

FINANCIAL ECONOMICS II

ECO 1501H - SPRING 2022

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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 and efficiency of capital markets.
- (2) The “relevance” of corporate financial structure and determinants of optimal financial structure.
- (3) Interactions between corporate investment and financing decisions.
- (4) 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 Quercus.

The following textbook provides a good introduction to Corporate Finance:

Ross, Westerfield, Jaffe and Roberts, Corporate Finance, McGraw-Hill Ryerson, 2019, 8th 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 and discussion of these papers by students in class. A five page write-up of the paper will be handed in by each student at the end of the course.

Contact Hour

Lectures and tutorials will be online synchronous on Thursdays 7:10 – 9:00 pm.

- Lectures on Zoom (Zoom meeting ID and passcode will be announced on Quercus)

Some lectures after January 31 may be in person.

Grade Composition:

Midterm examination (Feb 17, 2022)	30%
Final examination	35%
Paper (to be assigned)	35%

Week 1**Course Introduction****Fisher Separation Theorem (handout)****Weeks 2 and 3****(i) PERFECT AND EFFICIENT CAPITAL MARKETS; FISHER SEPARATION THEOREM; CAPITAL STRUCTURE RELEVANCE**

Capital Market Efficiency (handout)

Modigliani-Miller Financial Structure Irrelevance Theorem (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.

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.

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

Week 4**(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.)

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. Aivazian and S. Zhou, “Is Chapter 11 Efficient?” Financial Management, 2011.

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

Weeks 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.

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 7: Midterm [Feb. 17, 2022]

Week 8

(v) DIVIDEND POLICY

Handout on Dividend Policy

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.

Week 9

(vi) VALUATION: Discounted Cash Flow, Weighted Average Cost of Capital, Real Options (handout)

Weeks 10

(vii) INTERACTION BETWEEN PRODUCTION AND FINANCING DECISIONS

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.

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

V. Aivazian and Y. Xu. "Production Flexibility, Demand Uncertainty and Capital Structure: Theory and Evidence", Work in Progress, University of Toronto, 2019

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

(viii) EMPIRICAL STUDIES OF CORPORATE FINANCIAL POLICY

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.

Fukui, T., Mitton, T. and Schonlau, R.J., 2018. Determinants of Capital Structure: An Expanded Assessment. Available at SSRN 3293965.

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

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.

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

of Economics, August 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.

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 11, 12, 13: Articles for Student Class Presentations

(x) THE DEBT "OVERHANG" PROBLEM

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

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

S. Chava and M R. Roberts, "How Does Financing Impact Investment? The Role of Debt Covenants" , Journal of Finance, October 2008.

G. Pawlina, "Underinvestment, capital structure and strategic debt restructuring", Journal of Corporate Finance, 2010.

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.

Sundaresan, Wang and J. Yang, “Dynamic Investment, Capital Structure, and Debt Overhang”, Review of Corporate Finance Studies, 2015.

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.
9. Amihud, Y., & Levi, S. (2019). The Effect of Stock Liquidity on the Firm's Investment and Production. *Available at SSRN 3183091*.
10. Berger, A. N., Himmelberg, C. P., Roman, R. A., & Tsyplakov, S. (2019). Bank Bailouts, Bail-ins, or No Regulatory Intervention? A Dynamic Model and Empirical Tests of Optimal Regulation. *A Dynamic Model and Empirical Tests of Optimal Regulation (May 19, 2019)*.
11. Aivazian, V. A., & Xu, Y. (2019). The Problem of Debt Overhang: Canadian Evidence. *Work in progress, University of Toronto*.