, real options, 127
Vertical investments, multinationals, 756
Volatility. *See also* Beta risk
 biotechnology, 68
 commodity prices, 75
 cumulative, 387
 foreign exchange, 749
 growth options, 509

industry, 68
market, 238, 332n, 749
option value, 652
real options, 663, 688n
strategic options, 387, 509

Wage rates, global manufacturing, 748
Waiting strategies
asset price, 256–258
effect, 155–158
investments, 253
option pricing, 689
valuing, 174, 253
Warrants, 30
Waste disposal, flexibility option, 413
Weighted average cost of capital, 64
Weiss, A. M., 517
Whaley method, multiple options, 544–551
Weiner process, investment timing, 209, 240, 254
Williams model, developed property, 820n
Within-country options, global manufacturing, 745, 756
Working capital, abandonment option, 832