

**Finance 790B**

**Spring 2007, first half**

**Class meetings: 1/31, 2/14, 2/21, 2/28, 3/6, 3/13, 3/20 (Thursdays, 15:00-17:50, Room 3401**

**Sudipto Dasgupta**

**Email: dasgupta@ust.hk**

**Readings:**

This part of the course will emphasize theoretical frameworks that underlie some of the important ideas in modern corporate finance. A good account of these ideas can be found in Chapters 16-19 of “Financial Markets and Corporate Strategy” by Grinblatt and Titman, McGraw-Hill (GT, 2<sup>nd</sup> Edition). The references at the back of the chapters from this book are recommended. The material will be supplemented by additional topics and journal articles to be discussed in class.

The papers listed below correspond to topics from the relevant chapters in Grinblatt and Titman. The relevant “theory” papers are listed first. Relevant empirical papers are listed next. Some empirical papers will be discussed to motivate some of the issues, but we will not go into details of empirical methodology in this part of the course.

Articles marked with (\*) or (\*\*) are essential reading. Those marked with (\*\*\*) are considered classic papers.

Please note: I will give eight lectures. The last one will be supplementary and outside of regular meeting time.

## GT Chapter 16 (Bankruptcy and Debtholder-equityholder Conflicts) (2 lectures)

- 1) Innes, R., 1990, Limited liability and incentive contracting with ex-ante action choices, *Journal of Economic Theory*, 45-67. (\*)
- 2) Gale, D., Hellwig, M., 1985, Incentive-Compatible Debt Contracts: The One-Period Problem, *Review of Economic studies*, 647-663. (\*\*)
- 3) Myers, S., 1977, The determinants of corporate borrowing, *Journal of Financial Economics* 5, 147-175. (\*\*)
- 4) Green, R., 1984, Investment incentives, debt and warrants, *JFE* 13, 115-136. (\*)
- 5) Dewatripont, M. and J. Tirole, 1992, A theory of debt and equity: diversity of securities and manager-shareholder congruence, *QJE* 109, 1027-54. (\*)
- 6) Detragiache, E., Public versus Private Borrowing: A Theory with Implications for Bankruptcy Reform, *Journal of Financial Intermediation* 3, 327-354. (\*)
- 7) Rajan, R. G., 1992, Insiders and outsiders: the choice between informed and arms-length debt, *Journal of Finance* 47, 1367-99. (\*)
- 8) Joseph E. Stiglitz, Andrew Weiss, 1981, Credit Rationing in Markets with Imperfect Information, *American Economic Review* 71, 393-410. (\*\*)
- 9) Mitchell Berlin and Loretta Mester, 1992, Debt Covenants and Renegotiation, *Journal of Financial Intermediation* 2, 95-133.
- 10) Park, Cheol, 2000, Monitoring and the Structure of Debt Contracts, *Journal of Finance* 5, 2157-2195.
- 11) Repullo, R. and J. Suarez, 1998, Monitoring, Liquidity and Security Design, *Review of Financial Studies* 11, 163-187.
- 12) Bolton, P. and D. Scharfstein, 1996, Optimal debt structure and the number of creditors, *JPE* 104, 1-25.

## GT Chapter 17 (Capital Structure and Corporate Strategy) (1 lecture)

You may need some introduction to Bargaining Theory (especially the Nash Bargaining Solution) and IO (Cournot, Bertrand, Stackelberg etc.). A good source for the former is “Bargaining and Markets” by Osborne and Rubinstein (Chapter 2 covers Nash bargaining). For the latter, see an Intermediate level Microeconomics text book, and then read relevant chapters chapter 10 from Kreps, “A Course in Microeconomic Theory”.

