Finance 555: Financing Decisions, Payout Policy and Corporate Control

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Office Hours: W 5:30-6:30, Th 1:30-2:30
and by appointment

This course provides a general economic and financial framework for analyzing the effects of financing decisions, as opposed to investment decisions, on corporate value. The material extends and enhances the frameworks covered in the Core Finance component and other Finance courses. Specifically, we will study decisions involving capital structure, payout policy, management compensation, ownership structure, and the distribution of control rights – virtually anything related to the way that contracts are structured within the corporation.

This class parallels much of the subject matter of Finance 552 (but not financial planning, which 552 does cover). There is a large difference of approach, however, between the two classes. While Finance 552 works on getting the students to apply the principles that they learned in the Core classes, the focus of this class is to extend the frameworks developed there. Finance 555 will also do some application, but it will primarily be application of this new material.

The class will be heavily based on microeconomic principles. You will be required, for example, to understand analysis using indifference curves and budget lines. If you did not get this from your core microeconomics class, you should study this on your own – Evening MBA students get this in the core, and there is no time to re-teach it for a limited group.

Readings

There will be a required textbook, Berk and Demarzo's Corporate Finance, 3rd edition, which is abbreviated BD below. It is a classic textbook, and anyone serious about finance should own it or a close substitute. I understand that most of you have a copy of the first 19 chapters of the book which is packaged as "The Core" in a separate book. If you don't have this, you should buy it. We will read some extra material from the book, which will be in the course pack for the class.

Because the course investigates new theories and goes into much more detail than BD in some areas, the class will not be primarily textbook based. Instead there will be other readings that will be required, and class handouts will be used to supplement the material when necessary. In addition there will be optional readings that should be read by students with a specific interest in a topic. Class handouts are required reading. A course pack will be available from the University Readers website (https://students.universityreaders.com/store/) that contains other required readings. Optional readings will be available through the library, with some on reserve. Some newer readings can be found on www.ssrn.com, www.jstor.org, or other library resources when accessed from the library terminals (or from home through the library website).

Required Work and Evaluation

Evaluation in this course will be determined by written assignments, class participation, and examinations. The percentages for grading will be

Written Assignments	25%
Class Participation	10%
Midterm	30%
Final	35%

Written Assignments will be two write-ups done about cases and two or three homeworks. Students will work in groups on the cases, with two to five people in a group. Homeworks must ultimately be done **individually**, although I recommend that students discuss how to *approach* the questions with fellow students. Cases are available for purchase (download or hard copy) from Harvard at http://cb.hbsp.harvard.edu/cbmp/access/62805009 .

Class Participation grades will be determined primarily by the **quality** of participation and also somewhat by student attendance.

The examination questions will usually require a student to apply the course material to potential or actual circumstances. Some of these questions will be set in relatively unstructured situations. They will thus test whether you can discern the correct concepts to apply, as well as whether you can apply these concepts correctly. Exams will be **closed book and closed notes**. Some key formulas will be written on the face of the exam to alleviate the urge to memorize.

Students should read the required material before the class covering that material. Reading the required material before class should enable you to make the most out of the lecture. All students are responsible for the material covered in class, as well as the material in the handouts and required readings for each class, regardless of whether they attend the class.

Other Matters: Attitudes, Inflexibility, and Idiosyncrasies

A few matters that may concern students relate to my philosophy towards teaching, classroom sessions, and grading. First, I enjoy teaching itself -- that is, communicating ideas to students eager to learn. Teaching is one of the two key inputs in the production of your knowledge. I get a thrill from having an impact on the way many bright young people will think and act. I also usually learn quite a few things from the students in the process.

Different teaching techniques seem to work best for different teachers. I find my teaching to be most effective when students actively participate in class. This means that students must think along with me during class sessions. There must be substantial student-teacher interaction--typically through student questions, comments, and answers to my questions. Students should have a strong impact on the class session.

The worst part of teaching is the grading and evaluating required of teachers. Grading consumes a large portion of professorial time and student attention despite the fact that, in the long run, grades are of little importance to anyone. Consider how disproportionate the time spent on grades is, given that seldom does anyone ask about your grades once you have been out of school for more than a year or two. (As proof of this latter proposition, consider my own situation. When I took introductory MBA Corporate Finance, I received the equivalent of a C. Yet in my first 25 years at UW no one asked me about this grade, or any other grades, when deciding whether I should teach this class.) De-emphasizing grades and emphasizing learning would seem to be in the interest of all of us.

