GM1407 Applied Corporate Finance, 7.5 credits

Tillämpad corporate finance, 7,5 högskolepoäng

Second Cycle

Reading list for GM1407, to be valid from spring semester of 2024

Reading list was confirmed by Graduate School on 2023-12-21 to be valid from 2024-01-15.

See appendix.

Literature GM1407 Applied Corporate Finance, spring 2024.

Minor modifications may occur during the course.
NB: Information on literature seminars and assignments are given separately.
NB2: All lecture slides (including from guest lectures) are to be considered literature.

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L1 Intro (CO)

Introduction:

The introductory lecture serves to introduce the course wrt intended scope and learning outcomes, content, examination and formalities.

PART I: DEBT CAPITAL

L2 Debt capacity (AM)

Introduction:

This lecture provides a theoretical framework for understanding and applying basic models of valuation of corporate capital, including pricing models for primary financial assets and contingent claims on financial assets (futures, options, swaps etc.). It is aimed to provide necessary knowledge in analysing capital structure and pricing debt capacity. The main topics it aims to cover are: types of debt financing, the cost of debt, the debt tax shield and financial leverage. This lecture requires basic knowledge in microeconomics, corporate finance and option theory.

Important lessons:

- Understanding capital structure.
- Pricing debt capacity.
- Understanding the "option" lens.

Readings:

1. Myers, S. (1977). "Determinants of corporate borrowing". *Journal of Financial Economics*, 5(2), pp. 147–175.
2. Myers, S. (1984). "The capital structure puzzle", *Journal of Finance, 39*(3), pp. 574-592.
3. Fama, E. and French, K. (2002). Testing trade-off and pecking order predictions about dividends and debt. *The Review of Financial Studies*, *15*(1), pp. 1-33.

Supplementary Material:

- Berk, J. and DeMarzo, P. (2017). *Corporate finance*, 4th Edition, Pearson: Chapters 14-16
- Hull, J. (2009). *Options, futures, and other derivatives*, 7th Edition, Pearson: Chapters 20-22

Optional readings:

- Fama, E. (1970) "Efficient capital markets: A review of theory and empirical work", *Journal of Finance,* 25(2), pp. 383–417.
- Fama, E. (1991). "Efficient capital markets: II", *Journal of Finance,* 46(5), pp.1575–1617.

L3 Pricing of corporate debt (AM)

Introduction:

This lecture concerns the valuation of corporate securities, both debt and equity, and the choice of financial structure by the firm. In addition, it will discuss the determinants of the optimal call boundary of corporate debt and the effect of bankruptcy costs and taxes on corporate borrowing (Merton, 1974). The literature, building on Merton (1974)'s insights, has attempted to enhance the original theoretical framework and provide empirical results regarding this issue. Concluding, we also aim to summarize these developments and briefly explain the major theoretical and empirical follow-up models.

Important lessons:

- Pricing debt, equity and other corporate securities.
- Introduction to stochastic models and strategic default.
- Pricing managerial flexibility using option techniques.

Readings:

1. Black F, and Scholes M. 1973. The pricing of options and corporate liabilities. *Journal of Political Economy*, 81(3), pp. 637–654.
2. Merton, R. 1974. On the pricing of corporate debt: The risk structure of interest rates. *Journal of Finance* 29(2), pp. 449–470.
3. Brennan, M and Schwartz, E. 1978. Corporate taxes, valuation and the problem of optimal capital structure. *Journal of Business*s, 51, pp. 103–114.
4. Bharath, S.T. and Shumway, T., 2008. Forecasting default with the Merton distance to default model. *The Review of Financial Studies*, *21*(3), pp.1339-1369.

Supplementary Material:

- Hull, J. (2010). *Risk management and financial institutions*, 2nd Edition, Pearson: Chapters 9, 14 & 15
- Wiersema, U., 2008. *Brownian motion calculus*. John Wiley & Sons: Chapters 4-6
- Björk, T., 2009. *Arbitrage theory in continuous time*. 3rd Edition, Oxford Press.

Optional readings:

- Black F, and Cox, J. 1976. Valuing corporate securities: some effects of bond indenture provisions. *Journal of Finance*, 31, pp. 351–67.
- Leland H. 1994. Corporate debt value, bond covenants, and optimal capital structure. *Journal of Finance,* 49(4), pp. 1213–1252.
- Leland, H. 1998. Agency costs, risk management, and capital structure. *Journal of Finance,* 53(4), pp. 1213–1243

PART II: EQUITY CAPITAL

L4 Initial public offerings (AM)

<u>Introduction:</u>

This lecture will introduce equity financing for private companies. We will start by discussing why new ventures are hard to finance, introduce the lemon's problem in an equity issuance setting, different sources of funding for private firms (including venture financing) as well as external financing and control. We will go through the IPO process and discuss puzzles associated with IPOs. We will discuss empirical research associated with the going public process including market timing of IPOs as well as how different alternative funding sources interact with one another.

