

## MN20211 Advanced Corporate Finance

### Spring Semester, 2011

The course will be lectured by Anthony Birts and Richard Fairchild. Anthony's specialism is international cash management (but you will have to wait until your final year to enjoy this). Richard's specialisms are capital structure (particularly the impact of agency/incentive problems and signalling), dividends and share repurchases, venture capital, and behavioural corporate finance.

### **Textbook(s):**

#### **Required:-**

**Advanced Corporate Finance:** Compiled by Richard Fairchild and Anthony Birts. This is a book specially compiled for the course, taking relevant focused chapters from Berk and DeMarzo's textbook.

In addition to this textbook, the following books are good, and we thoroughly recommend that you may like to view them (they are available in the library, if you do not wish to buy them!):

**Corporate Finance (European Edition):** by Hillier, Ross, Westerfield, Jaffe, and Jordan.

**Behavioural Corporate Finance** by Hersch Shefrin.

**6 roundtable discussions of corporate finance** Editor Joel Stern.

**Revolution in Corp Finance** Stern and Chew editors.

**Dividend policy: its impact on firm value:** Lease et al.

You do not have to obtain any of these, but if you can view any of them, they will strengthen your knowledge/understanding of the subject of corporate finance, and the issues being researched and analyzed at academic and practitioner level.

AB's lectures will closely follow the Berk and Demarzo book in the main with the exception of the session on Project Finance. RF's lectures will NOT simply be carbon-copies of the book, but will cover material BEYOND the book, such as academic articles. Therefore, it is essential that you attend the lectures AND read the book and recommended articles.

*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 the recommended textbook 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 lectures and the books, you will be expected to read some academic articles around the subject. I have suggested some good articles below for the first couple of topics (investment appraisal and capital structure). Suggested articles for the other topics will appear later.*

### **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 21<sup>st</sup> Century”, Graham, Harvey, and Michaelis., 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*.

- “Infrastructure Investment as a Real Options Game: The Case of European Airport Expansion.” Han Smit, *Financial Management* 2003.
- “Strategic Options and Games in Analysing Dynamic Technology Investments.” Smit and Trigeorgis, *Long Range Planning* (2007).
- “The Value of real options investments under abnormal uncertainty: The Case of the Korean Economic Crisis.” Lee et al, *Journal of World Business*, 2008.
- “Sunk Costs, Uncertainty and Market Exit: a real Options perspective.” O’Brien and Folta, *Industrial and Corporate Change*, 2009.
- “Are Real Options more valuable in the presence of agency conflicts?” Harreiter et al, *RMS* (2007).
- “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.**

### Highly Recommended:

- Modigliani and Miller. “The Cost of Capital, Corporation Finance, and the Theory of Investment.” *American Economic Review* 1958, 261 – 297.
- 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.
- Graham and Harvey (1999): “The Theory and Practice of Corporate Finance: Evidence From the Field.” SSRN data base.
- Beattie et al (2004). “Diversity and determinants of corporate financing decisions: survey evidence.” University of Stirling working paper.

Other possible reading:-

- Wu, X. and Z. Wang. “Equity financing in a Myers-Majluf framework with private benefits of control.” *Journal of Corporate Finance* 11 (2005) 915-945.
- Thepot, J. “Jensen-Meckling 30 years after: a game theoretic view.” Downloadable from Google.
- “Corporate Financial Structure and Managerial Incentives.” Grossman and Hart 1982: in **The Economics of Information and Uncertainty**. Edited by John McCall.\*
- Ang, Cole and Lin. “Agency Costs and Ownership Structure.” *Journal of Finance* 2000.
- Stultz. “Managerial Discretion and Optimal Financing Policies.” *JFE* 1990.
- Leland and Pyle. “Informational Asymmetries, financial structure, and financial intermediation.” *Journal of Finance* 1977.
- Harris and Raviv. “Capital Structure and the Informational Role of Debt.” *Journal of Finance* 1990.
- Goswami, G, et al. (1995). “Debt Financing Under Asymmetric Information.” *Journal of Finance* Vol 1 no 2; pg 633 – 658.
- Fairchild, R. “Conflicts between Managers and Investors over the Optimal Financial Contract.” *International Journal of Business and Economics* December 2003 Vol 2 No.3.

### **III Payout Policy.**

#### **a) Dividend Policy.**

- Fairchild “Dividend Policy, Signalling and Free-cashflow: an Integrated Approach.” SSRN.
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#### **b) Repurchases:**

- Constantinides, G.M and B. Grundy. (1990). “Optimal Investment with Stock Repurchases and Financing as Signals.” *Review of Financial Studies*. Vol 2 no 4; pp 445 – 465.
- Jagannathan, M. and C. Stephens. (2003) “Motives for Multiple Open-Market Repurchase Programs.” *Financial Management*.
- McNally, W.J. “Open Market Stock Repurchase Signalling.” SSRN.
- Bhattacharya, U. and A. Dittmar. “Costless Versus Costly Signalling: Theory and Evidence from Share Repurchases.” SSRN.

