

## FINANCIAL ECONOMICS II

### ECO 2504 - SPRING 2019

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The focus of this course is on corporate finance. The course deals with the following issues:

- (1) Theoretical and empirical issues concerning the nature of capital markets and the “relevance” of corporate financial structure.
- (2) Interactions between corporate investment and financing decisions.
- (3) The debt “overhang” problem.

There is no required textbook. The course will primarily rely on readings of journal articles and on hand-outs posted on Blackboard.

The following textbook provides a good introduction to Corporate Finance:

Ross, Westerfield, Jaffe and Roberts, *Corporate Finance*, McGraw-Hill Ryerson, 2017, 7<sup>th</sup> Canadian Edition.

You are not expected to read all the listed articles. I will indicate in class the central articles for the course; the rest should be useful to those pursuing the study of financial economics beyond this course.

**Paper:** Each Student will be assigned a paper(s) to summarize and critique. The last 3 lectures will be devoted to presentations of these papers by students in class. A four page write-up of the paper will be handed in by each student at the end of the course.

#### **Grade Composition:**

Midterm examination (February 26, 2019)	30%
Final examination	35%
Paper (to be assigned in class)	35%

#### **Weeks 1 and 2**

##### **(i) PERFECT AND EFFICIENT CAPITAL MARKETS; FISHER SEPARATION THEOREM; CAPITAL STRUCTURE RELEVANCE**

Fisher Separation Theorem (handout)

Modigliani-Miller Irrelevance (handout)

E. Fama and M. Miller, The Theory of Finance, 1976 (Chapter 2)

S. Grossman and J. Stiglitz, “Information and Competitive Price Systems,” American Economic Review, May 1976.

J. Stiglitz, “A Re-Examination of the Modigliani-Miller Theorem”, American Economic Review, 59, 1969.

J. Stiglitz, "On the Irrelevance of Corporate Financial Policy," American Economic Review, 1974.

F. Modigliani, "MM-Past, Present, and Future", Journal of Economic Perspectives", 2, 1988, 99-120.

M. Miller, "The Modigliani-Miller Propositions After Thirty Years", Journal of Economic Perspectives, 2, 1988.

E. Fama, "The Effects of a Firm's Investment and Financing Decisions on the Welfare of its Security Holders." American Economic Review, June 1978.

J. Stiglitz, "Why Financial Structure Matters", Journal of Economic Perspectives, 2, 121-126, 1988.

S. Myers, "The Capital Structure Puzzle", Journal of Finance, July 1984.

S. Myers, "Capital Structure", Journal of Economic Perspectives, Spring 2001.

Zingales, L., "In Search of New Foundations," Journal of Finance, 2000, 1623-1653.

### **Week 3**

#### **(ii) TAXATION AND CORPORATE FINANCIAL POLICY**

M. Miller, "Debt and Taxes", Journal of Finance, May 1977.

V. Aivazian and J. Callen, "Miller's Irrelevance Mechanism: A Note", Journal of Finance, March 1987.

V. Aivazian and S. Turnbull, "Taxation and Capital Structure: A Selected Review", in The Impact of Taxation on Business Activity, 1987, J. Mintz and D. Purvis (ed.)

S. Benninga and E. Talmor, "The Interaction of Corporate and Government Financing in General Equilibrium", Journal of Business, 1988, vol. 61, no. 2.

R. Dammon and R. Green, "Tax Arbitrage and the Existence of Equilibrium Prices for Financial Assets", Journal of Finance, December 1987.

H. DeAngelo and R. Masulis, "Optimal Capital Structure under Corporate and Personal Taxation," Journal of Financial Economics, 1980.

#### **(iii) BANKRUPTCY**

G. Andrade and S. Kaplan, "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed," Journal of Finance, October 1998.

V. Maksimovic and G. Phillips, "Asset Efficiency and Reallocation Decision of Bankrupt Firm," Journal of Finance, October 1998.

E. Altman, "A Further Empirical Investigation of the Bankruptcy Cost Question", Journal of Finance, September 1984.

A. Shleifer and R. Vishny, "Liquidation Values and Debt Capacity: A Market Equilibrium Approach", Journal of Finance, September 1992.

