

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

Type	Weighting	Date
Class participation and attendance	25%	-
Mid-term examination	25%	TBA
Final examination	50%	TBA
Total	100%	

4. Class participation

I expect you to have read the assigned 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.

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. I will follow the 8th edition of the book, but you can get a copy of the book with different editions.
3. *Tirole (2006)* covers the more contract-theoretic material in the course in a clear, succinct and easy-to-follow fashion. This book will be very useful from the middle of this course toward the end of this semester.
4. In addition to these books, I suggest that you read "*Lecture Notes on Corporate Finance*" written by Professor Alan Morrison, Said Business School, University of Oxford. You will get a copy of the lecture notes at the start of the semester.
5. 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	Topic	Reading
1	Introduction to Corporate Finance <ul style="list-style-type: none"> • What should companies do? • What do investors care about? 	Morrison: Chapters 1 & 2 Grinblatt and Titman: Chapters 4 & 5 Brealey, Myers and Allen: Chapters 7-9 Tirole: Chapter 2
2	Capital Budgeting <ul style="list-style-type: none"> • Using the Capital Asset Pricing Model • Discounted cash flow valuation 	M: Chapters 3 & 4 GT: Chapters 4, 5, 9 & 10 BMA: Chapters 1-9
3	The Modigliani & Miller Propositions <ul style="list-style-type: none"> • Alternative valuation approaches • Capital structure and company valuation 	M: Chapters 5 & 6 GT: Chapters 10, 12 & 14 BMA: Chapters 5 & 17 T: Chapter 2 Graham & Harvey (2001)
4	Taxation and WACC <ul style="list-style-type: none"> • Tax shields and corporate value • Bankruptcy and its costs • Trade-off theory of capital structure • Tax-adjusted weighted average cost of capital 	M: Chapters 7 & 8 GT: Chapter 13 BMA: Chapters 18 & 19 Miles & Ezzell (1980; 1985) Graham (2000)

	<ul style="list-style-type: none"> Adjusted present value The Miller equilibrium 	
5	Company Valuation and Delevering <ul style="list-style-type: none"> Delevering company betas 	M: Chapter 9 GT: Chapters 11 & 13 BMA: Chapter 19
6	Dividend; Credit Rationing <ul style="list-style-type: none"> Dividend Credit rationing: concepts and evidence 	M: Chapters 10 & 11 GT: Chapter 15 BMA: Chapter 16 T: Chapter 3 Fazzari, Hubbard & Petersen (1988) Hoshi, Kashyap & Scharfstein (1991) Kaplan & Zingales (1997)
7	Adverse Selection in Corporate Finance <ul style="list-style-type: none"> Informational efficiency and allocative efficiency Lemons problems and the pecking order theory of capital structure Adverse selection and IPO underpricing 	M: Chapter 12 GT: Chapters 16-20 BMA: Chapters 13, 17 & 18 T: Chapter 5 Lee & Verbugge (1996) Myers (1984) Myers & Majluf (1984) Rock (1986)
8	Moral Hazard and Corporate Finance <ul style="list-style-type: none"> Agency problems in corporate finance Theory and evidence concerning takeovers Gambling for resurrection Executive compensation Debt overhang 	M: Chapter 13 GT: Chapters 16-20 BMA: Chapters 13, 17 & 18 T: Chapter 5 Myers (1977) Grossman & Hart (1980) Andrade, Mitchell & Stafford (2001)
9	Compensation Contracts	M: Chapter 14 Migrom & Roberts (1992, chapter 7) Jensen & Murphy (1990) Hall & Liebman (1998) Bebchuk and Grinstein (2005)
10	Mid-term Exam	Topics for Classes 1-8
11	Costly State Verification <ul style="list-style-type: none"> The revelation principle Costly state verification Non-verifiable cash flows Predation and financial contracting 	M: Chapter 15 T: Chapter 3 Appendix Townsend (1978)
12	Non-verifiable Cash Flows and Predation	M: Chapter 16 T: Chapter 3 Appendix Bolton & Scharfstein (1990)
13	Cash Flow Pledgeability	M: Chapter 17

	<ul style="list-style-type: none"> • Two-state models of pledgeability • Shadow price of own capital • Tirole's canonical model of moral hazard in corporate finance 	T: Chapter 4 Tirole (2001)
14	Pledgeability with Multiple States <ul style="list-style-type: none"> • Monotone likelihood ratio property • Optimal contracting with moral hazard and verifiable cash flows 	M: Chapter 18 T: Chapter 4 Milgrom (1981) Innes (1990)
15	Collateral <ul style="list-style-type: none"> • Why do borrowers pledge collateral? • Who pledges the most collateral? 	M: Chapter 19 T: Chapter 4 Bester (1985) Berger & Udell (1990) Gonas, Highfield & Mullineaux (2004) Berger, Espinosa-Vega, Frame & Miller (2006)
16	Banks <ul style="list-style-type: none"> • Why are banks special? • What do banks bring to the economy? • Why do bank failures matter? 	M: Chapter 20 Diamond & Dybvig (1983) Diamond (1984) James (1987) De Long (1991) Morrison & White (2005) Morrison & White (2004)
17	Liquidity in Corporate Finance <ul style="list-style-type: none"> • Banks and liquidity shocks • Liquidity in corporate finance: voice and exit 	M: Chapters 22 & 23 T: Chapter 4 Diamond & Dybvig (1983)
18	Debt Structure and Control Rights <ul style="list-style-type: none"> • What determines the optimal number of creditors, and how should their voting rights be distributed? • Why do control and ownership matter? • How are control and ownership distributed in optimal contracts? 	M: Chapters 24 & 25 T: Chapter 10 Bolton & Scharfstein (1996) Aghion & Bolton (1992)
19	Final Exam	Topics for Classes 1-18