Departament d'Economia i Empresa
Universitat Pompeu Fabra

Winter 2012

Corporate Finance
Syllabus and References

Professor: Albert Banal-Estanol (albert.banalestanol@upf.edu)
Lectures: Tuesday- Thursday, 15:00–17:00
Office: Jaume I, 20E26
Office hours: Friday 11:00-12:00 or by email appointment.

Teaching assistant: Miguel De Jesus (Miguel.dejesus@upf.edu)
Classes: Thursday, 14:00-15:00
Office: 20.140
Office hours: By email appointment

Description of the Course

This course covers the theory and empirics of corporate finance. The starting point of the course is an introduction to the Modigliani-Miller irrelevance theorems, which describe a frictionless set-up in which capital structure is independent of the firms' characteristics or choices and is irrelevant for the valuation of the firm.

A variety of deviations from this frictionless scenario are then studied. In these different cases we analyse optimal capital structure, corporate taxation, financial distress, the use of capital structure as a signalling device, and control allocation, amongst others, and how these affect the firm's valuation and investment decisions. In addition, we will also cover topics related to mergers and acquisitions, initial public offerings, project finance, and securitisation.

Students should organize in pairs. Each group will present and discuss one of the empirical articles, together with related papers, in class. Presentations should last for about 25-30 minutes. A class discussion about the paper or related issues will follow the presentation. Therefore, all students should read the paper in advance and ask questions and make comments. In addition, the empirical articles are part of the material to be covered in the final exam. The articles marked # are suitable for presentation by students. Students are welcome to suggest other (relevant) papers outside of this list they may be interested in presenting instead.

The papers (and book chapters) marked with a * are compulsory readings while the others should be used to complement the lectures. Every week practice sessions will be held with exercises to be handed in regularly. Handouts will be distributed during the course.

Grading

The final grade will be based on the final exam (65%) the grades from the practical exercises (15%) and the presentation of the empirical paper (15%). A final 5% will be based on active participation in class discussion following the presentations.

Recommended Books

The books are intended just to clarify concepts, not to introduce new ones. Given that even within relevant subsections of the books sometimes the authors digress a bit into topics outside our immediate interest, you should notice those and skip them accordingly. So, in general, even for required-reading subsections, read them a bit diagonally, skimming through it.

Berk, Jonathan and Peter DeMarzo, Corporate Finance, Boston Mass.: Pearson Addison Wesley, 2007

Grinblatt M. and S. Titman (2002) 2nd Edition “Financial Markets and Corporate Strategy” McGraw-Hill

Brealey, R. A., Myers, S.C., and Allen F.: “Principles of Corporate Finance”, 9th Edition, McGraw-Hill

Tirole, Jean (2006) “The Theory of Corporate Finance” Princeton University Press.

Other Useful Books

Chew, Donald, 1993, “The New Corporate Finance: Where Theory Meets Practice”, McGraw-Hill. (For those that want to gain more insight into the practice of corporate finance).

Copeland, T.E. and J.F. Weston “Financial Theory and Corporate Policy”, 3rd edition (Addison-Wesley, 1988)

Hart, O. (1995) “Firms Contracts and Financial Structure” (Oxford)

Higgins, R.C. “Analysis for Financial Management”, 8th edition

Jarrow R., V. Maksimovic and W. Ziemba (eds) (1995) Handbook of Operational Research and Management Science vol. 9 North Holland

Kevin F. Hallock and Kevin F. Murphy: *The Economics of Executive Compensation Vol I and Vol II* Cheltenham, UK (Edward Elgar 1999)

Stern Joel M. and Donald H. Chew Jr “The Revolution in Corporate Finance” Blackwell (2002) 4th Edition

Topics and reference articles:

1. The Modigliani and Miller Irrelevance Propositions, Taxes and Bankruptcy Costs

- The Modigliani-Miller Theorem
- Corporate Taxes – the debt tax shield
- Personal Taxes
- Bankruptcy Costs – The Static Trade-Off Theory

