FBE 652. FINANCIAL ECONOMICS I

Fall Semester 2010

Professors John G. Matsusaka and Oguzhan Ozbas

Continues with FBE 655. FINANCIAL ECONOMICS III in Spring 2010

SYLLABUS

Overview

This two-course sequence (FBE 652/655) is a rigorous introduction to modern theories of corporate finance. The first third of the course establishes foundational concepts, beginning with the neoclassical and tradeoff models, moving to agency problems and asymmetric information, and then considering security design and control rights. The remainder of the course – covering Fall and Spring semesters – focuses on a select group of current topics, including internal capital markets, diversification, mergers and acquisitions, executive compensation, financial development, corporate governance, and politics and finance, areas where recent research has significantly advanced our understanding and in some cases reversed what was previously believed. The goal of the course is to familiarize students with central ideas underpinning research in corporate finance, and to bring students to the research frontier in select areas. By the end of the course, students will have a working knowledge of the main tools of corporate finance research, and be equipped to begin independent research.

Course Methods

Class meetings are organized around lectures that develop models and discuss empirical results. Many classes will be led by other faculty at USC and outside USC who are leading experts in their area. Some papers will be presented by students in order to help develop presentation skills and create a participatory environment. There is a weekly homework assignment that focuses on modeling. Working through models has several benefits: it develops a deeper understanding of the underlying theory, prepares the student for independent theoretical research, and provides a foundation for empirical research.

READINGS FOR FOUNDATIONAL CONCEPTS

The following list is provisional and may be modified as the semester progresses. Required readings will be identified as we go. Asterisks indicate readings that will be discussed in depth in class.

PART I. Capital Structure: Debt versus Equity

1. Neoclassical Model and Tradeoff Model

*E. F. Fama & M. H. Miller, *The Theory of Finance*, Dryden Press, 1972, Chapters 1, 2, 4. [Neoclassical model. Book is out of print but can be downloaded at http://gsbwww.uchicago.edu/fac/eugene.fama/research/.]

R. G. Rajan and L. Zingales, "What Do We Know About Capital Structure? Some Evidence from International Data," *Journal of Finance*, December 1995. [Stylized facts.]

F. Modigliani and M. H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, June 1958. [The classic article.]

F. Modigliani and M. H. Miller, "Reply to Heins and Sprenkle," *American Economic Review*, September 1969. [Simpler proof using the risk-class method.]

*M. H. Miller, "Debt and Taxes," *Journal of Finance*, May 1977. [Another fundamental article.]

H. DeAngelo and R. W. Masulis, "Optimal Capital Structure under Corporate and Personal Taxes ," *Journal of Financial Economics,* March 1980. [Extends Miller.]

*G. Andrade & S. N. Kaplan, "How Costly is Financial (not Economic) Distress?," *Journal of Finance*, October 1998.

*J. R. Graham, "How Big Are the Tax Benefits of Debt?," *Journal of Finance*, October 2000.

H. Almeida & T. Philippon, "The Risk-Adjusted Cost of Financial Distress," *Journal of Finance*, December 2007. [Risk-adjusted estimates.]

2. Security Choice: Agency Problems & Asymmetric Information

*M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 1976. [Asset substitution]

*S. C. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics*, 1977. [Debt overhang/underinvestment]

D. W. Diamond, “Reputation Acquisition in Debt Markets,” *Journal of Political Economy*, August 1989. [Reputation as a solution]

*S. C. Myers and N. S. Majluf, “Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have,” *Journal of Financial Economics*, 1985. [Asymmetric information/adverse selection]

S. A. Ross, “The Determinants of Financial Structure: The Incentive Signalling Approach,” *Bell Journal of Economics*, 1977. [Signaling]

*M. C. Jensen, “Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,” *American Economic Review*, May 1986. [Free cash flow problem]

*R. Stulz, “Managerial Discretion and Optimal Financing Policies,” *Journal of Financial Economics*, 1990. [Attempt to formalize FCF idea]

M. Harris and A. Raviv, “Capital Structure and the Informational Role of Debt,” *Journal of Finance*, June 1990. [Another attempt to formalize idea]

S. C. Myers, “Capital Structure,” *Journal of Economic Perspectives*, Spring 2001. [“Pecking order” theory]

*I. Shyam-Sunder and S. C. Myers, “Testing Static Tradeoff Against Pecking Order Models of Capital Structure,” *Journal of Financial Economics*, 1999. [Tradeoff versus pecking order theory.]

*E. F. Fama & K. R. French, “Financing Decisions: Who Issues Stock?,” *Journal of Financial Economics*, June 2005. [Evidence against the “pecking order” theory]

M. T. Leary & M. R. Roberts, “Do Firms Rebalance Their Capital Structures?,” *Journal of Finance*, 2005. [Evidence for tradeoff model with adjustment costs]

J. Graham & C. Harvey, “The Theory and Practice of Corporate Finance: Evidence from the Field,” *Journal of Financial Economics*, 2001. [What managers say they do]

PART II. Security Design/Financial Contracting

3. Assigning Cash Flow

R. Townsend, “Costly State Verification,” *Journal of Economic Theory*, 1979. [First CSV paper]

*D. Gale and M. Hellwig, “Incentive-Compatible Debt Contracts: The One-Period Problem,” *Review of Economic Studies*, 1985. [Easier to understand than Townsend]

P. DeMarzo and Y. Sannikov, “A Continuous-Time Agency Model of Optimal Contracting and Capital Structure,” *Journal of Finance*, 2006. [Dynamic security design]

P. DeMarzo and M. Fishman, “Optimal Long-Term Financial Contracting,” *Review of Financial Studies*, 2007.

T. Piskorski and M. Westerfield, “Debt Covenants and Distressed Equity Issuance: Optimal Financing in the Present of Monitoring,” USC working paper, 2008.

