

## FINANCIAL ECONOMICS II

**ECO 1501H - SPRING 2025**

**Instructor: Prof. V. Aivazian**

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The goal of this course is to understand the determinants of firms' best financing decisions and the impact of these decisions on firm value and the welfare of firm stakeholders. The course deals with the following issues:

- (1) The nature of the firm.
- (2) Theoretical and empirical issues concerning the nature and efficiency of capital markets.
- (3) The "relevance" of corporate financial structure and determinants of optimal financial structure.
- (4) Interactions between corporate investment and financing decisions, and the "debt overhang" or "under-investment" problem.

There is no required textbook. The course will primarily rely on readings of journal articles and on handouts posted on Quercus.

The following textbook provides a good introduction to Corporate Finance:

Ross, Westerfield, Jaffe and Roberts, Corporate Finance, McGraw-Hill, 2022, 9<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.

### **Contact Hour**

In person lecture on Thursdays 7:10-9pm.

### **Grade Composition:**

Midterm examination (February 27, 2025)	40%
Final examination	45%
Class participation	15%

### **Office Hours:**

"On demand" Appointment, via Zoom.

**Week 1 (January 9)**

Course Introduction.

The firm and the market.

R. Coase, "The Nature of the Firm", Economica, 1937

Fisher Separation Theorem (handout)

**Weeks 2 (January 16)****(i) EFFICIENT CAPITAL MARKETS**

Capital Market Efficiency (handout)

E. Fama, "Two Pillars of Asset pricing," Nobel Prize lecture, 2013

R. Shiller, "Speculative Asset Prices," Nobel Prize lecture, 2013

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

**Week 3 (January 23)****The Coase Theorem and Modigliani-Miller Financial Structure Irrelevance**

Modigliani-Miller Financial Structure Irrelevance Theorem (handout)

R. Coase, "The problem of Social Cost," Journal of Law and Economics, 1960

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

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

S. Medema, "The Coase Theorem at Sixty," Journal of Economic Literature, 2020, 1045-1128.

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

V. Aivazian and J. Callen, "Some Fallacies in Corporate Finance: A Coaseian Perspective," Journal of Law, Finance, and Accounting, Forthcoming.

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 (January 30)****(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.

**Weeks 5, 6 (February 6, 13)**

(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 [February 27]**

**Week 8 (March 6)**

(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.

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. Lopez-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, 10 (March 13, 20)**

(vi) **Valuation Models in Corporate Finance: Discounted Cash Flow, Weighted Average Cost of Capital, Real Options.**

**Valuation of Intangible assets.**

Handout on Valuation Models in Corporate Finance.

B. Lev, "Sharpening the Intangibles Edge," *Financial Analysis*, 2004.

### **Weeks 11, 12 (March 27, April 3)**

(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. Demircug-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.

(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. Chang (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.

(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.

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 Relevant Papers**

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. (2022). The Problem of Debt Overhang: Canadian Evidence. *Work in progress, University of Toronto*.
12. Wittry, M. D. (2021). (Debt) Overhang: Evidence from Resource Extraction. *The Review of Financial Studies*, 34(4), 1699-1746.
13. Barbiero, F., Popov, A., & Wolski, M. (2020). Debt overhang, global growth opportunities, and investment. *Journal of Banking & Finance*, 120, 105950.
14. Consolo, A., Langiulli, M., & Sondermann, D. (2019). Business investment in euro area countries: the role of institutions and debt overhang. *Applied Economics Letters*, 26(7), 561-575.
15. Melzer, B. T. (2017). Mortgage debt overhang: Reduced investment by homeowners at risk of default. *The Journal of Finance*, 72(2), 575-612.