References

Brealey, R.A. and S.C. Myers *Principles of Corporate Finance*, 9th Edition (New York McGraw-Hill 1997) *Chapters 18 and 19*

* Grinblatt M. and S. Titman (2002) 2nd Edition "Financial Markets and Corporate Strategy" McGraw-Hill *Chapters 14, 15, and section 16.1*
(CH14: important sections: 14.1, 14.2, 14.4 and 14.9, skim through section 14.5, skip 14.3, 14.6-14.8, and 14.10 /
CH15: important section: 15.2, skim through 15.1, 15.3 15.6, skip 15.4 and 15.5)

Copeland, T.E. and J.F. Weston *Financial Theory and Corporate Policy*, 3rd edition (Addison-Wesley, 1988) (Chapters 13 & 14)

Modigliani F. and M. Miller (1958) *The Cost of Capital, Corporation Finance, and the Theory of Investment* American Economic Review, 48:162-197

De-Angelo H, and R. Masulis (1980) *Optimal Capital Structure Under Financial Taxation* Journal of Financial Economics 8:3-29

Duffie, D. (1992), "Modigliani-Miller Theorem", in Newman, P. et al. (eds.), *The New Palgrave Dictionary of Money and Finance*, vol. II, MacMillan, pp. 715-718.

Stiglitz (1969) *A Re-Examination of the Modigliani Miller Theorem* American Economic Review 59: 784-793

Stiglitz, J. (1974), "On the Irrelevance of Corporate Financial Policy", *American Economic Review*, 66, pp. 851-866.

MacKie Mason J. K. (1990) *Do Firms Care Who Provides Their Financing* Corporate Finance and Investment University of Chicago

Miller M. (1977) *Debt and Taxes* Journal of Finance 32:261-275

Miller, M. (1988), "The Modigliani-Miller Propositions after Thirty Years", *Journal of Economic Perspectives*, 2, pp. 99-120.

Givoly, Dan, Carla Hayn, Aharon R. Ofer, and Oded Sarig, 1992, Taxes and Capital Structure: Evidence from Firms' Response to the Tax Reform Act of 1986, Review of Financial Studies 5, 331–355.

Fama, Eugene, and Kenneth R. French, 1998, Taxes, Financing Decisions and Firm Value, Journal of Finance 53, 819–843.

Graham, J.R. (2000), "How Big Are The Tax Benefits of Debt," Journal of Finance 55, 1901-1941.

Rajan, Raghuram, and Luigi Zingales (1994), "What Do We Know About the Capital Structure? Some Evidence from International Data," Journal of Finance, 50:1421-1460.

J.R. Graham and C.R. Harvey (2001), "The theory and practice of corporate finance: Evidence from the field," Journal of Financial Economics 61.

Alderson, Michael J., and Betker, Brian L., 1995, "Liquidation Costs and Capital Structure," *Journal of Financial Economics* 39, 45-69.

Andrade, Gregor and Steven N. Kaplan, 1998, "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed," *Journal of Finance* 53 1443-1493.

2. Agency problems and capital structure

- Moral hazard
- Effort problem
- Asset Substitution or Risk shifting
- Underinvestment
- Debt overhang

References

* Grinblatt M. and S. Titman (2002) 2nd Edition "Financial Markets and Corporate Strategy" McGraw-Hill *Chapter 16 (important section: 16.2, skim through 16.4, and skip sections 16.1, 16.3 and 16.5)*

Tirole, Jean (2006) "The Theory of Corporate Finance" Princeton University Press. *Chapter 3 (especially sections 3.2 and 3.4)*

Jensen M. and W, Meckling (1976) *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* Journal of Financial Economics 3:305-360

* Myers S.C. (1977) *The Determinants of Corporate Borrowing* Journal of Financial Economics 5:147-175

Green R. C. (1984) *Investment Incentives, Debt, and Warrants* Journal of Financial-Economics; 13(1): 115-36

Hart, O. (1993) *Firms, Contracts and Financial Structure* (Oxford)

Oliver Hart; John Moore (1995) *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management* The American Economic Review, Vol. 85, No. 3. Jun., pp. 567-585.

