

UNIVERSITY OF ROCHESTER

William E. Simon Graduate School of Business Administration

Finance 423

Corporate Financial Policy & Control
Winter 2008
Tu 5:50-8:50

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This course will cover the theory and evidence concerning major corporate financial policy decisions. FIN 423 discusses alternative methods of issuing and retiring securities, mergers and acquisitions, and the market for corporate control.

The *required* text for this course is

J. Fred Weston, Mark L. Mitchell, and Harold Mulherin, *Takeovers, Restructuring, and Corporate Governance*, (4th ed.), Prentice-Hall, New York, 2004 [referred to as “WMM” in the reading assignments].

Some of the required and supplemental articles are contained in the book edited by Donald Chew, *The New Corporate Finance: Where Theory Meets Practice*, (3rd ed.), McGraw-Hill, 2001.

If you do not already own this book (which has been required for FIN 413 in recent years), you should try to purchase a copy. Articles in the Chew book are indicated by “(DC)” in the list below. Required readings are indicated by an asterisk “*”. You will be provided with copies of those required readings that are not included in DC. In addition, the relevant sections from the book,

R. Brealey, S. Myers, and F. Allen, *Principles of Corporate Finance*, (8th ed.), McGraw-Hill, New York, 2006,

are listed as supplemental readings. This book has been used in most recent offerings of FIN 402, Capital Budgeting and Corporate Objectives, which is a prerequisite for FIN 423. Finally, and perhaps most important, I would like all of the students in the class to read the *Wall Street Journal* or some similar publication on a regular basis since the topics covered in this course are discussed regularly in this newspaper. The discussion of “current events” will be a major part of some lectures.

Relation to Other Finance Courses

In addition to FIN 402, FIN 411 (Investments) is a prerequisite for this course. FIN 411 teaches students how to evaluate the response of security prices to information (“event studies”). Since much of the evidence in FIN 423 depends on understanding event study methods, it is important that you have satisfied the FIN 411 prerequisite. FIN 413 (Corporate Finance) is a co-requisite for FIN 423. FIN 413 covers topics such as bankruptcy costs and agency costs that relate to capital structure and dividend policy. If you have not already taken FIN 402, 411, and 413 (or you are not simultaneously taking 413), **you** are responsible for making up these deficiencies in your background.

Many of you may have already taken FIN 433 (Issues in Corporate Control) with Gregg Jarrell, or plan to take it in the future. FIN 433 spends quite a bit of time talking about mergers and acquisitions (M&A). In the past I have found that about a third of the students who have taken FIN 433 felt that there was too much overlap between FIN 423 and FIN 433. On the other hand, about a third felt that the somewhat different perspective offered in FIN 423 was very valuable to them (the remaining third did not express strong feelings either way). Unfortunately, I have been unable to find any measurable variable that would help me advise students about whether to bypass FIN 423. If you are concerned about this question, I encourage you to look carefully at the course outline and consider taking a different course. For those of you who choose to take FIN 423 after previously taking FIN 433, I have constructed a grading option that will let you take advantage of your background (see below).

Expectations of Student Performance

My expectations are that students will come to class prepared by having read the necessary material. The lectures will not rehash the readings. Rather, we will discuss different perspectives on the arguments presented in the readings. Active, high quality class participation will enhance the grades of students who are near margins in the final grade distribution.

I will hand out notes to accompany many of the lectures. Occasionally, I will also hand out stories reproduced from the popular business press (e.g., the *Wall Street Journal*). Class attendance is very important to successful completion of this course. If you know that you will be unable to attend more than a few of the classes, you should probably not register for this course (see the description of grading policies below). If you know that you have to be late for class, or leave early, please show courtesy to the rest of the class (and to me) by entering and leaving the room as discretely as possible. If you miss a class, or are late in arriving, it is your responsibility to obtain copies of any handouts that were

distributed in class [*do not rummage around on the teaching desk looking for handouts if you arrive late!*] I suggest that you form study teams and help each other out -- get extra copies of handouts for missing team-mates. I will not provide a long-term inventory of class handouts for people who miss class, but most of the handouts will be available on the class web page (see below).

Grading

The grading for this course will be based on a flexible system. There are several options:

Option A

There will be a Midterm Exam on February 12 (worth 20% of the course grade) and a Final Exam between March 12-16 (worth 30% of the course grade). There will also be one or two individual (not group) take-home assignments due within a week or less (in aggregate worth 10% of the course grade). Usually, exam questions will be related to the lectures, and/or the required reading, and/or current events that relate to the material that is being discussed in class.

