Finance 555: Financing Decisions, Payout Policy and Corporate Control
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Office Hours: W 5:30-6:30, Th 1:30-2:30 and by appointment

This course provides a general economic and financial framework for analyzing the effects of financing decisions, as opposed to investment decisions, on corporate value. The material extends and enhances the frameworks covered in the Core Finance component and other Finance courses. Specifically, we will study decisions involving capital structure, payout policy, management compensation, ownership structure, and the distribution of control rights – virtually anything related to the way that contracts are structured within the corporation.

This class parallels much of the subject matter of Finance 552 (but not financial planning, which 552 does cover). There is a large difference of approach, however, between the two classes. While Finance 552 works on getting the students to apply the principles that they learned in the Core classes, the focus of this class is to extend the frameworks developed there. Finance 555 will also do some application, but it will primarily be application of this new material.

The class will be heavily based on microeconomic principles. You will be required, for example, to understand analysis using indifference curves and budget lines. If you did not get this from your core microeconomics class, you should study this on your own – Evening MBA students get this in the core, and there is no time to re-teach it for a limited group.

Readings
There will be a required textbook, Berk and Demarzo’s Corporate Finance, 3rd edition, which is abbreviated BD below. It is a classic textbook, and anyone serious about finance should own it or a close substitute. I understand that most of you have a copy of the first 19 chapters of the book which is packaged as “The Core” in a separate book. If you don’t have this, you should buy it. We will read some extra material from the book, which will be in the course pack for the class.

Because the course investigates new theories and goes into much more detail than BD in some areas, the class will not be primarily textbook based. Instead there will be other readings that will be required, and class handouts will be used to supplement the material when necessary. In addition there will be optional readings that should be read by students with a specific interest in a topic. Class handouts are required reading. A course pack will be available from the University Readers website (https://students.universityreaders.com/store/) that contains other required readings. Optional readings will be available through the library, with some on reserve. Some newer readings can be found on www.ssrn.com, www.jstor.org, or other library resources when accessed from the library terminals (or from home through the library website).

Required Work and Evaluation
Evaluation in this course will be determined by written assignments, class participation, and examinations. The percentages for grading will be

- Written Assignments: 25%
- Class Participation: 10%
- Midterm: 30%
- Final: 35%
Written Assignments will be two write-ups done about cases and two or three homeworks. Students will work in groups on the cases, with two to five people in a group. Homeworks must ultimately be done individually, although I recommend that students discuss how to approach the questions with fellow students. Cases are available for purchase (download or hard copy) from Harvard at http://cb.hbsp.harvard.edu/cbmp/access/62805009.

Class Participation grades will be determined primarily by the quality of participation and also somewhat by student attendance.

The examination questions will usually require a student to apply the course material to potential or actual circumstances. Some of these questions will be set in relatively unstructured situations. They will thus test whether you can discern the correct concepts to apply, as well as whether you can apply these concepts correctly. Exams will be closed book and closed notes. Some key formulas will be written on the face of the exam to alleviate the urge to memorize.

Students should read the required material before the class covering that material. Reading the required material before class should enable you to make the most out of the lecture. All students are responsible for the material covered in class, as well as the material in the handouts and required readings for each class, regardless of whether they attend the class.

Other Matters: Attitudes, Inflexibility, and Idiosyncrasies

A few matters that may concern students relate to my philosophy towards teaching, classroom sessions, and grading. First, I enjoy teaching itself -- that is, communicating ideas to students eager to learn. Teaching is one of the two key inputs in the production of your knowledge. I get a thrill from having an impact on the way many bright young people will think and act. I also usually learn quite a few things from the students in the process.

Different teaching techniques seem to work best for different teachers. I find my teaching to be most effective when students actively participate in class. This means that students must think along with me during class sessions. There must be substantial student-teacher interaction--typically through student questions, comments, and answers to my questions. Students should have a strong impact on the class session.