4. Assigning Control Rights

S. J. Grossman and O. Hart, “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,” *Journal of Political Economy*, 1986. [First paper using ‘residual rights of control’]

O. Hart and J. Moore, “Property Rights and the Nature of the Firm,” *Journal of Political Economy*, 1990. [The other foundational paper]

*P. Aghion and P. Bolton, “An ‘Incomplete Contracts’ Approach to Financial Contracting,” *Review of Economic Studies*, July 1992. [Application of control rights to security choice]

O. Hart and J. Moore, “A Theory of Debt Based on the Inalienability of Human Capital,” *Quarterly Journal of Economics*, 1994, 841-879.

M. Dewatripont and J. Tirole, “A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence,” *Quarterly Journal of Economics*, 1994.

Grades

Grades will be assigned on the following basis:

Homework	20%
Midterm (October 19)	30%
Final exam (December 14, 11 am – 1 pm)	40%
In-class presentation / participation	10%

At times this class will follow a standard lecture format, but we will also approach learning in a variety of other ways. Here are your responsibilities:

1. Attend class, learn the lecture material.
2. Read the assigned papers.
3. In-class presentations.
4. Complete homework assignments.
5. Attend the Finance Seminar when the paper is in the area of corporate finance, and be prepared to discuss the paper the following class.

Teaching Assistant

The teaching assistant is Junbo Wang: junbo.wang.2013@marshall.usc.edu. Junbo is a doctoral student in finance who is working on his dissertation. He will be grading homework and going over the solutions at a time to be arranged.

Contact Information

Don't hesitate to contact either one of us if you have questions about the class. The easiest way to reach us is by email: matsusak@usc.edu and ozbas@usc.edu. We would be glad to schedule an appointment if you would like to speak in person.

Instructor Profile
John G. Matsusaka

Education

B.A. Economics, University of Washington
M.A., Ph.D. Economics, University of Chicago

Professional

Vice Dean for Faculty and Academic Affairs, USC Marshall School, 2007-
Charles F. Sexton Chair in American Enterprise, 2009-
Professor of Finance and Business Economics, USC Marshall School, 1991-
Professor of Business and Law, USC Law School, 2004-
Professor of Political Science, USC, 2005-
President, Initiative & Referendum Institute at USC, 2004-
John M. Olin Visiting Professor of Economics, GSB, University of Chicago, 2001
Visiting Associate in Economics, California Institute of Technology, 2000
Visiting Scholar, Anderson School, UCLA, 1996
National Fellow, Hoover Institution, Stanford University, 1994-1995

Other Professional

Consultant on corporate governance, Council of Economic Advisors, Executive Office of the President, Washington D.C., 2002

Research in Finance and Governance

"When Are Outside Directors Effective?," with R. Duchin and O. Ozbas*, Journal of Financial Economics*, 2010.

"50+ Years of Diversification Announcements," with M. Akbulut, *Financial Review*, forthcoming.

"Disobedience and Authority," with A. Marino and J. Zabojnik, *Journal of Law, Economics, and Organization*, forthcoming.

"From Families to Formal Contracts: An Approach to Development," with K. Kumar, *Journal of Development Economics*, 2009.

"Decision Processes, Agency Problems, and Incomplete Information: An Economic Analysis of Capital Budgeting," with A. M. Marino, *Review of Financial Studies*, 2005.

"Internal Capital Markets and Corporate Refocusing," with V. Nanda, *Journal of Financial Intermediation*, 2002.

"Corporate Diversification, Value Maximization, and Organizational Capabilities," *Journal of Business*, 2001 [Merton Miller Prize for "most significant paper."]

Instructor Profile
Oguzhan Ozbas

Education

B.S. Industrial Engineering, Boğaziçi University
M.S. Industrial Administration, Carnegie Mellon University
Ph.D. Financial Economics, Massachusetts Institute of Technology

Professional

Associate Professor of Finance and Business Economics, USC Marshall, 2002-
Treasury associate, Ford Motor Company, Dearborn, MI, 1995-1998

Research in Corporate Finance and Governance

"Evidence on the Dark Side of Internal Capital Markets," with D. Scharfstein, *Review of Financial Studies*, 2010.

"Costly External Finance, Corporate Investment, and the Subprime Mortgage Credit Crisis," with R. Duchin and B. Sensoy, *Journal of Financial Economics*, 2010.

"When Are Outside Directors Effective?," with R. Duchin and J. Matsusaka, *Journal of Financial Economics*, 2010.

"Club Deals in Leveraged Buyouts," with M. Officer and B. Sensoy, *Journal of Financial Economics*, forthcoming.

"Integration, Organizational Processes, and Allocation of Resources," *Journal of Financial Economics*, 2005.

"Corporate Diversification and the Cost of Capital," with R. Hann and M. Ogneva, working paper.

"Corporate Fraud and Real Investment," working paper.