Finally, I expect all of us in the class to behave responsibly. People who behave irresponsibly, imposing costs on others, should expect to bear the consequences of their actions. These attitudes, and other factors, give rise to the following policies:

1. I will use graders to do most of the grading, but will make sure that any grader is highly competent.

2. I will be happy to go over exam questions with students to explain the correct answer and/or where they went wrong. However, I refuse to listen to grade complaints. Complaints are almost always unsuccessful and a waste of everyone's time. In over two decades of teaching, never has a student complaint caused me to change a grade I have given (except when scores were added incorrectly).

3. I will expect all students to be prepared for class and to turn in assignments on time. Similarly, students can expect me to be prepared for class and to present them with assignments, handouts, and course materials on time.

4. I will encourage students to ask questions and otherwise participate in class. In some instances, "votes" on particular questions will be taken. All students will be expected to vote.

5. Students should focus on the class session during class. **They should not have laptops open** in class, unless they have received special approval from the instructor.

Topic Outline -- (Dates are approximate)

Goals, the Nature of the Firm, and Tool-Building – March 27 and 29

- The Firm as a Nexus of Contracts
- Wealth Creation by the Firm
- Fisher Diagram
- Alternative Firm Goals
- Stakeholders and the Firm
- States of the World Models and Pricing

Required: Class Handouts
Brealey and Myers, *Principles of Corporate Finance*, Chapter 2, 2nd ed.

Optional Readings: Martin, Cox, and MacMinn, 1988, Chapter 2, "Financial Decisions and the Theory of Choice," and part of Chapter 3, in *The Theory of Finance: Evidence and Applications*, pp. 19-46, 70-72.(on reserve)
Copeland and Weston, "State-Preference Theory," Chapter 5 of *Financial Theory and Corporate Policy*, 3rd Edition. (on reserve)
BD -- Sections 3.3 and 21.3 (although 21.3 has a different context)

Capital Structure with Fixed Investment Decisions – April 3 to April 19

- Perfect Markets (M & M)
- Weighted Average Cost of Capital
- Corporate Taxes
- Personal Taxes
- Financial Distress Costs
- Signaling

Required: BD Ch. 14 and 15 and Sections 16.1-16.4

Written Assignment: Bed Bath and Beyond Case (due April 17)

Optional Readings: DeAngelo and Masulis, 1980, "Optimal Capital Structure under Personal and Corporate Taxation," *Journal of Financial Economics*, Vol. 8.

Merohtra, Mikkelson, and Partch, 2003, "The Design of Financial Policies in Corporate Spin-offs," *Review of Financial Studies*, Vol. 16, No. 4.

Opler and Titman, 1994, "Financial Distress and Corporate Performance," *Journal of Finance*, Vol. 49.

Andrade and Kaplan, 1998, "How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed," *Journal of Finance*, Vol. 53, No. 5.

Glover, 2016. "The Expected Cost of Default." *Journal of Financial Economics,* Volume 119, Pages 284-299.

Korteweg, 2010. "The Net Benefits to Leverage," *Journal of Finance*, Vol. 65, No. 6, December, pp. 2137-2170.

Chalmers, 1998, "Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations," *Review of Financial Studies*, Vol. 11, No. 2 – especially first few pages.

Ross, 1977, "The Determination of Financial Structure: The Incentive Signaling Approach," *The Bell Journal of Economics*, Vol. 8, No. 1. (Read first 8 pages or so)

Graham and Harvey, 2001, "The theory and practice of corporate finance: evidence from the field**,"** *Journal of Financial Economics,* Volume 60, Issues 2-3, May, Pages 187-243.

Senbet and Wang, 2010, "Corporate Financial Distress and Bankruptcy: A Survey," *Foundations and Trends in Finance*, Vol. 5, No. 4 pp. 243-335.

Blouin, Core, and Guay, 2010. "Have the tax benefits of debt been overestimated?" *Journal of Financial Economics,* Volume 98, Pages 195-213.

Damodaran, 2001. Corporate Finance: Theory and Practice, 2nd ed. Chapters 18-20. (on reserve)

Capital Acquisition – April 24 and 26

- Overview of Financing Alternatives
- How Securities are Issued
- Stock Price Reactions to Capital Structure Decisions
- The IPO Market

Required: BD Ch. 23, Section 16.8

Tim Loughran and Jay Ritter, 2004, "Why Has IPO Pricing Changed Over Time?" *Financial Manageement*, Autumn.

Cliff Smith, 1986, "Raising Capital: Theory and Evidence," *Midland Corporate Finance Journal*, Vol. 4.

Bro Utal, July 21 1986, "Inside the Deal that made Bill Gates $350,000,000," *Fortune*.

Optional Readings: Asquith and Mullins, 1986, "Equity Issues and Offering Dilution," *Journal of Financial Economics*, Vol. 15.

Jay Ritter and Ivo Welch, 2002, "A Review of IPO Activity, Pricing, and Allocations," *Journal of Finance*, Vol. 57.