V. Aivazian and S. Zhou, "Is Chapter 11 Efficient?" Financial Management, 2011.

D. Baird and R. Rasmussen, "Antibankruptcy," Yale Law Journal, 2010.

## **Weeks 4 and 5**

### **(iv) CORPORATE FINANCIAL POLICY AND AGENCY AND INCOMPLETE INFORMATION PROBLEMS**

M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure", Journal of Financial Economics, 3, 1976.

S. Myers, "Determinants of Corporate Borrowing", Journal of Financial Economics, 5, 1977.

E. Fama and M. Jensen, "Organizational Forms and Investment Decisions", Journal of Financial Economics, 1985.

V. Aivazian and J. Callen, "Corporate Leverage and Growth: The Game-Theoretic Issues", Journal of Financial Economics, 8, 1980.

M. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers", American Economic Review, May 1986.

R. Stulz, "Managerial Discretion and Optimal financial Policies," Journal of Financial Economics, 26, 1990.

S. Myers and N. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information Investors Do Not Have", Journal of Financial Economics, 1984.

P. Viswanath, "Strategic Considerations, the Pecking Order Hypothesis, and Market Reactions to Equity Financing," Journal of Financial and Quantitative Analysis, June 1993.

## **Week 6**

### **(v) DIVIDEND POLICY**

E. Fama and K. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" Journal of Financial Economics, 60, 2001, pp. 3-43.

H. DeAngelo and L. DeAngelo, "The Irrelevance of the MM Dividend Irrelevance Theorem", Journal of Financial Economics, 2006.

S. LeRoy, "The MM Theorems in the Presence of Bubbles" 2008.

K. Dewenter and V. Warther, "Dividends, Asymmetric Information, and Agency Conflicts: Evidence from a Comparison of the Dividend Policies of Japanese and U.S. Firms", Journal of

Finance, 1998.

V. Aivazian, L. Booth, S. Cleary, “Do Emerging market Firms Follow Different Dividend Policies From U.S. Firms?” Journal of Financial Research, Fall 2003.

R. La Porta, F. Loopez-de-Silanes, A. Shleifer, and R. Vishny, “Agency Problems and Dividend Policies Around the World,” Journal of Finance, 55, 1-33, 2000.

V. Aivazian, L. Booth, S. Cleary. “Why Some Firms Smooth Dividends and Other Firms Do Not,” Journal of Financial and Quantitative Analysis, 2006.

J. Handley, “Dividend Policy: Reconciling DD with MM,” Journal of Financial Economics, 2008.

H. DeAngelo, L. DeAngelo, and D. Skinner, “Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings,” Journal of Financial Economics, 2003.

## **Week 7: Midterm**

### **Weeks 8 and 9**

#### **(vi) INTERACTION BETWEEN PRODUCTION AND FINANCING DECISIONS**

R. Dammon and L. Senbet, “The Effect of Taxes and Depreciation on Corporate Investment and Financial Leverage”, The Journal of Finance, June 1988.

V. Aivazian and M. Berkowitz, “Precommitment and Financial Structure: An Analysis of the Effects of Taxes”, Economica, 1992.

V. Aivazian and M. Berkowitz, “Ex Post Production Flexibility, Asset Specificity and Financial Structure”, Journal of Accounting, Auditing, and Finance, Winter 1998.

D. Mauer and A. Triantis, “Interactions of Corporate Financing and Investment Decisions: A Dynamic Framework”, The Journal of Finance, September 1994.

A. Abel, A. Dixit, J. Eberly, R. Pindyck, “Options, the Value of Capital, and Investment,” Quarterly Journal of Economics, August 1996.

C.F. Foley and K. Manova, “International Trade, Multinational Activity, and Corporate Finance,” Annual Review of Economics, March 2015.

#### **(vii) EMPIRICAL STUDIES OF CORPORATE FINANCIAL POLICY**

L. Shyam-Sunder and S. Myers, “Testing Static-Tradeoff Against Pecking Order Models of Capital Structure,” Journal of Financial Economics, 1999.