There will be two case problems that will be done in groups of between 3 and 5 people. The case problems will involve an analysis of: (1) a security offering (e.g., an IPO), and (2) a merger/acquisition (M&A) problem. Either case could involve negotiation with an opposing team. The total group score for the cases equals the average case score times the number of students in the group. On the last day of class (March 11), each group will turn in their grade-allocation sheet containing:

- (a) the percentage (summing to 100%) of the total group score that each member by name is to receive towards his/her final grade, and
- (b) the signature of each group member.

If one group member's signature is missing, the grade allocation sheet is valid and binding on all members. If two or more signatures are missing, the allocation sheet is invalid and the group's score will be allocated equally among the members. I will not arbitrate disputes among group members. No grade allocation sheets will be accepted after March 11. Each case will be worth 20% of the course grade.

Option B

In addition, M.B.A. students have the option of writing a paper that can count for up to **40%** of their grade (you must specify the fraction when you hand in the paper). The weight given to the exams, quizzes and the case problems will be reduced proportionately. The paper should be between 5 and 15 typed pages and it is due on Tuesday, March 11, in class. The topic of the paper can be anything related to the course. I will approve paper topics that are unconventional, but you do not need to ask permission to write a paper on a topic similar to those listed below. In general, these papers should simulate a business research report to your boss. For example, if you are analyzing a potential merger, you might pretend that you are a junior staff member of an investment banking firm (or one of the companies involved in the transaction), and I (your boss) have asked you to report your analysis and recommendations concerning the merger (for example, Is the price a 'good' one? Why? What are the purported gains from this merger? Does the stock market think it is a wise transaction for our company or the other company? Are there likely to be regulatory problems or litigation? etc.) You may ask for general guidance as you might ask your boss, but don't come and ask me what you should write because I (your boss) expect you to be able to do this analysis yourself. Examples would be:

- (1) an event study on price performance of new issues in 2004, or 2005, or 2006, or 2007;
- (2) an analysis of the use of "real options" methods in valuing IPOs (with an example);
- (3) a case study (similar to Ruback's paper on Conoco) on a major acquisition, spin-off, or proxy fight. Students in past years have studied Chase-Lincoln, Norstar-Security, Xerox-Crum & Forster, Computer Consoles-N.B.I., and Kodak-Sterling Drug;
- (4) a case study of the performance of a successful merger or tender offer from 1 to 5 years after it was completed;
- (5) or any other topic that I approve.

Option C

If you took FIN 433 (and therefore did a lot of case work), you have the option of substituting your paper for the casework in this course, but you must receive prior approval from me for this option (and approval of your paper topic).

Option Ph.D.

Ph.D. students *must* write a paper and will not participate in the case problems.

Course Information on the World Wide Web (WWW)

Most of the materials for this course will be posted on the home page for this course [<http://schwert.simon.rochester.edu/f423/f423.htm>]. For example, I plan to post copies of the slides used in the classroom presentations as Adobe Acrobat files (so they can be viewed and printed from the WWW). In addition, I have collected lists of sites that students can use to collect information on security prices (if you want to do an event study), on financial news, on securities filings with the S.E.C. (if you want to study a particular IPO prospectus, for example), and so forth. I want to encourage all students to use this resource throughout the course. One possible “paper” that students might do is to create web pages that would allow future students to analyze particular types of deals that are discussed in this course (e.g., information and data sources, examples of similar transactions, etc.) If you are interested in pursuing that option, please see me early in the quarter.

Topics and Readings

Additional journal articles, *which are not required*, are included for students who want more information on particular topics. These are not on reserve in the library, although copies of the *Journal of Financial Economics* and the *Journal of Finance* are available in the Management Library (and available online through these links if you are logged into the UR network).

I. Introduction to the Course

*Smith, Clifford W., “Raising Capital: Theory and Evidence,” (*DC*, 277-293).

Brealey, Myers & Allen, Ch. 14 and 15.

Henderson, Brian J., Narasimhan Jegadeesh and Michael S. Weisbach, “World markets for raising new capital,” *Journal of Financial Economics*, 82 (October 2006) 63-101.

