



FBE 655. FINANCIAL ECONOMICS III

Spring Semester 2011

Professors John G. Matsusaka and Oguzhan Ozbas

Continuation of FBE 652. FINANCIAL ECONOMICS I

SYLLABUS

Overview

This two-course sequence (FBE 652/655) is a rigorous introduction to modern theories of corporate finance. The first third of the sequence 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 sequence – spanning Fall and Spring semesters – focuses on a select group of current topics, including 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. During Spring Semester, students will prepare an original research paper.

Course Methods

Class meetings are organized around lectures that develop models and discuss empirical results. Several classes will be led by other faculty members at USC who are leading experts in their area. The structure of the class is similar to FBE 652 with some important exceptions. Most important, students will spend a good part of the semester preparing and writing an original research paper. To allow time for this, homework assignments to teach modeling skills will be less frequent than in FBE 652, and students will not present any class readings. Students will present their original research at the end of the semester.

READINGS

The following list is provisional and may be modified as the semester progresses. As usual, the list is provided as a research reference; students are not expected to read every paper below. Required readings will be identified as we go.

1. Corporate Diversification

- M. E. Akbulut and J.G. Matsusaka, "50+ years of diversification announcements," *The Financial Review*, 2010.
- Y. Amihud and B. Lev, "Risk reduction as a managerial motive for conglomerate mergers," *Bell Journal*, 1981. [Managerial risk aversion]
- P. G. Berger and E. Ofek, "Diversification's effect on firm value," *Journal of Financial Economics*, 1995.
- J. Campa and S. Kedia, "Explaining the diversification discount," *Journal of Finance*, August 2002. [Evidence the discount causes diversification]
- J. Graham, Lemmon, and Wolf, "Does corporate diversification destroy value?," *Journal of Finance*, April 2002. [Hardwired discount]
- R. G. Hubbard and D. Palia, "A re-examination of the conglomerate merger wave in the 1960s: An internal capital markets view," *Journal of Finance*, December 1988.
- S. Kaplan and M. Weisbach, "The success of acquisitions: Evidence from divestitures," *Journal of Finance*, 1991. [High divestiture rate for conglomerate acquisitions]
- *L. Lang and R. Stulz, "Tobin's q, Corporate Diversification, and Firm Performance," *Journal of Political Economy*, 1994.
- W. Lewellen, "A pure financial rationale for conglomerate mergers," *Journal of Finance*, May 1971. ["Coinsurance" argument, not quite correct]
- R. Hann, M. Ogneva and O. Ozbas, "Corporate Diversification and the Cost of Capital," University of Southern California, working paper, 2010.
- J. G. Matsusaka, "Takeover Motives during the Conglomerate Merger Wave," *RAND Journal of Economics*, 1993.
- *J. G. Matsusaka, "Corporate Diversification, Value Maximization, and Organizational Capabilities," *Journal of Business*, 2001.
- *V. Maksimovic and G. Phillips, "Do Conglomerate Firms Allocation Resources Inefficiently across Industries? Theory and Evidence," *Journal of Finance*, 2002.

R. Morck, A. Shleifer, and R. W. Vishny, "Do managerial objectives drive bad acquisitions?," *Journal of Finance*, 1990.

C. Montgomery, "Corporate diversification," *Journal of Economic Perspectives*, 1994 [Survey of theories in strategy literature, with some useful facts]

A. Schoar, "Effects of corporate diversification on productivity," *Journal of Finance*, December 2002.

R. Sobel, *The Rise and Fall of the Conglomerate Kings*, 1984.

H. Servaes, "The Value of Diversification during the Conglomerate Merger Wave," *Journal of Finance*, 1996. [Diversification discount/premium in 1960s]

B. Villalonga, "Does diversification cause the 'diversification discount'?" *Financial Management*, 2004. [More on endogeneity]

*B. Villalonga, "Diversification discount or premium? New evidence from BITS establishment-level data," *Journal of Finance*, 2004. [Discount mismeasured?]

2. Mergers and Takeovers

G. Andrade, M. Mitchell, and E. Stafford, "New evidence and perspectives on mergers," *Journal of Economic Perspectives*, 2001.

S. J. Grossman and O. D. Hart, "Takeover bids, the free-Rider problem, and the theory of the corporation," *Bell Journal of Economics*, Spring 1980.

R. Roll, "The Hubris Hypothesis of corporate takeovers," *Journal of Business*, 1986.

A. Shleifer and R. W. Vishny, "Large shareholders and corporate control," *Journal of Political Economy*, June 1986.

B. Jovanovich and S. Braguinsky, "Bidder discounts and target premia in takeovers," *American Economic Review*, March 2004. [Market equilibrium approach]

A. Shleifer and R. W. Vishny, "Stock market driven acquisitions," *Journal of Financial Economics*, December 2003. [Behavioral approach]

3. Cash

M. Miller and D. Orr, "A model of the demand for money by firms," *Quarterly Journal of Economics*, 1966.

T. Opler, L. Pinkowitz, R. Stulz, and R. Williamson, "The determinants and implications of corporate cash holdings," *Journal of Financial Economics*, 1999.