- 1) Dasgupta, S., 1998, How Firms’ Financing Decisions Impact Product Markets: A Selective Survey, in *Contemporary Macroeconomics*, A. Bose, D. Ray and A. Sarkar eds., Oxford University Press. (\*)
- 2) Brander, J. and T. Lewis, 1986, Oligopoly and financial structure: the limited liability effect, *American Economic Review* 76, 956-970. (\*)
- 3) Chevalier, Judith A., David S. Scharfstein, 1996, Capital-Market Imperfections and Counter cyclical Markups: Theory and Evidence, *American Economic Review* 86(4), 703-25. (\*)

- 4) Dasgupta, S. and Titman, S., 1998, Pricing strategy and financial policy, *Review of Financial Studies* 11, 705-737. (\*)
- 5) Fabio C. Bagliano and Alberto Dalmazzo, 1999, Liquidation risks in the Rotemberg-Saloner implicit collusion model, *Economics Letters* 62, 69-74.
- 6) Perotti, E. and K. Spier, 1993, Capital Structure as a Bargaining Tool: The Role of Leverage in Contract Renegotiation, *American Economic Review*, 1131-1141.
- 7) Bronars, S. and D. Deere, The Threat of Unionization, the Use of Debt, and the Preservation of Shareholder Wealth, *Quarterly Journal of Economics*, February 1991; 106(1): 231-54. (\*) [theory + empirical]
- 8) Dasgupta, S. and K. Sengupta, 1993, Sunk Investment, Bargaining, and the Choice of Capital Structure, *International Economic Review*, 203-220. (\*)

#### *Empirical Papers*

- 9) Judith A. Chevalier, David S. Scharfstein, 1995, Liquidity Constraints and the Cyclical Behavior of Markups, *American Economic Review* 85(2), 390-396.
- 10) Severin Borenstein, Nancy L. Rose, 1995, Bankruptcy and Pricing Behavior in U.S. Airline Markets, *American Economic Review* 85(2), 397-402.
- 11) Chevalier, J., 1995, Do LBO Supermarkets Charge More? An Empirical Analysis of the Effects of LBOs on Supermarket Pricing, *JF* 50, 1095-1112. (\*)
- 12) Chevalier, J., 1995, Capital Structure and Product-Market Competition: Empirical Evidence from the Supermarket Industry, *AER* 85, 415-35. (\*)
- 13) Phillips, G., 1995, Increased Debt and Industry Product Markets: An Empirical Analysis, *JFE* 37, 189-238.

## GT Chapter 18 (How Managerial Incentives Affect Investment Decisions) (1 lecture)

- 1) Jensen, M. and W. Meckling 1976, Theory of the firm: managerial behavior, agency cost, and capital structure, *JFE*, pp 305-360. (\*\*)
- 2) Jensen, M., 1986, Agency cost of free cash flow, corporate finance and takeovers, *AER*, pp 323-339. (\*\*)
- 3) Stulz, R., 1990, Managerial discretion and optimal financial policies, *JFE*, pp 3-27.
- 4) Hart, O., 1991, Theories of optimal capital structure: a managerial discretion perspective, in *The Deal Decade: What Takeovers and Leveraged Buyouts Meant for Corporate Governance*, Washington: Brookings Institute. (\*)
- 5) Li, Shan, 1992, A theory of corporate scope and financial structure, *JF*.
- 6) Zwiebel, J., 1996, Dynamic capital structure under managerial entrenchment, *AER*, December, 1197-1215. (\*)

## Large shareholders and takeover markets as monitors (1 lecture)

- 1) Grossman, S. and O. Hart, 1980, Takeover bids, the free rider problem, and the theory of the corporation, *Bell Journal of Economics* 11, 42-64. (\*\*)
- 2) Shleifer, A. and R. Vishny, 1986, Large shareholders and corporate control, *Journal of Political Economy* 94, 461-486. (\*\*)
- 3) Dasgupta, S. and V. Nanda, Tender Offers, Proxy Contests, and Large Shareholder Activism, 1997, *Journal of Economics and Management Strategy* 6, 787-820. (\*)
- 4) Burkart, Mike, D. Gromb, and F. Panunzi, 1997, Large shareholders, monitoring, and the value of the firm, *Quarterly Journal of Economics*, August, 693-727. (\*)
- 5) Maug Ernst, 1998, Large shareholders as monitors: is there a trade off between liquidity and control? *Journal of Finance* 53, 65-98. (\*)

*Empirical Papers*

- 6) Morck, R., A. Shleifer and R. Vishny, Do Managerial Objectives Drive Bad Acquisitions? *Journal of Finance*, March 1990; 45(1): 31-48. (\*)
- 7) Morck, R., A. Shleifer and R. Vishny, Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics*, Jan./Mar. 1988; 20(1/2): 293-315. (\*)
- 8) Lang, L., R. Stulz and R. Walking, A Test of the Free Cash Flow Hypothesis: The Case of Bidder Returns, *Journal of Financial Economics*, October 1991; 29(2): 315-35.
- 9) Mitchell, M. and K. Lehn, Do Bad Bidders Become Good Targets? *Journal of Political Economy*, April 1990; 98(2): 372-98.
- 10) Blanchard, O., F. Lopez-de-Silanes and A. Shleifer, What Do Firms Do with Cash Windfalls? *Journal of Financial Economics*, December 1994; 36(3): 337-60.

