Corporate Finance I – RSM3032

Instructors:

Pat Akey (empirical)
pat.akey@rotman.utoronto.ca
Office: RSM 431

Jan Mahrt-Smith (theory)
jmahrt@rotman.utoronto.ca
Office: RSM 204

Course Description (both parts)

This course is designed to introduce students to foundational theoretical models and empirical techniques in corporate finance. It is designed to have two components - a theory focused module and an empirical methods module - that are linked. The course will begin with the theory-focused module and conclude with the empirical-focused module. The goal of the theoretical component is to review classical theory papers in corporate finance and contract theory. It is assumed that students have taken an introductory course in microeconomics and are familiar with game theory and incomplete information. The goal of the empirical component of the course is to review econometric methods commonly used in corporate finance research. The module is designed to act as a bridge between a typical graduate course in theoretical microeconometrics and the practice of empirical research. It is assumed that students have taken an introductory course in econometrics and are familiar with, among other things, evaluation of econometric estimators and problems with omitted variables.

Course Evaluation (both parts)

Class Participation	20%
Problem Set (1)	15%
Referee Report (2)	25%
Comment on Empirical Methodology	10%
Final Paper	30%

Class meetings (both parts)

- Thursday, 2pm – 5 pm, RSM6024
    - Theory: October 13, 20, November 3, 10
    - Empirical: November 17, 24, December 1, 8

Course resources (theory – Pat will send his separately for the empirical section)

- There is no required textbook, but there is a highly recommended on:
  The Theory of Corporate Finance, by Jean Tirole, Princeton University Press

Class requirements (theory – Pat will send his separately for the empirical section)

- Depending on the topic, we will cover 2-4 papers each class. Students are expected to read these papers carefully and should be prepared to actively contribute to class discussions. At a minimum, you should have a thorough understanding of the central idea of each paper. You should critically evaluate each paper and think of some improvements, extensions, and additional research ideas related to the paper. Talking to each other BEFORE class will definitely improve our conversations in class.
- Additional papers are listed for each topic, including overview and survey papers. We will not have time to cover these papers in class, but you should make an effort to read them.

Topics (theory – Pat will send his separately for the empirical section)

1) Capital Structure – the classics
2) Capital Structure – “slightly” more modern
3) Financial Contracting
4) Corporate Diversification and M&A

Tentative reading list (theory – Pat will send his separately for the empirical section)

- Papers marked with a "*" will be discussed in class – read and understand and be ready to discuss
- Papers marked in bold will also be discussed, but not in depth – read
- Note: I listed way more "non-bold" papers than you can possibly read, but it is a useful list passed down by prior instructors both at Rotman and other schools

Some background readings (optional, but helpful)

Smith, C., 1990, The theory of corporate finance: a historical overview, in The modern theory of corporate finance, 2nd edition, ed. C. Smith, McGraw-Hill, New York.

Zingales, L., 2000, In search Of new foundations, Journal of Finance, 1623-1653.

Graham, J., and C. Harvey, 2001, The theory and practice of corporate finance: evidence from the field, Journal of Financial Economics 60, 187-243.

Class 1: Capital structure – the classics

***Modigliani, F., and M. Miller, 1958, The cost of capital, corporation finance and the theory of investment, American Economic Review 48, 261-297.**

***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., 1977, Determinants of corporate borrowing, Journal of Financial Economics 5, 147-175.**

Harris, M., and A. Raviv, 1991, The theory of capital structure, Journal of Finance 46, 297-356.

Graham, J., 2000, How big are the tax benefits of debt? Journal of Finance 55, 1901-1941.

MacKie-Mason, J., 1990, Do taxes affect corporate financing decisions? Journal of Finance 45, 1471-1493.

Miller, M., 1977, Debt and taxes, Journal of Finance 32, 261-275.

DeAngelo, H., and R. Masulis, 1980, Optimal capital structure under personal and corporate taxation, Journal of Financial Economics 8, 3-30.

Leland, H. and D. Pyle, 1977, Informational asymmetries, financial structure, and financial intermediation, Journal of Finance 32, 371-387.

Class 2: Capital structure – "slightly" more modern

***Myers, S., and N. Majluf, 1984, Corporate financing and investment decisions when firms have information that investors do not have, Journal of Financial Economics 13, 187-221.**

***Ross, S., 1977, The determination of financial structure: the incentive signaling approach, Bell Journal of Economics 8, 23-40.**

***Rajan, R., 1992, Insiders and outsiders: the choice between informed and arm's-length debt, Journal of Finance, 67, 1367-1400**

***Hennessy, C, and T. Whited, 2005, Debt Dynamics, Journal of Finance, 55, 1129-1165**

Baker, M., and J. Wurgler, 2002, Market timing and capital structure, Journal of Finance 57, 1-32.