II. Venture Capital and Initial Public Offerings of Common Stock

- *Gompers, Paul and Josh Lerner, "Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations," *Journal of Financial Economics*, 55 (February 2000) 281-325.
- *Ibbotson, Roger, Jody Sindelar, and Jay Ritter, "The Market's Problem with the Pricing of Initial Public Offerings," *Journal of Applied Corporate Finance*, 7 (Spring 1994) 66-74.
- *Kim, Moonchul and Jay Ritter, "Valuing IPOs," *Journal of Financial Economics*, 53 (September 1999) 409-437.
- *Ritter, Jay and Ivo Welch, "A Review of IPO Activity, Pricing, and Allocations," *Journal of Finance*, 57 (August 2002) 1795-1828.
- Aggarwal, Rajesh K., Krigman, Laurie, and Womack, Kent L., "Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling," *Journal of Financial Economics*, 66 (October 2003) 105-137.
- Aggarwal, Reena, "Allocation of Initial Public Offerings and Flipping Activity," *Journal of Financial Economics*, 68 (April 2003) 111-135.
- Amihud, Yakov, Hauser, Shmuel, and Kirsh, Amir, "Allocations, Adverse Selection, and Cascades in IPOs: Evidence from the Tel Aviv Stock Exchange," *Journal of Financial Economics*, 68 (April 2003) 137-158.
- Ang, James S. and Brau, James C., "Concealing and Confounding Adverse Signals: Insider Wealth-maximizing Behavior in the IPO process," *Journal of Financial Economics*, 67 (January 2003) 149-172.
- Asquith, Daniel, Jonathan D. Jones, and Robert Kieschnick, "Evidence on Price Stabilization and Underpricing in Early IPO Returns," *Journal of Finance*, 53 (October 1998) 1759-1773.
- Barry, Christopher B., Chris J. Muscarella, John W. Peavy III, and Michael R. Vetsuypens, "The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going-Public Process," *Journal of Financial Economics*, 27 (September 1990) 447-471.
- Beatty, Randolph P. and Jay R. Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings," *Journal of Financial Economics*, 15 (1986) 213-232.
- Benninga, Simon, Mark Helmantel and Oded Sarig, "The Timing of Initial Public Offerings," *Journal of Financial Economics*, 75 (January 2005) 115-132.
- Black, Bernard S. and Ronald J. Gilson, "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets," *Journal of Financial Economics*, 47 (March 1998) 243-277.

II. Venture Capital and Initial Public Offerings of Common Stock

- Brav, Alon and Paul A. Gompers, "Myth or Reality? The Long-run Underperformance of Initial Public Offerings: Evidence from Venture and Non-venture Capital-backed Companies," *Journal of Finance*, 52 (December 1997) 1791-1822.
- Brennan, M. J., and Julian Franks, "Underpricing, ownership and control in initial public offerings of equity securities in the U.K.," *Journal of Financial Economics*, 45 (September 1997) 391-413.
- Busaba, Walid Y., Lawrence M. Benveniste, and Re-Jin Guo, "The Option to Withdraw IPOs during the Premarket: Empirical Analysis," *Journal of Financial Economics*, 60 (April 2001) 73-102.
- Carter, Richard B., Frederick H. Dark, and Ajai K. Singh, "Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks," *Journal of Finance*, 53 (February 1998) 285-311.
- Chemmanur, Thomas J. and Imants Paeglis, "Management Quality, Certification, and Initial Public Offerings," *Journal of Financial Economics*, 76 (May 2005) 331-368.
- Cochrane, John H., "The Risk and Return of Venture Capital," *Journal of Financial Economics*, 75 (January 2005) 3-52.
- Cook, Douglas O., Robert Kieschnick and Robert A. Van Ness, "On the marketing of IPOs," *Journal of Financial Economics*, 82 (October 2006) 35-61.
- Demers, Elizabeth and Katharina Lewellen, "The Marketing Role of IPOs: Evidence from Internet Stocks," *Journal of Financial Economics*, 68 (June 2003) 413-437.
- Dunbar, Craig G., "The Use of Warrants as Underwriter Compensation in Initial Public Offerings," *Journal of Financial Economics*, 38 (May 1995) 59-78.
- Dunbar, Craig G., "Factors Affecting Investment Bank Initial Public Offering Market Share," *Journal of Financial Economics*, 55 (January 2000) 3-41.
- Edelen, Roger M. and Gregory B. Kadlec, "Issuer Surplus and the Partial Adjustment of IPO Prices to Public Information," *Journal of Financial Economics*, 77 (August 2005) 347-373.
- Ellis, Katrina, "Who Trades IPOs? A Close Look at the First Days of Trading," *Journal of Financial Economics*, 79 (February 2006) 339-363.