R. Rajan and L. Zingales, “What do we know about capital structure? Some Evidence from International Data,” Journal of Finance, 1995.

L. Booth, V. Aivazian, A. Demirguc-Kunt, and V. Maksimovic "Capital Structure in Developing Countries", Journal of Finance, February 2001.

S. Byoun, "How and When Do Firms Adjust Their Capital Structures Toward Targets", Journal of Finance, Dec. 2008.

M. Lemmon, M. Roberts, J. Zender, "Back to the Beginning: Persistence and the Cross-section of Corporate Capital Structure", Journal of Finance, August 2008.

**(viii) CORPORATE GOVERNANCE**

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, "Corporate Ownership Around the World," Journal of Finance, 54, 471-517.

Oliver Williamson, "Corporate Finance and Corporate Governance", Journal of Finance, July 1988.

R. Posner, Economic Analysis of Law, 2007; Chapters 14 & 15.

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Investor Protection and Corporate Governance," Journal of Financial Economics, 58, 1-27, 2000.

A. Shleifer and R. Vishny, "A Survey of Corporate Governance," Journal of Finance, 1997.

**(ix) FINANCIAL SYSTEM, LEGAL SYSTEM, AND ECONOMIC GROWTH**

R. Levine, "Financial Development and Economic Growth: Views and Agenda," Journal of Economic Literature, 35, 1997.

F. Modigliani and E. Perotti, "The Rules of the Game and the Development of Security Markets," Pacific-Basin Capital Markets Research, volume II, S. Rhee and R. Change (eds.), 1991, North Holland.

V. Aivazian, "Microeconomic Elements of Financial Liberalization: Perspectives From Finance Theory," in J. Fanelli and R. Medhora, eds., Financial Reform in Developing Countries, London, MacMillan, 1998.

R. King and R. Levine, "Finance and Growth: Schumpeter Might be Right," Quarterly Journal of Economics, August 1993.

J. Stiglitz, The Role of the State in Financial Markets, The Institute of Economics, Academia Sinica, Taiwan, April 1993.

La Porta, Lopez-de-Silanes, Shleifer, Vishny, "Law and Finance," Journal of Political Economy, 1998.

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Investor Protection and Corporate Governance," Journal of Financial Economics, 58, 1-27, 2000.

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Investor Protection and Corporate Valuation," Journal of Finance, 57, 1147-1170, 2002.

R. Rajan and L. Zingales, "Financial Dependence and Growth," American Economic Review, 1998.

A. Demirguc-Kunt and V. Maksimovic, "Law, Finance, and Firm Growth", Journal of Finance, December 1998.

R. Stulz, and R. Williamson, "Culture, Openness, and Finance," Journal of Financial Economics, 70, 313-349, 2003.

R. Rajan, and L. Zingales, "The Great Reversals: the Politics of Financial Development in the Twentieth Century," Journal of Financial Economics, 69, 5-50, 2003.

H. Demsetz, B. Villalonga, "Ownership structure and corporate performance," Journal of Corporate Finance, 7, 209-233, 2001.

B. Villalonga, "Does Diversification cause the Diversification Discount?," Financial Management, Summer 2004.

M.C. Jensen, W. H. Meckling, "Specific and General Knowledge, and Organizational Structure," Journal of Applied Corporate Finance, Fall 1995.

R. M. Stulz, "The Limits of Financial Globalization," Journal of Finance, 60(4), pp. 1595-638, 2005.

## **Weeks 10, 11 and 12: Articles for Student Class Presentations**

### **(x) THE DEBT "OVERHANG" PROBLEM**

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

C A. Hennessy, " Tobin's Q, Debt Overhang, and Investment", Journal of Finance, August 2004.

M. Campello, "Debt financing: Does it boost or hurt firm performance in product markets?" , Journal of Financial Economics, 2006.