Morck, Randall, Andrei Shleifer, y Robert W. Vishny (1988), "Management Ownership and Market Valuation: An Empirical Analysis", *Journal of Financial Economics*, vol. 20(1/2), pp. 293-315.

Himmelberg, Charles P., R. Glenn Hubbard, y Darius Palia (1999), "Understanding the Determinants of Managerial Ownership and the Link between Ownership and Performance", *Journal of Financial Economics*, vol. 53(3), pp. 353-84.

Baker, Malcom and Jeffrey Wurgler (2002) "Market Timing and Capital Structure" *Journal of Finance, Vol. 57, No. 1, February 2002*

3. Capital Structure as a Control Mechanism

- Agency costs
- Liquidation and termination threat
- Control allocation

References

* Hart , Oliver D.,Theories of Optimal Capital Structure: A Managerial Discretion Perspective(September 1993). NBER Working Paper No. R1806. Available at SSRN: http://ssrn.com/abstract=227171

* Grinblatt M. and S. Titman (2002) 2nd Edition "Financial Markets and Corporate Strategy" McGraw-Hill *Chapter 18 (only sections 18.3 and 18.4)*

Gale D. and M. Hellwig (1985) *Incentive Compatibility Debt Contracts: The One Period Problem* Review of Economic Studies, 52:647-663

Bolton P. and D. Scharfstein (1990) *A Theory of Predation Based on Agency Problems in Financial Contracting* American Economic Review 8:94-106

Hart O. and J. Moore (1994) *A Theory of Debt Based on the Inalienability of Human Capital* Quarterly Journal of Economics 109:841-879

Hart O. and J. Moore (1998) *Default and Renegotiation: A Dynamic Model of Debt* Quarterly Journal of Economics; 113(1): 1-41

Innes, R.D. (1990) *Limited Liability and Incentive Contracting with Ex-ante Action Choices* Journal of Economic Theory; 52(1):45-67

Rajan R. and L. Zingales *Power in a Theory of the Firm* Quarterly-Journal-of-Economics; 113(2), May 1998

Aghion p. and P. Bolton (1992) *An Incomplete Contracts Approach to Financial Contracting* Review of Economic Studies 77:388-401

Allen and Winton (1995) *Corporate Financial Structure, Incentives and Optimal Contracting* in Jarrow, Maksimovic and Ziemba (eds) Handbook of Operational Research and Management Science vol. 9 North Holland

Diamond D. W. (1994) *Financial Intermediation and Delegated Monitoring* Review of Economic Studies51:393-414

Harris M. and A. Raviv (1991) *A Theory of Capital Structure* Journal of Finance 20:297-355

Hart O. (1995) Firms Contracts and Financial Structure. Oxford University Press.

Townsend R. (1979) *Optimal Contracts and Competitive Markets With Costly State Verification* Journal of Economic Theory 21:265-293

4. Asymmetric Information

- Adverse Selection
- The pecking order theory
- Market Timing
- Signalling
    - Signalling through dividends
    - Signalling through capital structure

References

* Grinblatt M. and S. Titman (2002) 2nd Edition "Financial Markets and Corporate Strategy" McGraw-Hill *Chapter 19 (only section 19.5)*

Bhattacharya S. (1979) *Imperfect Information, Dividend Policy and the Bird in the Hand Fallacy.* Bell Journal of Economics 10: 259-270

Black F. (1976) *The Dividend Puzzle* Journal of Portfolio Management 2, 5-8

Litner J. (1956) *Distribution of Incomes Among Dividends, Retained Earnings, and Taxes* American Economic Review 46: 97-113

Miller M. and K. Rock (1985) *Dividend Policy Under Asymmetric Information* Journal of Finance 40(4): 1031-1051

* Myers S. C. (1984) *The Capital Structure Puzzle* Journal of Finance 39:575-592

Myers S. C. and N. Majluf (1984) *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have* Journal of Financial Economics, 8:23-40

Ross (1977) *The Determination of Financial Structure: The Incentive Signalling Approach* Bell Journal of Economics 8:23-40

Benartzi, Michaely, and Thaler, (1997), *Do Dividend-Changes Signal the Future or the Past?*, Journal of Finance 52, 1007-1034.