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- Gande, Amar, Manju Puri, and Anthony Saunders, "Bank Entry, Competition and the Market for Corporate Securities Underwriting," *Journal of Financial Economics*, 54 (November 1999) 165-195.
- Gompers, Paul A., "Optimal Investment, Monitoring, and the Staging of Venture Capital," *Journal of Finance*, 50 (December 1995) 1461-1489.
- Griffin, John M., Jeffrey H. Harris and Selim Topaloglu, "Why are IPO investors net buyers through lead underwriters?" *Journal of Financial Economics*, 85 (August 2007) 518-551.
- Hanley, Kathleen Weiss and William J. Wilhelm, "Evidence on the Strategic Allocation of Initial Public Offerings," *Journal of Financial Economics*, 37 (February 1995) 239-257.
- Hansen, Robert S., "Do Investment Banks Compete in IPOs?: The Advent of the "7% plus Contract"," *Journal of Financial Economics*, 59 (March 2001) 313-346.
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- Hellmann, Thomas , "IPOs, acquisitions, and the use of convertible securities in venture capital," *Journal of Financial Economics*, 81 (September 2006) 649-679.
- Ibbotson, Roger, "Price Performance of Common Stock New Issues," *Journal of Financial Economics*, 2 (September 1975) 235-272.
- Ibbotson, Roger, Jody Sindelar, and Jay Ritter, "Initial Public Offerings," (*DC*, 309-317).
- Jain, Bharat A. and Omesh Kini, "The Post-issue Operating Performance of IPO Firms," *Journal of Finance*, 49 (December 1994) 1699-1726.
- James, Christopher and Jason Karceski, "Strength of analyst coverage following IPOs," *Journal of Financial Economics*, 82 (October 2006) 1-34.
- James, Christopher and Peggy Wier, "Borrowing Relationships, Intermediation, and the Cost of Issuing Public Securities," *Journal of Financial Economics*, 28 (November 1990) 149-171.
- Jenkinson, Tim, Alan D. Morrison and William J. Wilhelm, Jr., "Why are European IPOs so rarely priced outside the indicative price range?" *Journal of Financial Economics*, 80 (April 2006) 185-209.
- Kerins, Frank, Kenji Kutsuna and Richard Smith, "Why are IPOs underpriced? Evidence from Japan's hybrid auction-method offerings," *Journal of Financial Economics*, 85 (September 2007) 637-666.

II. Venture Capital and Initial Public Offerings of Common Stock

- Krigman, Laurie, Wayne H. Shaw and Kent L. Womack, "The Persistence of IPO Mispricing and the Predictive Power of Flipping," *Journal of Finance*, 54 (April 1998) 1015-1044.
- Koh, Francis and Terry Walter, "A Direct Test of Rock's Model of the Pricing of Unseasoned Issues," *Journal of Financial Economics*, 23 (August 1989) 251-272.
- Lee, Peggy M. and Sunil Wahal, "Grandstanding, Certification and the Underpricing of Venture Capital Backed IPOs," *Journal of Financial Economics*, 73 (August 2004) 375-407.
- Lerner, Joshua, "Venture Capitalists and the Decision to Go Public," *Journal of Financial Economics*, 35 (June 1994) 293-316.
- Lerner, Joshua, Shane, Hilary and Tsai, Alexander, "Do equity financing cycles matter? evidence from biotechnology alliances," *Journal of Financial Economics*, 67 (March 2003) 411-446.
- Ljungqvist, Alexander P. and Wilhelm, William J., Jr., "IPO Allocations: Discriminatory or Discretionary?" *Journal of Financial Economics*, 65 (August 2002) 167-201.
- Loughran, Tim and Jay R. Ritter, "The New Issues Puzzle," *Journal of Finance*, 50 (March 1995) 23-51.
- Lowry, Michelle, "Why Does IPO Volume Fluctuate So Much?" *Journal of Financial Economics*, 67 (January 2003) 3-40.
- Lowry, Michelle and Kevin J. Murphy, "Executive stock options and IPO underpricing," *Journal of Financial Economics*, 85 (July 2007) 39-65.
- Lowry, Michelle and G. William Schwert, "IPO Market Cycles: Bubbles or Sequential Learning?" *Journal of Finance*, 57 (June 2002) 1171-1200.
- Lowry, Michelle and G. William Schwert, "Is the IPO Pricing Process Efficient?" *Journal of Financial Economics*, 71 (January 2004) 3-26.
- Lowry, Michelle and Shu, Susan, "Litigation Risk and IPO Underpricing," *Journal of Financial Economics*, 65 (September 2002) 309-335.
- Meggison, William L. and Kathleen A. Weiss, "Venture Capitalist Certification in Initial Public Offerings," *Journal of Finance*, 46 (July 1991) 879-903.
- Mello, Antonio S. and John E. Parsons, "Going Public and the Ownership Structure of the Firm," *Journal of Financial Economics*, 49 (July 1998) 79-109.
- Mikkelsen, Wayne H., Partch, M. Megan, and Shah, Kshitij, "Ownership and Operating Performance of Companies That Go Public," *Journal of Financial Economics*, 44 (June 1997) 281-307.