There is also a large literature here on internal capital markets, diversification and investment (in)efficiency. Here is a basic reading list.

- 11) Motta, Adolfo de, 2003, "Managerial Incentives and Internal Capital Markets", *Journal of Finance* 58, 1193-1220.
- 12) Stein, J, 1997, "Internal Capital Markets and Competition for Corporate Resources", *Journal of Finance* 52, 111-133.
- 13) Dasgupta, Sudipto, Vidhan Goyal and Guofu Tan, Active Asset Markets, Divestitures, and Divisional Cross-Subsidization ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=223208](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=223208)).

*Empirical Papers*

- 14) Ahn, Seoungpil, and David J. Denis, 2004, "Internal Capital Markets and Investment Policy: Evidence from Corporate Spinoffs", *Journal of Financial Economics* 71, 489-516.
- 15) Berger, P. and Ofek, 1995, Diversification's Effect on Firm Value, *Journal of Financial Economics* 37, 39-65.
- 16) Berger P. and E. Ofek, 1999, "Causes and Effects of Corporate Refocusing Program", *Review of Financial Studies* 12, 311-345.

- 17) Chevalier, 2000, J. A, "What do We Know about Cross-Subsidization? Evidence from the Investment Policies of Merging Firms", *Advances in Economic Analysis & Policy*, Vol. 4: No:1, Article 3, 2004.
- 18) Comment, R. and G. Jarrell, 1995, "Corporate Focus and Stock Returns", *Journal of Financial Economics* 37, 67-87.
- 19) Graham, J., M. Lemmon and J. Wolf, "Does Corporate Diversification Destroy Value"? *Journal of Finance* 57, 2002, 695-720.
- 20) John, K. and E. Ofek, "Asset Sales and Increase in Focus", *Journal of Financial Economics* 37, 105-139.
- 21) Lang, Larry H. P and Rene M. Stulz, 1994, "Tobin's Q, Corporate Diversification and Firm Performance", *Journal of Political Economy* 102, 1248-1280
- 22) Rajan, Raghuram, Henri Servaes, and Luigi Zingales, 2000, "The Cost of Diversity: the Diversification Discount and Inefficient Investment", *Journal of Finance* 55, 35-79.
- 23) Scharfstein, David S, and Jeremy C Stein, 2000, "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment", *Journal of Finance* 55, 2537-2564.
- 24) Shin, H, and R. Stulz, 1998, "Are Internal Capital Markets Efficient?", *Quarterly Journal of Economics* 113, 531-552.

## GT Chapter 19 (The Information Content of Financial Decisions) (2 lectures)

- 1) Myers, S. and N. Majluf, 1984, Corporate financing and investment decisions when firms have information that investors do not have, *JFE*, pp 187-221. (\*\*)
- 2) Daniel, K. and S. Titman, 1994, Financing investment under asymmetric information, (a survey), in *Handbooks in Operations Research and management Science*, Volume 9 ("Finance"), R. Jarrow, V. Maksimovic and W. Ziemba eds., Elsevier 1995. (\*\*)
- 3) Leland, H. and D. Pyle, 1977, Information asymmetries, financial structure and financial intermediation, *JF* 32, 371-387. (\*\*)
- 4) Stein, J, 1992, Convertible bonds as backdoor equity financing, *JFE* 32, 3-21. (\*)
- 5) Riley, J. , 1979, Informational equilibrium, *Econometrica* 47, 331-359. (useful reference for signaling models) (\*)
- 6) Miller, M. and K. Rock, 1985, Dividend policy under asymmetric information, *JF*, 1031-51. (\*\*)
- 7) John K. and J. Williams, 1985, Dividends, dilution and taxes: a signalling equilibrium, *JF*, 1053-70. (\*)
- 8) Bajaj, M., Chan Yuk-Shee and S. Dasgupta, 1998, The Relationship Between Ownership, Financing Decisions and Firm Performance: A Signaling Model, *International Economic Review* 39, 723-744.