Bernheim D. B and A. Wantz, *A Tax-Based Test of the Dividend Signaling Hypothesis* American Economic Review; 85(3):532-51.

5. Financial Constraints

- Moral Hazard and Debt Capacity
- The Role of Collateral
- Macroeconomic Implications of Financial Constraints

References

* Tirole, Jean (2006) “The Theory of Corporate Finance” Princeton University Press.
    - Moral Hazard: *Sections 3.1, 3.2.1, 3.2.2, 3.4.1, 3.4.2*
    - Collateral: *4.3(intro), 4.3.1, 4.3.2, 4.3.3, 14.2.1, 14.2.2*
    - Macroeconomic Implications: *13.1, 13.3.1, 13.3.2*

Hubbard, R. G. (1998) Capital market imperfections and investment, Journal of Economic Literature 36, 193–227

Berger A.N and G. F. Udell (1998) *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle* Journal of Banking and Finance; 22(6-8):613-73.

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Kaplan S. N. and L. Zingales (1997) *Do Investment Cash Fow Sensitivities Provide Useful Measures of Financing Constraints?* Quarterly Journal of Economics 112(1):169-125

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Whited Toni, "Debt, Liquidity Constraints and Corporate Investments: Evidence from Panel Data, Journal of Finance, 47, 1425-1460,1992.

6. Mergers and Acquisitions

Mergers and acquisitions
Block trading
Disciplinary effect of M&A

References:

Andrade, Mitchell and Stafford (2001), "New Evidence and Perspectives on Mergers", Journal of Economic Perspectives.

Andrade and Stafford (2004), "Investigating the Economic Role of Mergers", Journal of Corporate Finance.

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Berger, P., and Eli Ofek, 1996, Bust-up Takeovers of Value-Destroying Diversified Frms, Journal of Finance 51, 1175−1200.

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Bhagat S., A. Shleifer and R. W. Vishny (1990) *Hostile Takeovers in the 1980s: The Return to Corporate Specialization* Brookings-Papers-on-Economic-Activity; 0(0), Special Issue: 1-72.

Billett, Matthew T, Tao-Hsien Dolly King, and David C. Mauer (2004) *Bondholder Wealth Effects in Mergers and Acquisitions: New Evidence from the 1980s and 1990s* The Journal of Finance Volume 59 Page 107 – February

Campa, J. and S. Kedia, 2002, Explaining the Diversification Discount, Journal of Finance 57, 1731-1762.

S. Datta, M. Iskandar-Datta, and K. Raman, (2001) *Executive compensation and corporate acquisition decisions* Journal of Finance 56, 2299-2336.

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and Consequences Journal of Political Economy 93(6):1155-1177

Grinblatt M. and S. Titman (1998) Financial Markets and Corporate Strategy Chapter 19 McGraw-Hill

Grossman S and O. Hart (1988) *One Share one Vote, and the Market for Corporate Control* Journal of Financial Economics 20: 203-235

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J. Hartzell, E. Ofek, and D. Yermack, (2004) *What's in it for me? CEOs whose firms are acquired* Review of Financial Studies 17, 37-61.

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Weston, Kwang and Hoag (1990), "Mergers, Restructuring, and Corporate Control", Prentice Hall.