Lowry, Officer, and Schwert, 2010, "The Variability of IPO Initial Returns," *Journal of Finance*, Vol. 65.

BD Ch. 24

MIDTERM EXAM – May 1

Capital Structure Theory with Informational Inefficiency and Costly Arbitrage – May 3

- Market Inefficiency and Arbitrage Costs
- Recent Evidence
- Implications for Capital Structure

Required: BD Section 13.6

Jeffrey Pontiff, 2006, "Costly Arbitrage and the Myth of Idiosyncratic Risk," *Journal of Accounting and Economics*, October.

Optional Readings: Shleifer and Vishny, 1990, "Equilibrium Short Horizons of Investors and Firms," *American Economic Review*, Vol. 80.

Loughran and Ritter, 1995, "The New Issues Puzzle," *Journal of Finance*, Volume 50, pp. 23-51.

Lowry and Schwert, 2002, "IPO Market Cycles: Bubbles or Sequential Learning," *Journal of Finance*, vol. 57, No. 3.

Ikenberry, Lakonishok, and Vermaelen, 1995, "Market Underreaction to Open Market Share Repurchases," *Journal of Financial Economics*, Vol. 39.
Baker and Wurgler, 2002, "Market Timing and Capital Structure," *Journal of Finance*, vol.57, Issue 1.
BD Ch. 13 (other than 13.6 which is required)

Dividend Policy with Fixed Investment Decision – May 8 and 10

- Perfect Markets (M & M)
- Personal Taxes
- New Issue Costs
- Portfolio Rebalancing Costs
- Signaling
- Why Our Theories Do Not Give Valuable Decision-Making Guidance

Required: BD Ch. 17

Optional Readings: Miller and Rock, 1985, "Dividend Policy Under Asymmetric Information," *Journal of Finance*, Vol. 40.
Skinner, 2008, "The evolving relation between earnings, dividends, and stock repurchases," *Journal of Financial Economics,* Vol. 87, no. 3.

Agency Problems and Changes in Investment due to Financial Structure - May 15 to May 31

- Agency Theory
- Agency Costs of Debt
- Agency Costs of Equity
- Agency Costs and Dividend Policy
- Financial Contracting
- Management Compensation

Required: Byrd, Parrino, and Pritsch, 1998, "Stockholder-Manager Conflicts and Firm Value," *Financial Analysts Journal*, Vol. 54, No. 3.
Jensen and Meckling, 1976, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, vol. 3 (Beginning up to figure 1 – remaining is optional).
BD Sec. 16.5-16.7, 16.9
Murphy, 2012, "Executive Compensation: Where We Are, and How We Got There," *Handbook of the Economics of Finance*, pp. 1-42, 128-156.

Written Assignment: Kennecott Copper Case (due May 22)

Optional Readings: Smith and Warner, 1979, "On Financial Contracting: An Analysis of Bond Covenants," *Journal of Financial Economics*, vol. 7.

DeAngelo and DeAngelo, 2006, "The irrelevance of the MM dividend irrelevance theorem" *Journal of Financial Economics*, Vol. 79.

Oyer and Schaefer, 2005, "Why do some firms give stock options to all employees? An empirical examination of alternative theories," *Journal of Financial Economics,* Volume 76, Issue 1, April, Pages 99-133.

W. Maxwell and C. Stephens 2003, "The Wealth Effects of Repurchases on Bondholders," *Journal of Finance*, Vol. 58, No. 2, April, pp. 895-919.

T. Gormley and D. Matsa, 2016. "Playing it safe? Managerial preferences, risk, and agency conflicts," *Journal of Financial Economics,* Volume 122, Pages 431-455.

Bebchuk and Fried, 2003, "Executive Compensation as an Agency Problem**,"** *Journal of Economic Perspectives*, 71-92.

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

Sundaram and Yermack, 2007, "Pay Me Later: Inside Debt and Its Role in Managerial Compensation," *Journal of Finance*, August, vol. 62, no. 4.

Fich, Rice, and Tran, 2016, "Endogenous Contracting in Compensation: Evidence from Merger Bonuses to Target CEOs*," Journal of Accounting and Economics*, Vol. 61, pp. 338-368.

Gillan, Hartzell, and Parrino, 2009, "Explicit versus Implicit Contracts: Evidence from CEO Employment Agreements," *Journal of Finance*, Vol. 64, No. 4, August, pp. 1629-1655.

M. Bertrand and S. Mullainathan, 2003. "Enjoying the Quiet Life? Corporate Governance and Managerial Preferences," *Journal of Political Economy*, Vol. 111, No. 5, pp. 1043-1075.

BD Chapter 29

FINAL EXAM – During Finals Week (June 5-9) to be arranged