Information Asymmetry, Internal vs. External Finance, and Corporate Investment

Again, this is a huge literature. The following are very good surveys of the literature

- 1) R. Glenn Hubbard, 1998, Capital Market Imperfections and Investment, *Journal of Economic Literature*, 193-225.
- 2) Stein, J., 2003, Agency, information and corporate investment, *Handbook of the Economics of Finance*, Chapter 2, 109-163.

#### **Theoretical Foundations (1 lecture)**

- 3) Froot, K. , D. Scharfstein, and J. Stein, 1993, Risk Management: Coordinating Corporate Investment and Financing Policies, *JF*, 1629-58.
- 4) Gertner, Rober, and David Scharfstein, 1994, Internal versus external capital Market, *Quarterly Journal of Economics* 109, 1211-1230
- 5) Fazzari et al., 1997, see above.
- 6) Stein, J, 1997, Internal capital markets and competition for corporate resources, *Journal of Finance* 52, 111-133.
- 7) Kiyotaki, N. and J. Moore, 1997, Credit Cycles, *JPE*, 211-148.
- 8) Gomes, J., 2001, .Financing Investment,.*American Economic Review* 91, 1263-1285.
- 9) Inderst, Roman, and Holger M. Müller, 2003, Internal versus External Financing: An Optimal Contracting Approach, *Journal of Finance* 58, 1033-1062
- 10) Dasgupta, S. and K. Sengupta, 2003, Corporate Liquidity, Investment and Financial Constraints: Implications from a Multi-Period Model, working paper.
- 11) Alti, A., 2003, How Sensitive is Investment to cash Flows When Financing is Frictionless?, *JF*, 707-722.

#### *Empirical Papers*

- 12) Fazzari, S., R. Glenn Hubbard and B. Petersen, 1988, Financing Constraints and Corporate Investment, *Brookings Papers on Economic Activity*, 141-195.
- 13) Hoshi, T, A. Kashyap and D. Scharfstein, 1991, Corporate Structure, Liquidity, and Investment: Evidence from Japanese Panel Data, *QJE*, 33-60.
- 14) Kaplan, S. and L. Zingales, 1997, Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financial Constraints? *QJE*, 169-215.
- 15) Lamont, O, 1997, “Cash flow and investment: evidence from internal capital market” *Journal of Finance* 52, 83-109
- 16) Shin, H, and R. Stulz, 1998, Are internal capital markets efficient, *Quarterly Journal of Economics* 113, 531-552
- 17) Cleary, S., 1999, The Relationship Between Firm Investment and Financial Status, *JF*, 673-92.
- 18) Fazzari, S., R. Glenn Hubbard and B. Petersen, 2000, Investment- Cash Flow Sensitivities are Useful: A Comment, *QJE*, 695-705.
- 19) Kaplan, S. and L. Zingales, 2000, Investment-Cash Flow Sensitivities are Not Valid Measures of Financing Constraints, *QJE*, 707-12.
- 20) Almeida, H., M. Campello and M. Weisbach, 2004, The Cash Flow Sensitivity of Cash, *JF*,1777-1804. [Wang Zhen]

- 21) Acharya, Almeida, and Campello, Is Cash Negative Debt? A Hedging Perspective on Corporate Financial Policies, working paper [see Campello's website]
- 22) Almeida and Campello, Financial Constraints, Asset Tangibility, and Corporate Investment, working paper [see Campello's website]
- 23) Gan, J., 2004, .Financial Constraints and Corporate Investment: Evidence from an Exogenous Shock to Collateral., working paper, HKUST, Hong Kong.
- 24) Malmendier, U., and G. Tate, 2003, .CEO Overconfidence and Corporate Investment. [recently published in the JF.]
- 25) Rauh, J., 2004, .Investment and Financing Constraints: Evidence from the Funding of Corporate Pension Plans,[just published in the JF].
- 26) Booth and Cleary, 2006, Cash Flow Volatility, Financial Slack, and Investment Decisions [available from me].
- 27) Chang, Y. and S. Dasgupta, 2005, Beyond Internal Capital Markets: The In-House Transmission of Adverse sales Shocks and the Collateral Channel, Journal of Corporate Finance, forthcoming.