N. Moyen, "How big is the debt overhang problem?" , Journal of Economic Dynamics & Control, 2007.

- S. Sundaresan and N. Wang, "Investment under Uncertainty with Strategic Debt Service", The American Economic Review, May 2007.
- C. Hadlock and J. Pierce, "New Evidence on Measuring Financial Constraints: Moving Beyond the KZ Index," The Review of Financial Studies, 2010.
- S. Kaplan and L.Zingales, "Do Investment-Cash Flow Sensitivities Provide Useful Measure of Financial Constraints?" Quarterly Journal of Economics, 1997.
- Billett, King, and D C. Mauer, "Growth Opportunities and the Choice of Leverage, Debt Maturity, and Covenants", The Journal of Finance, April 2007.
- S. Chava and M R. Roberts, "How Does Financing Impact Investment? The Role of Debt Covenants" , Journal of Finance, October 2008.
- Nini, Smith and A. Sufi, "Creditor control rights and firm investment policy", Journal of Financial Economics, March 2009.
- S. Hirshand M. Uhrig-Homburg, "Investment timing, liquidity, and agency costs of debt", Journal of Corporate Finance, 2010.
- G. Pawlina, "Underinvestment, capital structure and strategic debt restructuring", Journal of Corporate Finance, 2010.
- T Shibata and M. Nishihara, "Investment timing under debt issuance constraint", Journal of Banking & Finance, 2012.
- N. Reisel, "On the value of restrictive covenants: Empirical investigation of public bond issues", Journal of Corporate Finance, 2014.
- S. Fazzari, R. Hubbard, and B. Petersen, "Financing Constraints and Corporate Investment," Brookings Papers on Economic Activity, 1988.
- V. Aivazian, J. Callen, D. Gelb "Unanticipated Growth, Tobin's Q, and Leverage" in I. Venezia and Z. Wiener (eds.), Bridging the GAAP: Recent advances in Accounting and Finance, World Scientific Publishers, 2014.
- V. Aivazian and E. Santor, "Financial Constraints and Investment: Assessing the Impact of a World Bank Credit Program on Small and Medium Enterprises in Sri Lanka", Canadian Journal of Economics, 2008.
- C B. Barry and V T. Mihov, "Debt financing, venture capital, and the performance of initial public offerings", Journal of Banking & Finance, 2015.  
( Empirical)
- Sundaresan, Wang and J. Yang, "Dynamic Investment, Capital Structure, and Debt Overhang", Review of Corporate Finance Studies, 2015.  
(Theory)
- L. Lang, E. Ofek, and R. Stulz, "Leverage, Investment, and Firm Growth," Journal of Financial Economics, 40, 1996.

V. Aivazian, Y. Ge, and J. Qiu, "The Impact of Leverage on Firm Investment: Canadian Evidence," Journal of Corporate Finance, 2005.

### **Additional Papers for Student Class Presentations**

1. Jensen, M. C. (2001). Value maximization, stakeholder theory, and the corporate objective function. *Journal of applied corporate finance*, 14(3), 8-21.
2. La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (1998). Law and finance. *Journal of political economy*, 106(6), 1113-1155.
3. DeAngelo, H., & Roll, R. (2016). Capital Structure Instability. *Journal of Applied Corporate Finance*, 28(4), 38-52.
4. Graham, J. R., Leary, M. T., & Roberts, M. R. (2016). The Leveraging of Corporate America: A Long-Run Perspective on Changes in Capital Structure. *Journal of Applied Corporate Finance*, 28(4), 29-37.
5. Rajan, R. G., & Zingales, L. (1995). What do we know about capital structure? Some evidence from international data. *The journal of Finance*, 50(5), 1421-1460.
6. Aivazian, V. A., Ge, Y., & Qiu, J. (2005). The impact of leverage on firm investment: Canadian evidence. *Journal of corporate finance*, 11(1), 277-291.
7. Yermack, D. (2017). Corporate governance and blockchains. *Review of Finance*, 21(1), 7-31.
8. Davidson, S., De Filippi, P., & Potts, J. (2018). Blockchains and the economic institutions of capitalism. *Journal of Institutional Economics*, 1-20.