

MAF: Corporate Finance MN50324: Semester 2, 2011/2012.

Final reading list 12/4/12

1. Lecturer's Details

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The course covers numerical, analytical and conceptual aspects of corporate finance. Therefore, students are expected to gain expertise in numerical and game-theoretic analysis, and deeper, conceptual understanding. Your performance on the course is assessed by exam only.

The exam consists of two sections. Section A will contain one numerical and one game-theory question. Section B will consist of two essay questions (from a choice of three).

In order to provide you with practice/feedback in your exam preparation, throughout the semester, you will be required to complete homework exercises (numerical and game-theoretic). The teaching assistant will then go through the answers in your fortnightly seminars. These exercises will give an example of the *type* of questions that will come up in section A of the exam (there will also be some numerical/game-theoretic examples in the lectures: it is worth practicing these as well).

In relation to the essay questions, I am happy for you to attempt, in groups of 4 or 5 (non-assessed) essays in order for me to give you some feedback on your essay technique. Therefore, I have provided a list of typical essay questions that have appeared in previous years' exams. For instance:

1. "The firm must understand that investing in a project is a now-or-never decision." Discuss, with particular reference to real option theory.
2. "The firm's capital structure is irrelevant." Discuss.
3. Compare and contrast the trade-off and pecking order theories of capital structure.
4. "Our firm needs to cut the dividend this year, as we have a lot of exciting new investment projects available!" Discuss the dangers inherent in doing this, and how the firm should handle such a policy.
5. A firm is deciding whether to use its excess cashflow to pay dividends or repurchase shares. Does it matter which it does? In your answer, refer to the relevant theories, and the empirical evidence.
6. "When negotiating contracts with entrepreneurs, venture capitalists must be aware of the potential for entrepreneurial opportunistic behaviour." Discuss, with reference to relevant theory and evidence.

3. Course Outline:

| <u>Topic</u> | <u>Relevant Chapters in CWS</u> | <u>Relevant chapters in Combined HRWJJ/Shefrin book.</u> |
|----------------------------------------------------------------|----------------------------------------|-----------------------------------------------------------------|
| 1. Investment Appraisal, decision trees. Real options | 9 | 4, 6, 7, 8, 22 |
| 2. Information Asymmetry/agency theory | 12 | |
| 3. Capital Structure and Firm Value/Optimal Capital Structure. | 15 | 15, 16 |
| 4. Payout Policy (Dividends/repurchases. | 16 | 18 |
| 5. Venture Capital/Private Equity | Not applicable: but see papers below | |
| 6. Behavioural Corporate Finance | | All of the Shefrin Chapters |

4. Reading List

Recommended Books:

Corporate Finance/ Behavioural Corporate Finance: Special Hybrid book developed specifically for this course, combining relevant chapters from Hillier, Ross, Westerfield, Jaffe and Jordan with relevant chapters from Shefrin's book on Behavioural Corporate Finance.

Financial Theory and Corporate Policy: Copeland, Weston, Shastri: You should already have this book from the first semester. The course will use this as the starting point.

Besides these books, I thoroughly recommend the following optional reading:

- **6 Roundtable Discussions of Corporate Finance** Editor Joel Stern (Available in the library).
- **Revolution in Corporate Finance** (3rd Edition preferred, but 4th edition also available) Stern and Chew editors (available in the library).
- **Dividend Policy: its Impact on Firm Value:** Lease et al (I have a copy!).

You do not have to purchase any of these, but they will help you to research the subject beyond the lectures, and deepen your understanding of the issues in Corporate Finance.

Please note that the text-books support (and are complementary to) the lecture slides. That is, the lectures do not follow the text-book exactly. The lectures cover material beyond the text-books (such as journal articles). It is up to the student to read/research beyond the text-book and the lectures (eg read the articles, use Google, SSRN and the financial press.

Furthermore, if HRWJJ is unavailable to you, the library has a whole host of alternative corporate finance books around the 658.15 reference. They all cover similar topics.