Further, we will briefly discuss public offerings for public companies, known as seasoned equity offerings (SEOs). We will start by discussing the mechanics of an SEO, and the role of asymmetric information (and adverse selection) in issuing equity. We will see how the lemon principle in equity issues is related to stock returns before and after an equity issue including supporting empirical results. We will end the lecture with discussing theories associated with equity issuance, including the pecking order hypothesis, the trade-off theory, the market timing hypothesis as well the corporate life cycle theory.

<u>Important lessons:</u>

You will learn that entrepreneurial financing situations are characterized by two fundamental problems; asymmetric information and moral hazard. You will also learn how theories are tested in empirical research, both in terms of market timing of IPOs as well as how private (venture capital) financing is associated with exit decisions.

You will also learn how theories are tested in empirical research, both in terms of stock returns around SEO announcements as well as how firm-specific and market-wide factors play a role in the equity issuance decision.

<u>Readings:</u>

1. OZMEL, U., ROBINSON, D. and STUART, T. (2013). Strategic alliances, venture capital, and exit decisions in early stage high-tech firms. Journal of Financial Economics 107, 655-670.
2. DEANGELO, H., DEANGELO, L. and STULZ, R. (2010). Seasoned equity offerings, market timing, and the corporate lifecycle. Journal of Financial Economics 95, 275-295.
3. AKERLOF, G. (1970). The market for "lemons": Quality uncertainty and the market mechanism. The Quarterly Journal of Economics 84 (3), 488-500.

4. DENIS, D. (2004). Entrepreneurial finance: An overview of the issues and evidence. Journal of Corporate Finance 10, 301-326.

Supplementary Material:

- BERK, J. and DEMARZO P. (2017). Corporate Finance, 4th edition, Pearson Education. Chapter 23

L5 Corporate venture capital (SS)

Introduction:
When corporations make investments, often outside their core activities, into new ventures it is called Corporate Venture Capital. We take a closer look at this phenomenon and investigate the logics behind why firms chose to invest in R&D outside their existing in-house R&D.

Important lessons:

The logic behind CVC
Similarities and differences between CVC and VC.
CVC as a strategic goal
CVC activities among existing corporations

Readings:

Basu, S, Phelps, C and S. Kotha, 2011, Towards understanding who makes corporate venture capital investments and why, Journal of Business Venturing, 26, 153-172.
Henry W Chesbrough, 2002 Making sense of Corporate Venture Capital. Harvard Business Review. (google Scholar)
The 2016 Global CVC report. CBInsight (download from the net)

Optional readings:

Agmon T. & S. Sjogren 2016, Venture Capital and The inventive Process, VC Funds for Ideas-Led Growht. Parlgrave Pivot

L6 Sustainable finance (CO)

Introduction:

The lecture draws on the students' knowledge from previous courses on asset pricing (CAPM, APT), and covers what expected consequences might follow from investment strategies such as negative or positive screening. The lecture also touches upon how financial institutions and instruments can serve as a means to sustainable development, and the empirical findings on ESG investing.

Important lessons:

Insights from the finance literature wrt diversification and arbitrage pricing give cause to expect that screening strategies yield lower risk-adjusted returns. Yet, there is a growing supply of finance attached with sustainability related requirements.

Readings:

Edmans, A. (2022). The end of ESG. *Financial Management*. https://doi.org/10.1111/fima.12413

Gillian, S., Koch, A., Starks, L. (2021). Firms and social responsibility: A review of ESG and CSR research in corporate finance, *Journal of Corporate Finance*, 66, 101889. https://www.sciencedirect.com/science/article/abs/pii/S0929119921000092

Hong, Harrison G. and Shore, Edward P. (2022). Corporate Social Responsibility, *Annual Review of Financial Economics*, Forthcoming, Available at SSRN: https://ssrn.com/abstract=4267476 or http://dx.doi.org/10.2139/ssrn.4267476

Optional readings:

Fauver, L., McDonald, M.B. (2014). International variation in sin stocks and its effects on equity valuation, *Journal of Corporate Finance*, 25, 173-187.

Flammer, C. (2021). Corporate green bonds, *Journal of Financial Economics*, 142, 2, 499-516. https://www.sciencedirect.com/science/article/abs/pii/S0304405X21000337

Hong, H., Kacperczyk, M. (2009). The price of sin: The effects of social norms on markets, *Journal of Financial Economics*, 93, 1, 15-36. https://www.sciencedirect.com/science/article/abs/pii/S0304405X09000634

Grantham Research Institute (2022). What are stranded assets? http://www.lse.ac.uk/GranthamInstitute/faqs/what-are-stranded-assets/

UNEP FI (2011). Universal ownership: Why environmental externalities matter to institutional investors, http://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf

PART III: TRANSACTIONS

L7 Mergers and acquisitions (CO)

Introduction:

Mergers and acquisitions play an important role in financial markets. They offer exit strategies for current shareholders, they make possible synergy gains, and they function as a governance mechanism to foster efficiency. This lecture will outline the rationales for takeovers, and present empirical evidence for the potential gains that follow from M&As. The lecture will also look at regulatory aspects related to M&As.