The worst part of teaching is the grading and evaluating required of teachers. Grading consumes a large portion of professorial time and student attention despite the fact that, in the long run, grades are of little importance to anyone. Consider how disproportionate the time spent on grades is, given that seldom does anyone ask about your grades once you have been out of school for more than a year or two. (As proof of this latter proposition, consider my own situation. When I took introductory MBA Corporate Finance, I received the equivalent of a C. Yet in my first 25 years at UW no one asked me about this grade, or any other grades, when deciding whether I should teach this class.) De-emphasizing grades and emphasizing learning would seem to be in the interest of all of us.
Finally, I expect all of us in the class to behave responsibly. People who behave irresponsibly, imposing costs on others, should expect to bear the consequences of their actions. These attitudes, and other factors, give rise to the following policies:

1. I will use graders to do most of the grading, but will make sure that any grader is highly competent.

2. I will be happy to go over exam questions with students to explain the correct answer and/or where they went wrong. However, I refuse to listen to grade complaints. Complaints are almost always unsuccessful and a waste of everyone's time. In over two decades of teaching, never has a student complaint caused me to change a grade I have given (except when scores were added incorrectly).

3. I will expect all students to be prepared for class and to turn in assignments on time. Similarly, students can expect me to be prepared for class and to present them with assignments, handouts, and course materials on time.

4. I will encourage students to ask questions and otherwise participate in class. In some instances, "votes" on particular questions will be taken. All students will be expected to vote.

5. Students should focus on the class session during class. They should not have laptops open in class, unless they have received special approval from the instructor.

**Topic Outline -- (Dates are approximate)**

Goals, the Nature of the Firm, and Tool-Building – March 27 and 29
♦ The Firm as a Nexus of Contracts
♦ Wealth Creation by the Firm
♦ Fisher Diagram
♦ Alternative Firm Goals
♦ Stakeholders and the Firm
♦ States of the World Models and Pricing

**Required:** Class Handouts
Brealey and Myers, *Principles of Corporate Finance*, Chapter 2, 2nd ed.

BD -- Sections 3.3 and 21.3 (although 21.3 has a different context)
Capital Structure with Fixed Investment Decisions – April 3 to April 19

- Perfect Markets (M & M)
- Weighted Average Cost of Capital
- Corporate Taxes
- Personal Taxes
- Financial Distress Costs
- Signaling

**Required:** BD Ch. 14 and 15 and Sections 16.1-16.4

**Written Assignment:** Bed Bath and Beyond Case (due April 17)

Capital Acquisition – April 24 and 26

- Overview of Financing Alternatives
- How Securities are Issued
- Stock Price Reactions to Capital Structure Decisions
- The IPO Market

**Required:** BD Ch. 23, Section 16.8


BD Ch. 24

**MIDTERM EXAM – May 1**

Capital Structure Theory with Informational Inefficiency and Costly Arbitrage – May 3

- Market Inefficiency and Arbitrage Costs
- Recent Evidence
- Implications for Capital Structure

**Required:** BD Section 13.6


Ikenberry, Lakonishok, and Vermaelen, 1995, “Market Underreaction to Open
BD Ch. 13 (other than 13.6 which is required)

Dividend Policy with Fixed Investment Decision – May 8 and 10
♦ Perfect Markets (M & M)
♦ Personal Taxes
♦ New Issue Costs
♦ Portfolio Rebalancing Costs
♦ Signaling
♦ Why Our Theories Do Not Give Valuable Decision-Making Guidance

Required: BD Ch. 17


Agency Problems and Changes in Investment due to Financial Structure - May 15 to May 31
♦ Agency Theory
♦ Agency Costs of Debt
♦ Agency Costs of Equity
♦ Agency Costs and Dividend Policy
♦ Financial Contracting
♦ Management Compensation

(Beginning up to figure 1 – remaining is optional).
BD Sec. 16.5-16.7, 16.9
Murphy, 2012, “Executive Compensation: Where We Are, and How We Got
There,” Handbook of the Economics of Finance, pp. 1-42, 128-156.

Written Assignment: Kennecott Copper Case (due May 22)


BD Chapter 29

**FINAL EXAM – During Finals Week (June 5-9) to be arranged**