Theoretical Foundations of Corporate Finance

Module 1, 2014-2015

Peking University HSBC Business School

1. Teaching Faculty

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2. Aims of the Course

The goal of this course is to provide students with an understanding of the fundamentals and main ideas behind various corporate finance theories at the Master's level. This course will focus on covering the theoretical aspects of capital structure, financing, payout and investment policy choices and derive some practical and policy implications on the real world. This course will also briefly introduce some important aspects of banks.

3. Assessment

Туре	Weighting	Date
Class participation and attendance	10%	-
Mid-term examination	40%	29th September 2014
Final examination	50%	10 th November 2014
Total	100%	

4. Class participation

I expect you to have read the assigned chapters/papers for each session thoroughly before each class. I will evaluate your participation based on the quality of your contribution to class discussions. If the presenter makes a mistake, you should be familiar enough with the papers to identify and help correct the mistake. Thorough preparation and participation in every class is mandatory. If you miss more than two classes, you will have to drop this course.

5. Recommended Readings

My recommended reading materials are as follows.

- 1. *Grinblatt & Titman* (2001) is an excellent book, which covers practical aspects of corporate finance and asset pricing and some of the theory that we will need.
- 2. *Brealey, Myers & Allen* (2006) is a slightly more practical book, with a more intuitive coverage of the material. In this sense, this book is still useful.
- 3. *Tirole* (2006) covers contract-theoretic material in a clear, succinct and easy-to-follow fashion. From Class 8, I will closely follow this book.
- 4. *Joao Amaro de Matos (2002)* covers many topics covered in this course, although the notation is quite different.
- 5. I closely follow *"Lecture Notes on Corporate Finance"* written by Professor Alan Morrison, University of Oxford. You will get a copy of the lecture notes at the beginning of the course.
- 6. I also recommend a number of academic papers. You can download these papers from the University's online library.

6. Class-by-Class Reading Lists

The reading list for this course appears below with suggested readings class-by-class.

Class	Торіс	Reading
1	Classical capital structure theories I	Modigliani and Miller (1958)
	• Why do we care about the firms'	Miller and Modigliani (1961)
	financial structure?	Tirole: Chapter 2
	Modigliani & Miller Propositions I	Matos: Chapter 2
	Modigliani & Miller Propositions II	
2	Classical capital structure theories II	Modigliani and Miller (1963)
	• Trade-off theory of capital structure	Miles & Ezzell (1980)
	Theoretical Background of using	Miles & Ezzell (1985)
	tax-adjusted weighted average cost	Miller (1977)
	of capital	Weiss (1990)
		Warner (1977)
		Kalay, Singhal & Tashjian (2007)
		Andrade & Kaplan (1998)
		Graham (2000)
		Inselbag & Kauford (1997)
		Matos: Chapter 2
3	Adverse selection in corporate finance I	Myers (1984)
	Informational efficiency and	Myers & Majluf (1984)

	allocative efficiency	Lee & Verbugge (1996)
	• Lemons problems and the pecking	Morrison: Chapter 12
	order theory of capital structure	Grinblatt & Titman (2001): Chapters
		16-20
4	Adverse selection in corporate finance II	Jenkinson, Morrison & Wilhelm (2005)
	Adverse selection and IPO	Ritter (2008)
	underpricing	Rock (1986)
		M: Chapter 12
		GT: Chapters 16-20
5	Moral hazard and corporate finance I	M: Chapter 13
	Moral hazard and commitment	GT: Chapters 16-20
	problems	Myers (1977)
	Resolving commitment problems:	Grossman & Hart (1980)
	takeover markets	Andrade, Mitchell & Stafford (2001)
6	Moral hazard and corporate finance II	Jensen & Meckling (1976)
	Moral hazard and leverage	M: Chapter 13
	Risk-shifting	GT: Chapters 16-20
	Debt overhang	
7	Moral hazard and corporate finance III	Migrom & Roberts (1992, chapter 7)
	A simple model of managerial	Jensen & Murphy (1990)
	compensation	Hall & Liebman (1998)
	Evidence on managerial	Bebchuk and Grinstein (2005)
	compensation	M: Chapter 14
8	Costly state verification and optimal	Townsend (1978)
	contracting	Gale & Hellwig (1985)
	Introduction to contract theory	M: Chapter 15
	The revelation principle	T: Chapter 3 Appendix
	Costly state verification	
9	Mid-term Exam	Topics for Classes 1-8
10	Non-verifiable cash flows and optimal	Bolton & Scharfstein (1990)
	contracting	M: Chapter 16
	Non-verifiable cash flows	T: Chapter 3 Appendix
	Predation and financial contracting	
11	Verifiable cash flows and optimal	Tirole (2001)
	contracting I	M: Chapter 17
	• Two-state models of pledgeability	T: Chapter 4
	Tirole's canonical model of moral	
	hazard in corporate finance	
12	Verifiable cash flows and optimal	Milgrom (1981)
	contracting II	Holmstrom (1979)
	Monotone likelihood ratio property	Innes (1990)

	Pledgeability with multiple states	M: Chapter 18
	Optimal contracting with moral	T: Chapter 4
	hazard and verifiable cash flows	
13	Collateral	Bester (1985)
	Why do borrowers pledge	Berger & Udell (1990)
	collateral?	Gonas, Highfield & Mullineaux (2004)
	• Who pledges the most collateral?	Berger, Espinosa-Vega, Frame & Miller
	Application of the contract theory	(2006)
	(adverse selection models vs. moral	M: Chapter 19
	hazard models)	T: Chapter 4
14	Some issues about banks	Diamond & Dybvig (1983)
	• Why are banks special?	Diamond (1984)
	• What do banks bring to the	James (1987)
	economy?	De Long (1991)
	• Why do bank failures matter?	Morrison & White (2005)
		Morrison & White (2004)
		M: Chapter 20
15	Banks and liquidity shocks	Diamond & Dybvig (1983)
	Diamond and Dybvig model	M: Chapter 22
16	Liquidity in corporate finance	Aghion, Bolton, & Tirole (2004)
	Verifiable liquidity shocks	Gomes & Philips (2005)
	• Interim signals and speculative	M: Chapter 23
	monitoring	T: Chapter 4
17	Optimal debt structure	Bolton & Scharfstein (1996)
	What determines the optimal	M: Chapter 24
	number of creditors, and how	
	should their voting rights be	
	distributed?	
18	Control rights	Aghion & Bolton (1992)
	Why do control and ownership	M: Chapter 25
	matter?	T: Chapter 10
	How are control and ownership	
	distributed in optimal contracts?	
19	Final Exam	Topics for Classes 10-18