Important lessons:

The value creating logic of mergers and acquisitions.
Mitigating factors for value increasing mergers and acquisitions.
Typical M&A regulation.

Readings:

Sirower, M.L., Sahni, S., (2006). Avoiding the “synergy trap”: Practical guidance on M&A decisions for CEOs and boards, *Journal of Applied Corporate Finance*, 18, 3,1745-6622.

Berglöf, E., Burkhart, M., Boeri, T., & Franks, J. (2003). European takeover regulation. *Economic Policy*, 18, 171-213.

Eckbo, E. (2009). Bidding strategies and takeover premiums: A review. *Journal of Corporate Finance*, 15, 149-178.

Berk, J., DeMarzo, P., (2017). *Corporate finance*, 4th Edition, Pearson: Chapter 28

L8 Due diligence (CO)

Introduction:

The lecture introduces due diligence, a business term used to describe the investigative process preceding the signing of a contract. Concepts and theoretical arguments are mixed with empirical results on the importance of DD.

Important lessons:

Information asymmetry and adverse selection
The difference between DD by mangers and external agents

Readings:

Cumming, D., Zambelli, S., (2017). Due diligence and investee performance, *European Financial Management*, 23, 2, 211-253.

Optional readings:

Yung, C., (2009). Entrepreneurial financing and costly due diligence, *Financial Review*, 44, 1, 1540-6288.

L9 An introduction to event studies (CO)

Introduction:

The lecture focuses on event studies, a methodology typically used in literature to study the value effects of mergers and acquisitions (among other events).

Important lessons:

The meaning of (Cumulative) Abnormal Returns, and how they are determined.

Readings:

Kothari, S.P. and Warner, Jerold B., The Econometrics of Event Studies (October 20, 2004). Available at SSRN: https://ssrn.com/abstract=608601 or http://dx.doi.org/10.2139/ssrn.608601

MacKinlay, A.C., 1997. Event studies in economics and finance, Journal of Economic Literature, 35, 1, 13-39.

Optional readings:

Stephen J. Brown, S.J., Warner, J.B., (1980). Measuring security price performance, *Journal of Financial Economics*, 8, 3, 205-258.

Brown S.J, Warner, J.B., (1985). Using daily stock returns: The case of event studies, *Journal of Financial Economics*, 14, 1, 3-31.

Eckbo, E. (2009). Bidding strategies and takeover premiums: A review. *Journal of Corporate Finance*, 15, 149-178.

PART IV: HUMAN CAPITAL

L10 Agency and compensation (MH)

Introduction:

Incentive based compensation schemes are often used in trying to align managerial and investor interests. This opens up for gaming opportunities. This lecture focus on earnings based compensation schemes in particular, and relates to the literature on earnings management. Earnings management can be performed by manipulating accruals directly, or by altering real activities with the purpose to influence the outcome in reported earnings.

Important lessons:

Incentives work, but not always as intended.
Accruals management and real earnings management act as substitutes.

Readings:

Bebchuk, L.A., Fried, J.M. (2003). Executive Compensation as an Agency Problem. *Journal of Economic Perspectives*, 17, 3, 71-92.

Goergen, M., Renneboog, L. (2011). Managerial compensation. *Journal of Corporate Finance*, 17, 4, 1068–1077.

Graham, J.R., Harvey, C.R., Rajgopal, S., (2005). The economic implications of corporate financial reporting, *Journal of Accounting and Economics*, 40, 1–3, 3-73.

Optional readings:

Chan, L. H., Chen, K. W., Tai Yuan, C., Yangxin, Y. (2015). Substitution between real and accruals-based earnings management after voluntary adoption of compensation clawback provisions, *Accounting Review*, 90, 1, 147-174.

L11 Employee stock options (MH)

Introduction:

Employee stock options (ESOs) have become important part of executive compensation over the past several decades. The main objective with this form of executive compensation is to reduce agency problems between managers and owners. However, one problem with the use of ESOs is that it is difficult to value at the time they are granted. In this lecture we will examine valuation techniques of ESOs that are practical and easy-to-implement. Another problem with the use of ESOs is that they may provide executives with some strategic loopholes that increase the possibility of agency problems between insiders and outside minority shareholders. Such strategic loopholes are said to lead to "dating games". The second aim of this lecture is to examine the mechanics behind such strategies.

Readings:

Damodaran, Aswath, 2005, Employee Stock Options (ESOPs) and Restricted Stock: Valuation Effects and Consequences, Working paper, Stern School of Business, New York University.
Hull, John and White, Alan, 2002, How to value employee stock options? Working paper, Joseph L. Rotman School of Management, University of Toronto.
Kulatilaka, Nalin and Marcus, Alan J., 1994, Valuing employee stock options, Financial Analyst Journal, 46-56.
Narayanan, M.P., Schipani, Cindy A., and Seyhun, H. Nejat, 2007, The economic impact of backdating executive stock options, Michigan Law Review, 1597-1642.