T. Bates, K. Kahle, and R. Stulz, "Why do U.S. firms hold so much more cash than they used to?," *Journal of Finance*, September 2009.

H. Almeida, M. Campello, and M. Weisbach, "The cash flow sensitivity of cash," *Journal of Finance*, 2004.

R. Duchin, "Cash holdings and corporate diversification," *Journal of Finance*, May 2010.

C. Kim, D. C. Mauer, and A. E. Sherman, "The determinants of corporate liquidity: theory and evidence," *Journal of Financial and Quantitative Analysis*, September 1998.

4. Executive Compensation

5. Corporate Governance and Boards

A. Shleifer and R. W. Vishny, "A survey of corporate governance," *Journal of Finance*, 1997.

R. Morck, A. Shleifer, and R. W. Vishny, "Management ownership and market valuation: An empirical analysis," *Journal of Financial Economics*, 1988.

M. Burkart, D. Gromb, and F. Panunzi, "Large shareholders, monitoring and the value of the firm," *Quarterly Journal of Economics*, 1997.

B. E. Hermalin and M. S. Weisbach, "Endogenously chosen boards of directors and their monitoring of the CEO," *American Economic Review*, 1998. [Theory of endogenous boards but may focus on second-order mechanism.]

C. Raheja, "Determinants of board size and composition: A theory of corporate boards," *Journal of Financial and Quantitative Analysis*, June 2005.

M. Harris and A. Raviv, "A theory of board control and size," *Review of Financial Studies*, 2008. [Good attempt to incorporate information]

R. B. Adams and D. Ferreira, "A theory of friendly boards," *Journal of Finance*, 2007. [Theory in which boards provide advice.]

R. Duchin, J. G. Matsusaka and O. Ozbas, "When are outside directors effective?," *Journal of Financial Economics*, 2010. ["Endogeneity-free" estimates of effectiveness]

Black, B., H. Jang, and W. Kim, "Does corporate governance predict firms' market values?: Evidence from Korea," *Journal of Law, Economics, and Organization*, October 2006. [Identification strategy]

H. Fu and X. Yu, "Is board structure one-size-fits-all? The unintended informational consequence of the Sarbanes-Oxley Act." Working paper, Texas Christian University and Indiana University, April 2008. [Evidence on information]

Romano, R., "The Sarbanes-Oxley Act and the making of quack corporate governance," *Yale Law Journal*, 2005. [Law perspective]

R. A. Prentice and D. B. Spence, "Sarbanes-Oxley as quack corporate governance: How wise is the received wisdom?," *Georgetown Law Review*, 2007. [Alternative law perspective]

B. Nguyen and K. Nielsen, "The value of independent directors: Evidence from sudden deaths," *Journal of Financial Economics*, 2010.

6. Banking, Bankruptcy, and the Financial Crisis

7. Finance, Development, and Law

R. G. King and R. Levine, "Finance and growth: Schumpeter might be right," *Quarterly Journal of Economics*, August 1993. [Beginning of literature.]

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, "Law and finance," *Journal of Political Economy*, December 1998. [Seminal paper on legal origins]

R. G. Rajan and L. Zingales, "Financial dependence and growth," *American Economic Review*, June 1998.

A. Demirguc-Kunt and V. Maksimovic, "Law, finance, and firm growth," *Journal of Finance*, December 1998.

R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, "Legal determinants of external finance," *Journal of Finance*, July 1997.

F. Allen, J. Qian, and M. Qian, "Law, finance, and economic growth in China," *Journal of Financial Economics*, 2005.

8. Finance and Politics

R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, "Government ownership of banks," *Journal of Finance*, February 2002.

P. Sapienza, "The effects of government ownership on bank lending," *Journal of Financial Economics*, 2004.

I. S. Dinc, "Politicians and banks: Political influences on government-owned banks in emerging markets," *Journal of Financial Economics*, 2005. [Politics]

A. Khwaja and A. Mian, "Do lenders favor politically connected firms? Rent provision in an emerging financial market," *Quarterly Journal of Economics*, 2006.

S. Cole, "Fixing market failures or fixing elections? Elections, banks, and agricultural lending in India," *American Economic Journal: Applied Economics*, 2009.

D. Carvalho, "The real effects of government-owned banks," USC working paper, 2010.

Grades

Grades will be assigned on the following basis:

Homework	10%
Midterm (March 10)	30%
Research Paper (due time of final)	30%
Referee reports on other papers	30%

Teaching Assistant

The teaching assistant is Chao Zhuang: chao.zhuang.2013@marshall.usc.edu. Chao 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. He will be also helping with the research paper project.

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*, 2010.

“Disobedience and Authority,” with A. Marino and J. Zabojnik, *Journal of Law, Economics, and Organization*, 2010.

“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.