II. Venture Capital and Initial Public Offerings of Common Stock

- Muscarella, Chris J. and Michael R. Vetsuypens, "A Simple Test of Baron's Model of IPO Underpricing," *Journal of Financial Economics*, 24 (September 1989) 125-135.
- Nimalendran, M., Jay R. Ritter and Donghang Zhang, "Do today's trades affect tomorrow's IPO allocations?" *Journal of Financial Economics*, 84 (April 2007) 87-109.
- Puri, Manju, "Commercial Banks as Underwriters: Implications for the Going Public Process," *Journal of Financial Economics*, 54 (November 1999) 133-163.
- Ritter, Jay R., "The 'Hot Issue' Market of 1980," *Journal of Business*, 57 (April 1984) 215-240.
- Ritter, Jay R., "The Long-Run Performance of Initial Public Offerings," *Journal of Finance*, 46 (March 1991) 3-27.
- Sherman, Ann E., "Global Trends in IPO Methods: Book Building Versus Auctions with Endogenous Entry," *Journal of Financial Economics*, 78 (December 2005) 615-649.
- Sherman, Ann E. and Titman, Sheridan, "Building the IPO Order Book: Underpricing and Participation Limits with Costly Information," *Journal of Financial Economics*, 65 (July 2002) 3-29.
- Stoughton, Neal M. and Josef Zechner, "IPO-mechanisms, monitoring and ownership structure," *Journal of Financial Economics*, 49 (July 1998) 45-77.
- Teoh, Siew Hong, Ivo Welch, and T.J. Wong, "Earnings Management and the Long-Run Market Performance of Initial Public Offerings," *Journal of Finance*, 53 (December 1998) 1935-1974.
- Tinic, Seha M., "Anatomy of Initial Public Offerings of Common Stock," *Journal of Finance*, 43 (September 1988) 789-822.

III. Primary Distributions of Seasoned Stock, Underwriting, Rights and Private Placements

- *Asquith, Paul and David W. Mullins, Jr., "Equity Issues and Offering Dilution," *Journal of Financial Economics*, 15 (January 1986) 61-89.
- *Wu, YiLin, "The Choice of Equity-Selling Mechanisms," *Journal of Financial Economics*, 74 (October 2004) 93-119.
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- Krigman, Laurie, Wayne H. Shaw and Kent L. Womack, "Why Do Firms Switch Underwriters?" *Journal of Financial Economics*, 60 (May 2001) 245-284.
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- Loughran, Tim and Jay R. Ritter, "The Operating Performance of Firms Conducting Seasoned Equity Offerings," *Journal of Finance*, 52 (December 1997) 1823-1850.
- Myers, Stewart and N. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have," *Journal of Financial Economics*, 13 (June 1984) 187-221.

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IV. Corporate Bond Financing

*Brealey, Myers & Allen, Ch. 25.

Anderson, Ronald C., Mansi, Sattar A., and Reeb, David M., "Founding family ownership and the agency cost of debt," *Journal of Financial Economics*, 68 (May 2003) 263-285.

IV. Corporate Bond Financing

- Blume, Marshall E., Donald B. Keim and Sandeep A. Patel, "Returns and Volatility of Low-grade Bonds, 1977-1989," *Journal of Finance*, 46 (March 1991) 49-74.
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V. Intra-Firm Exchange Offers and Recapitalizations

*WMM, Ch. 13.

V. Intra-Firm Exchange Offers and Recapitalizations

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VI. Convertible Debt

- *Brealey, Myers & Allen, Ch. 25.
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VI. Convertible Debt

Singh, Ajay K., Arnold R. Cowan, and Nandkumar Nayar, "Underwritten Calls of Convertible Bonds," *Journal of Financial Economics*, 29 (March 1991) 173-196.

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