Brander, J., and T. Lewis, 1986, Oligopoly and financial structure: the limited liability effect, American Economic Review 76, 956-970.

Shleifer, A., R. Vishny, 1992, Liquidation values and debt capacity: a market equilibrium approach, Journal of Finance 47, 1343-1366.

Parrino, R., and M. Weisbach, 1999, Measuring investment distortions arising from stockholder-bondholder conflicts, Journal of Financial Economics 53, 3-42.

Jensen, M., 1986, Agency costs of free cash flow, corporate finance, and takeovers, American Economic Review 76, 323-329.

Zwiebel, J., 1996, Dynamic capital structure under managerial entrenchment, American Economic Review 86, 1197-1215

Myers, S., 1984, The capital structure puzzle, Journal of Finance 39, 575-592.

Frank, M., and V. Goyal, 2003, Testing the pecking order theory of capital structure, Journal of Financial Economics 67, 217-248.

Shyam-Sunder, L, and S. Myers, 1999, Testing static tradeoff against pecking order models of capital structure, Journal of Financial Economics 51, 219-244.

Maksimovic, V., 1988, Capital structure in repeated oligopolies, RAND Journal of Economics 19, 389-402.

Chevalier, J., 1995, Capital structure and product market competition: empirical evidence from the supermarket industry, American Economic Review 85, 206-256.

Phillips, G., 1995, Increased debt and industry product markets: an empirical analysis, Journal of Financial Economics 37, 189-238.

Asquith, P., R. Gertner, and D. Scharfstein, 1994, Anatomy of financial distress: an examination of junk-bond issuers, Quarterly Journal of Economics 109, 625-658.

Gertner, R. and D. Scharfstein, 1991, A theory of workouts and the effects of reorganization law, Journal of Finance 46, 1189-1222.

Warner, J., 1977, Bankruptcy costs: some evidence, Journal of Finance 32, 337-348.

Franks, J., and W. Torous, 1989, An empirical investigation of United States firms in reorganization, Journal of Finance 44, 747-769.

Bradley, M., G. Jarrell, and E. Kim, 1984, On the existence of an optimal capital structure: theory and evidence, Journal of Finance 39, 857-878.

Rajan, R., and L. Zingales, 1995, What do we know about capital structure? Some evidence from international data, Journal of Finance 50, 1421-1460.

<u>Class 3: Financial contracting</u>

***Hart, Oliver, 2001, Financial Contracting , Journal of Economic Literature 39, 1079-1100**

***Gale, D., and M. Hellwig, 1985, Incentive compatible debt contracts: the one period problem, Review of Economic Studies 52, 647-663.**

***Bolton, P., and D. Scharfstein, 1996, Optimal debt structure and the number of creditors, Journal of Political Economy 104, 1-25.**

Hart, O., 1995, *Firms, Contracts, and Financial Structure*, Oxford University Press.

Innes, R., 1990, Limited liability and incentive contracting with ex-ante action choices, Journal of Economic Theory 52, 45-67.

Diamond, D., 1984, Financial intermediation and delegated monitoring, Review of Economic Studies 51, 393-414.

Diamond, D., 1991, Debt maturity structure and liquidity risk, Quarterly Journal of Economics 56, 709-738.

Diamond, D., 1993, Seniority and maturity of debt contracts, Journal of Financial Economics 33, 341-368.

Mahrt-Smith, J., 2005, The interaction of capital structure and ownership structure, Journal of Business 78, 787-816.

Class 4: Mergers and Acquisitions (and, if time, empirics of corporate diversification)

***Grossman, S., and O. Hart, 1980, Takeover bids, the free rider problem, and the theory of the corporation, Bell Journal of Economics 11, 42-69.**

Kyle, A, and J-L Vila, Noise Trading and Takeovers, RAND Journal of Economics, 22, 54-71

Zingales, L, What determines the value of corporate votes?, The Quarterly Journal of Economics, 110, 1047-1073.

Jensen, M., 1986, Agency costs of free cash flow, corporate finance, and takeovers, American Economic Review 76, 323-329.

Lamont, O., 1997, Cash flow and investment: evidence from internal capital markets, Journal of Finance 52, 83-109

Bradley, M., A. Desai, and E. Kim, 1988, Synergistic gains from corporate acquisitions and their division between the stockholders of target and acquiring firms, Journal of Financial Economics 21, 3-40.

Lang, L., R. Stulz, and R. Walkling, 1989, Managerial performance, tobin's q, and the gains from successful tender offers, Journal of Financial Economics 24, 137-154.

Berger, P., and E. Ofek, 1995, Diversification's effect on firm value, Journal of Financial Economics 37, 39-65.

Martin, J., and A. Sayrak, 2003, Corporate diversification and shareholder value: a survey of recent literature, Journal of Corporate Finance 9, 37-57.