7. Initial Public Offerings

Going public-The free rider problem
Going private-Leveraged buyouts
Motives to go public
Stylised facts
Theories on underpricing- Asymmetric information and others

<u>References:</u>

Ellis K, M. O'Hara and R. Michaely (2000) *When the Underwriter is the Market*

Maker: An Examination of Trading in the IPO Aftermarket. Journal of Finance

Ibbotson R. G. and J. R. Ritter (1995) *Initial Public Offerings* in Jarrow, In Jarrow, Maksimovic and Ziemba (eds) Handbook of Operational Research and Management Science vol. 9 North Holland

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Roell A. *The Decision to Go Public: An Overview* European Economic Review; 40(3-5),:1071-81.

8. Project finance

Project finance versus corporate finance

<u>References:</u>

Brealey, R.A., I. A. Cooper, and M.A. Habib, 1996, Using Project Finance to Fund Infrastructure Investments, *Journal of Applied Corporate Finance* 9:3, pp. 25-38

Esty, B. C. "Petrozuata: A Case Study on the Effective Use of Project Finance." *Journal of Applied Corporate Finance* 12, no. 3 (fall 1999): 26-42.

Esty, Benjamin C. "The Economic Motivations for Using Project Finance." 2003. Mimeo.

9. Managerial Compensation (time permitting)

Managerial compensation as a standard principal agent model
Undersensitivity
Market vs. accounting data

Aggarwal R, Samwick A. 1999 *The other side of the trade-off: The impact of risk on executive compensation* Journal of Political Economy 107: 65-105

* Bebchuk,Lucian Arye, Fried, Jesse and Walker David I. (2002) *Managerial Power and Rent Extraction in the Design of Executive Compensation,* Harvard Law School DP 366

Bertrand, Marianne, and Mullainathan, Sendhil (2001), Are CEOs Rewarded for Luck ? The Ones Without Principal Are", Quarterly Journal of Economics

Bertrand, M. and S. Mullainathan, (2003), "Enjoying the Quiet Life? Corporate

Governance and Managerial Preferences", *Journal of Political Economy*, Vol. 111, No. 5.

Brian J. Hallock and Kevin F. Murphy: *The Economics of Executive Compensation Vol I and Vol II* Cheltenham, UK Edward Elgar 1999

Murphy K, 1999 *Executive Compensation* in Ed O. Ashenfelter and D. Card Handbook of Labor Economics Vol III Amsterdam North Holland 2485-2563

10. Risk and Liquidity Management (time permitting)

References

Froot, K.A., D.S. Scharfstein and J. Stein (1993): Risk Management: Coordinating Corporate Investment and Financing Policies, Journal of Finance 48, 1629-1658

Acharya, V. H. Almeida and Murillo Campello "Is Cash Negative Debt? A Hedging Perspective on Corporate Financial Policies,", 2007, Journal of Financial Intermediation

DeMarzo, Peter M & Duffie, Darrell, 1995. "Corporate Incentives for Hedging and Hedge Accounting," Review of Financial Studies

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De Marzo, Peter M. and Darrell Duffie (1991): Corporate Financial Hedging with Proprietary Information, Journal of Economic Theory 53, 261-286

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John R. Graham & Daniel A. Rogers, 2002. "Do Firms Hedge in Response to Tax Incentives?," Journal of Finance, American Finance Association, vol. 57(2), pages 815-839, 04

Smithson, Charles, and Betty J. Simkins (2005): Does Risk Management Add Value? A Survey of the Evidence, Journal of Applied Corporate Finance, 17(3), 8-17.

11. Securitisation (time permitting)

Criado and van Rixtel: "Structured finance and the financial turmoil of 2007-2008: an introductory overview", Bank of Spain working paper.

Echave: "Securitisation: the end of the beginning", journal of International Banking and Financial Law

Kavanagh, “Securitization and Structured Finance: Legitimate Business Management Tools”

Keys, Mukherjee, Seru, and Vig 2008, “Did Securitization Lead to Lax Screening? Evidence From Subprime Loans”, working paper LBS.