In addition to the chapters of CWS, and HRWJJ/Shefrin identified above, I recommend the following articles.

General Corporate Finance articles:

- “The theory and practice of corporate finance: Evidence from the field” , Graham and Harvey, Journal of Financial Economics, 2001.
- “How do CFOs make Capital Budgeting and Capital Structure Decisions?” Graham and Harvey, Journal of Applied Corporate Finance, 2002.
- “The Role of the Board of Directors in the Capital Budgeting Process – Evidence from S and P 500 firms.” Grintstein, Y, and E. Tolkowsky. 2004.
- “Payout Policy in the 21st Century”, Graham, Harvey, and Michaely., Journal of Financial Economics 2005.

1. Investment Appraisal /Decision Trees/real options.

Suggested Readings:

- Real Options Primer: A Practical Synthesis of Concepts and Valuation Approaches.” Kathleen T. Hevert, Journal of Applied Corporate Finance. 2001

- “Real Options and Games: Competition, alliances and other applications of valuation and strategy.” Smit, H, and L. Trigeorgis. *Review of Financial Economics* 15 (2006); 95-112.
- “A Two-stage Investment Game in Real Option Analysis.” Imai, J, and T. Watanabe. Downloadable from Google.
- “A Real Options and Game-Theoretic Approach to Corporate Investment Strategy under Competition.” Smit and Ankum. (1993). *Financial Management*.
- “Applications of Real Options analysis for Pharmaceutical R and D Project Valuation – Empirical Results from a Survey,” Hartmann and Hassan, *Research Policy* (2006).

2. The Financing Decision/ Optimal Capital Structure, Agency Costs, Signalling.

- Jensen and Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership structure.” *Journal of Financial Economics*, October 1976, 305-360.
- Jensen. “Agency Costs of Free Cashflow, Corporate Finance and Takeovers.” *American Economic Review*. May 1986.
- Myers and Majluf. “Corporate Financing and Investment Decisions when Firms Have Information that Investors do not have.” *Journal of Financial Economics* November 1977, 147 – 176.
- Ross. S.A. “The Determinants of Financial Structure: The Incentive Signalling Approach.” *Bell Journal of Economics* Spring 1977, 23 – 40.
- Harris and Raviv. “The Theory of Capital Structure.” Pg 297-355 *Journal of Finance* 1991.
- “An investigation of the determinants of BT’s debt levels: what does it tell us about the optimal capital structure?” Fairchild, R. *International Business and Economics research Journal*. Paper downloadable from Bath Working paper series.
- Fairchild, R. “Conflicts between Managers and Investors over the Optimal Financial Contract.” *International Journal of Business and Economics* December 2003 Vol 2 No.3.

3. Payout Policy.

a) Dividend Policy.

- Fairchild “Dividend Policy, Signalling and Free-cashflow: an Integrated Approach.” Managerial Finance. September 2010
- Wooldridge and Ghosh. “Dividend cuts: do they always signal bad news?” In the Revolution in Corporate Finance third edition.
- 6 roundtable discussions of corporate finance.

b) Repurchases:

- "Management's View on Share Repurchases and Tender Offer Premiums" by Wansley, Lane and Sarkar Financial Management 1989
- "An Empirical Survey of the Motivation for Share Repurchases in the UK" by Dixon et al Managerial Finance 2008
- "Stock Repurchases and the EPS Enhancement Fallacy" by Oded and Michel Financial Analysts Journal 2008
- "Share Repurchases and Managerial Opportunism" by Fried, California Law Review 2005
- "Why do Firms announce open market repurchase programs?" by Oded 2003
- Isagawa, N. "Open Market Repurchase Announcements and Stock price behaviour in Inefficient markets"
- Isagawa, N. "Open Market Stock Repurchase and Stock price behavior when management values real investment."