Stein, J., 1997, Internal capital markets and the competition for corporate resources, Journal of Finance 52, 111-133.

Gertner, R., D. Scharfstein, and J. Stein, 1994, Internal versus external capital markets, Quarterly Journal of Economics 109, 1211-1230.

Rajan, R., H. Servaes, and L. Zingales. 2000, The cost of diversity: the diversification discount and inefficient investment, Journal of Finance 55, 35-60.

Scharfstein, D., and J. Stein, 2000, The dark side of internal capital markets: divisional rent seeking and inefficient investment, Journal of Finance 55, 2537-2564.

Lang, L, and R. Stulz, 1994, Tobin's q, corporate diversification, and firm performance, Journal of Political Economy 102, 1248-1280.

Denis, D., D. Denis, and A. Sarin, 1997, Agency problems, equity ownership, and corporate diversification, Journal of Finance 52, 135-160.

Shin, H., and R. Stulz, 1998, Are internal capital market efficient, Quarterly Journal of Economics 113, 531-552.

Scharfstein, D., and J. Stein, 2000, The dark side of internal capital markets: divisional rent seeking and inefficient investment, Journal of Finance 55, 2537-2564.

Whited, T., 2001, Is it inefficient investment that causes the diversification discount?, Journal of Finance 56, 1667-1691.

Aggarwal, R., and A. Samwick, 2003, Why do managers diversify their firms? Agency reconsidered, Journal of Finance 58, 71-118.

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

Graham, J., M. Lemmon, and J. Wolf, 2002, Does corporate diversification destroy value?, Journal of Finance 57, 695-720.

Lamont, O. and C. Polk, 2002, Does diversification destroy value? Evidence from industry shocks, Journal of Financial Economics 63, 51-77.

Villalonga, B., 2003, Diversification discount or premium? New evidence from BITS establishment-level data, Journal of Finance, forthcoming.

Comment, R. and G. Jarrell, 1994, Corporate focus and stock returns, Journal of Financial Economics 37, 67-87.

John, K., and and E. Ofek, 1995, Asset sales and increase in focus, Journal of Financial Economics 37, 105-126.

Berger, P., and E. Ofek, 1996, Bustup takeovers of value-destroying diversified firms, Journal of Finance 51, 1175-1200.

Berger, P., and E. Ofek, 1999, Causes and effects of corporate refocusing programs, Review of Financial Studies 12, 311-345.

Schlingemann, F., R. Stulz, and R. Walkling, 2002, Divestitures and the liquidity of the market for corporate assets, Journal of Financial Economics 64, 117-144.

Lins, K., and H. Servaes, 1999, International evidence on the value of corporate diversification, Journal of Finance 54, 2215-2239.

Denis, D., D. Denis, and K. Yost, 2002, Global diversification, industrial diversification, and firm value, Journal of Finance 57, 1951-1979.

Fauver, L., J. Houston, and A. Naranjo, 2003, Capital market development, international integration, legal systems, and the value of corporate diversification: a cross-country analysis, Journal of Financial and Quantitative Analysis 38, 135-157.

Jensen, M., and R. Ruback, 1983, The market for corporate control: the scientific evidence, Journal of Financial Economics 11, 5-50.

Hirshleifer, D., 1995, Mergers and acquisitions: strategic and informational issues, *Finance: Handbooks in Operations Research and Management Science,* eds. R. Jarrow, M. Maximovich and W. Ziemba, North Holland.

Shleifer, A. and R. Vishny, 1986, Large shareholders and corporate control, Journal of Political Economy 94, 461-88.

Stulz, R., 1988, Managerial control of voting rights: financing policies and the market for corporate control, Journal of Financial Economics 20, 25-54.

Scharfstein, D., 1988, The disciplinary role of takeovers, Review of Economic Studies 60, 185-199.

Mitchell, M., and K. Lehn, 1990, Do bad bidders make good targets?, Journal of Political Economy 98, 372-398.

Healy, P., K. Palepu and R. Ruback, 1992, Does corporate performance improve after mergers?, Journal of Financial Economics 31, 135-176.

Servaes, H., 1994, Do takeover targets overinvest?, Review of Financial Studies 7, 253-277.

Loughran, T., and A. Vijh, 1997, Do long-term shareholders benefit from capital acquisitions?, Journal of Finance 52, 1765-1790.

Schwert, W., 2000, Hostility in takeovers: in the eyes of the beholder?, Journal of Finance 55, 2599-2640.

Holmström, B., and S. Kaplan, 2001, Corporate governance and merger activity in the U.S.: making sense of the 80's and 90's, Journal of Economic Perspectives 15, 121-144.

Moeller, S., F. Schlingemann, and R. Stulz, 2004, Firm size and the gains from acquisitions, Journal of Financial Economics 73, 201-228.