- Oded, J. (2005) “Why do firms announce Open-Market Repurchases?” Review of Financial Studies Vol 18 No 1; pp 271 – 300.
- Hausch and Seward. (1993) “Signaling with Dividends and Share Repurchases: A Choice between Deterministic and Stochastic Cash Disbursements.” Review of Financial Studies Vol 6, No 1; pp 121 – 154.
- Isagawa, N. (2000) “Open-market Stock Repurchase and Stock price Behavior when Management Values Real Investment.” Financial Review; pp 95 – 108.
- Isagawa, N. (2002) “Open-market repurchase announcements and stock price behaviour in inefficient markets.” Financial Management pp 5 – 20.
- Weston and Siu. (2003) “Changing Motives for Share Repurchases.” SSRN database.
- Chowdry and Nanda. (1994) “Repurchase Premia as a Reason for Dividends: A Dynamic Model of Corporate Payout Policies.” Review of Financial Studies, pp 321 – 350.
- Ofer and Thakor (1987). “A Theory of Stock Price Responses to Alternative Corporate Cash Disbursement Methods: Stock Repurchases and Dividends.” Journal of Finance June; pp 365 – 394.
- Pettit, J. (2001) “Is a Share Buyback Right for Your Company?” Harvard Business Review; April, Vol 79, Issue 4.
- Asquith and Mullins. (1986) “Signalling with Dividends, Stock Repurchases, and Equity Issues.” Financial Management, 27 – 44.

Fairchild’s papers:-

- “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.
- “Investor Irrationality and Optimal Open-Market Share Repurchasing.” (co-authored with G. Zhang). Bath School of Management Working Paper Series December 2004.
- “Repurchase and Dividend Catering, Managerial Myopia, and Long-run Value-destruction.” (co-authored with Ganggang Zhang) Bath School of Management Working Paper Series December 2005.

### **Efficient Markets:**

### **Mergers and Acquisitions:**

1. The Management of Corporate Capital Structure: Theory and Evidence.” Garvey, G., and G. Hanka.

### **Convertible Debt.**

Stein: “Convertible Debt as equity through the ‘back-door’”.

Mayers.

## **10. Behavioural Corporate Finance.**

**Behavioral Corporate Finance:** Text-book: Hersh Shefrin

- Mattson and Weibull. “Probabilistic Choice and Procedurally bounded rationality.” Games and economic Behavior 2002.\*
- Joyce. “Options and the behavioral aspects of the ability to revise.” 2002 Mimeo.
- Harbaugh. “Skill Reputation, prospect theory, and regret theory.” 2002. SSRN.\*
- Stein. “Rational capital budgeting in an irrational world.” Journal of Business 1996.\*
- 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.\*
- Fairchild’s papers:-
  - “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.
  - “The Effect of Managerial Overconfidence, Asymmetric Information, and Moral Hazard on Capital Structure Decisions.” The ICFAI Journal of Behavioral Finance vol II, no 4 . December 2005.
  - *“The Effect of Managerial Overconfidence, Asymmetric Information, and Moral Hazard on Capital Structure Decisions.”* Posted to SSRN database 29/04/05.
  - “Managerial Overconfidence, Moral Hazard, and Financing and Investment Decisions.” Bath School of Management Working Paper Series November 2005.

### **b) Venture Capitalism:**

Admati, A. and P. Pfleiderer. (1994). “Robust Financial Contracting and the Role of Venture Capitalists.” Journal of Finance 49, 371 – 395.

Amit, Glosten and Muller,. (1990). "Entrepreneurial ability, venture investments, and risk sharing." *Journal of Management Science* 36, 1232 –1243.

Baker and Gompers (1999). "Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists." SSRN database.

Bascha, A. (2000). "Why Do Venture Capitalists hold different Types of Equity Securities?" SSRN database.

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. Gaviols. (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.

Klausner and Litvak. (2001). "What Economists have taught us about Venture Capital Contracting." 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.

Sahlman (1990). "The Structure and Governance of Venture Capital Organizations." *Journal of Financial Economics* 27, 473 – 524.

Shepherd and Zacharakis. (2001). The Venture Capitalist-Entrepreneur Relationship: Control, Trust, and Confidence in Co-operative Behaviour." *Venture Capital* 129 – 149.

Ayayi, A. "Optimal Capital Structure and the interactions between New Venture Investment and Venture Capital Finance." SSRN.

Houben, E. (2002) "Venture Capital, Double-sided Adverse Selection, and Double-sided Moral Hazard." SSRN.

Hsu, D.H. (2004). "What Do Entrepreneurs pay for Venture Capital Affiliation?" *Journal of Finance*, August; pp 1805 – 1844.

Florin, J. (2005) "Is venture capital worth it? Effects on firm performance and founder returns." *Journal of Business Venturing*, pp 113 – 135.

Fairchild's papers:-

- “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.
- “The Effects of Self-interest and Fairness on Entrepreneur/Venture Capitalist Financial Contracting and Performance.” Posted to SSRN Database January 16<sup>th</sup> 2006. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=875833](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875833)

### **Private Equity:**

TBA

The lecture schedule is as follows:

Week	Topic	Lecturer	Book chapter	Recommended articles
1	Revision of first year: Investment Appraisal and additional considerations	AB		
2	Revision of first year: Portfolio analysis, CAPM, WACC	AB		
3	Real Options	RF		
4	Funding	AB		
5	Capital Structure/Dividends:	RF		
6	Capital Structure/Dividends	RF		
7	M and A	AB		
8	Project Finance	AB		
9	Venture Capital and Private Equity	RF		
10	Intro to Behavioural CF	RF		
11	Revision	AB/RF		



The exam will consist of numerical questions (there will be a chance for you to practice example numerical questions during the semester to help you prepare for these), and essays, testing your understanding of the concepts of CF. Past exam papers are available on the library website. You are advised to look at these so that you are prepared for the exam.