PTO:

4. Venture Capital

- Brander, J, and De Bettignies, J.E. (2007) “Financing Entrepreneurship: Bank Finance versus Venture Capital.” *Journal of Business Venturing*.”
- Cable, D.M, and S. Shane (1997). “A Prisoner’s Dilemma Approach to Entrepreneur-Venture capitalist relationships.” *Academy of Management Review*, Vol 22, no 1, 142 – 176.
- Casamatta, C. (2003). “Financing and Advising: Optimal Financial Contracts with Venture Capitalists.” *Journal of Finance* vol 58, no 5, 2059 – 2085.
- Elitzur, R., and A. Gavious. (2003). “Contracting, Signalling, and Moral Hazard: a Model of Entrepreneurs, ‘angels’, and Venture Capitalists.” *Journal of Business Venturing* 18, 709 – 725.
- Kaplan, S. and P. Stromberg. (2000). “Financial Contracting Meets the Real World: An Empirical Analysis of Venture Capital Contracts.” SSRN database.
- Tykvova, T. “What Economists tell us about Venture Capital.” SSRN/Google.
- Repullo and Suarez (2004). “Venture Capital Finance: A Security Design Approach.” *Review of Finance* 8: 75 – 108.
- Fairchild, R. “Financial Contracting between Managers and Venture Capitalists – The role of Value-added Services, Reputation seeking and Bargaining Power.” *Journal of Financial Research* Winter 2004 volume XXVI Number 4.
- Fairchild, R. “The Effects of Self-interest and Fairness on Entrepreneur/Venture Capitalist Financial Contracting and Performance.” MoRE database
- Fairchild, R. (2011) “An entrepreneur’s choice of venture capital or angel financing: a behavioural game-theoretic approach.” *Journal of Business Venturing*.

5. Behavioural Corporate Finance

In addition to reading the Shefrin chapters in your textbooks, we will cover the following in the remaining lectures:

- Fairchild (2005). “The Effect of Managerial overconfidence, Asymmetric information, and Moral Hazard on Capital Structure Decisions.” SSRN Working Paper.
- Fairchild (2007): “Behavioural Corporate Finance: Existing Research and Future Directions.” SSRN working paper.
- Fairchild (2009): “From Behavioural to Emotional Corporate Finance: a new research direction” SSRN working paper.
- Baker, Ruback and Wurgler 2005. “Behavioral Corporate Finance: a survey”. Online working paper.

- Statman and Caldwell. “Applying behavioural finance to capital budgeting: project terminations.” *Financial Management* 1987.
- Heaton. “Managerial Optimism and Corporate Finance.” *Financial Management* 2002.
- Gervais et al. “Overconfidence, Investment Policy, and Executive stock Options.” 2003 SSRN.
- Shefrin. “Behavioral Corporate Finance.” SSRN working paper.
- “Behavioral Finance in a Principal-agent Model of Capital Budgeting.” *The ICFAI Journal of Behavioral Finance* Vol II No. 1. March 2005.
- “Investor Irrationality and Optimal Open-Market Share Repurchasing.” Co-authored with G. Zhang. *The ICFAI Journal of Behavioral Finance* Vol II No. 3. September 2005.

You do not have to read all of these articles! Highly recommended articles are very important! Use your discretion regarding the other articles!

Seminars: Class Exercises.

In addition to the lectures, there will be weekly seminars (run by teaching assistant Vineet Upreti). These will commence in week 19 (week beginning 6th February).

In the exam, there will be an essay section, and a numerical/analytical section. The analytical section consists of a numerical question, and a game-theoretic question.

Throughout the course, you will receive exercises to do in your own time (these will provide good practice for the *sort of* questions that *may* arise in the numerical/game theoretic section of the Summer Exam). In the seminars, Vineet will work through the answers.

Each of you will attend fortnightly seminars. Your exercise schedule is as follows:

| Week | Class Exercise |
|-------|--------------------------------------------------------------|
| 20/21 | Decision Tree exercise/real options game theoretic exercise. |
| 22/23 | Capital Structure Exercise |
| 24/25 | Debt Signalling game. |
| 26/29 | Venture Capital Exercise. |
| 30/31 | Revision |