

Introduction to Recent Developments in Corporate Finance

Recent Developments in Corporate Finance

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This volume reprints 24 articles from the recent corporate finance literature. The articles reflect my tastes, but I have relied on the input of others, especially as reflected in the annual voting for “best paper” prizes that all of the leading journals now award. Some of the papers reprinted here have been certified as “instant classics” through winning a Smith Breeden or Brattle prize at the *Journal of Finance*, a Jensen prize at the *Journal of Financial Economics*, a Brennan prize at the *Review of Financial Studies*, a Merton Miller prize at the *Journal of Business*, a Sharpe prize at the *Journal of Financial and Quantitative Analysis*, or an Addison-Wesley prize at *Financial Management*. But not all of the reprinted articles are award winners, and not all of the award-winning papers are reprinted. The balloting for the awards is done shortly after the articles are published, and sometimes it is difficult to know how influential a paper is until several years, or more, have passed. Because only 24 articles are reprinted, many deserving articles had to be passed up.

Michael Brennan has edited two previous volumes in this series, *The Theory of Corporate Finance*, containing 46 articles published prior to 1995, and *Empirical Corporate Finance*, containing 72 articles published prior to 2000. Consequently, this volume focuses on recent articles, although I have included some articles that were published in the late 1990s but were not included in these previous volumes. But I have been loath to go too far back, since the title of this book includes *Recent*.

Several patterns distinguish the 24 articles reprinted (in **boldface**) here from the 118 corporate finance articles published in the two prior volumes. Some of the topics covered by Brennan’s subject headings, specifically that of shareholder objective functions (“shareholder unanimity”), have faded as research topics. The most noteworthy pattern, I think, is the relative paucity of important theoretical articles in recent years, a pattern also noted by Zingales (2000). There is no equivalent of Myers and Majluf (1984) in recent history. This absence partly reflects the natural tendency for researchers to tackle the most important topics first, and as a field matures it becomes more and more difficult to produce a seminal article.

Moral hazard models, commonly referred to as agency models, comprise a subset of asymmetric information models. Notable in recent research is a decreased emphasis on asymmetric information and contract design (normative agency theory), and an increased emphasis on positive analyses of agency problems. Normative agency theory addresses how agency problems can be reduced, while positive agency analysis addresses the problems associated with incomplete contracts. This change in emphasis is reflected in Jeremy Stein’s

“Agency, Information, and Corporate Investment” chapter in the *Handbook of the Economics of Finance* (2003), edited by George Constantinides, Milton Harris, and René Stulz.

The recent corporate finance literature reflects two major evolutionary trends, and two rather significant departures from prior work. One major trend is the integration of industrial organization theories into finance. This linkage is obvious when one is discussing the motivations for mergers and acquisitions or the advantages and disadvantages of internal capital markets. The second major trend is the continued refinement of ideas related to the impact of taxation on corporate decision making, especially in the areas of capital structure and payout policy, but also in the area of executive compensation. In this later area, an unresolved question continues to be the implications of executive stock options for incentivizing managers.

One of the sharp departures from prior paradigms is the literature’s increased focus on law and finance, especially on corporate governance issues. The second sharp departure is evidenced by many authors’ willingness to adopt behavioral approaches, including a willingness to assume that informational inefficiencies are an important determinant of managerial choices. Put another way, researchers today are more willing to explore the implications of market inefficiencies than were researchers in earlier periods.

What accounts for the increased willingness of researchers to drop the assumption of market efficiency? Partly the October 1987 market crash, partly the Japanese stock market bubble of the 1980s, and partly the worldwide TMT (technology, media, and telecom) bubble of the late 1990s. Furthermore, Shleifer and Vishny’s 1997 “Limits to Arbitrage” article exposed the shaky foundation on which the efficient markets hypothesis rests. My own summary of the empirical evidence on market efficiency is that the market gets the little things right, but sometimes gets the big things wrong.

The stock market bubble of the late 1990s, in my opinion, is the financial economics equivalent of the Great Depression to macroeconomics—an outlier event so huge, and so difficult to explain within the context of the framework that explains investor behavior most of the time, that it will affect future empirical studies dramatically.

In addition to changes in its underlying theoretical paradigms, the corporate finance literature has also experienced several notable methodological changes. Recent work in empirical corporate finance increasingly uses not only stock return data (e.g. CRSP), but also accounting data (e.g. Compustat), and forward-looking information (e.g. I/B/E/S). Datastream, Global Vantage, Thomson Financial Securities Data’s global new issues database, and the PACAP databases have also increasingly been used.

Empirical corporate finance papers have become increasingly sophisticated in their econometric approaches. Most corporate financing events are endogenous. Firms are not forced to repurchase shares, or issue equity, or acquire another firm. These events are all managerial choices. Recent papers commonly control for the endogeneity of right-hand side variables in regressions by using a two-step procedure with an instrumental variable. In an instrumental variables approach, a first-stage regression is run to predict the value of an endogenous variable. In the second stage, the predicted value is used as an explanatory variable, rather than the actual

value of the variable. Unfortunately, in practice there is a genuine problem with a lack of robustness in many applications. So researchers frequently face a situation in which either 1) controlling for endogeneity has little impact on the qualitative conclusions, or 2) if it does have an impact, the robustness of the results is uncertain.

The articles in this book could be arranged in several different ways: for example, by topic (payout policy, capital structure, corporate governance, etc.), by methodology (asymmetric information, contracting, behavioral, empirical, etc.), or by imperfection (taxes, contracting costs, etc.). I have chosen to arrange articles by topic, with five topics covered: capital structure, securities issuance, payout policy, corporate governance, and diversification. Within each topic, I have listed articles in chronological order. I now briefly discuss each of these five topics.

Capital Structure

Capital structure research has gone through three phases in the nearly half-century since Modigliani and Miller's (1958) pioneering work introduced arbitrage proofs into finance. Modigliani and Miller assume market efficiency and treat operating decisions as exogenous when analyzing corporate finance decisions. The first phase of research focused on relaxing assumptions regarding the "perfect market" assumptions about taxes, bankruptcy costs, and starting in the late 1970s, asymmetric information. Theoretical developments in the 1980s were affected by the increasing use of game theory in corporate finance. In this golden age of asymmetric information models in finance, the assumptions of exogenous operating decisions and semi-strong form market efficiency (that is, securities prices correctly reflect the value of all publicly available information) continued to prevail.

The second phase of capital structure research began with the publication of Jensen and Meckling (1976) and Myers (1977). The takeover battles of the 1980s, and Jensen's (1986) free cash flow analysis suggesting that financial policy's effect on managerial incentives was the primary motivation for leveraged buyouts and debt-financed takeovers, changed the paradigm. The dependence of operating decisions on financial policy is explicit in the literature on contracting and on product market-financial structure interactions. But almost all of the analysis maintains the assumption of semi-strong form market efficiency.

The third phase of capital structure research dropped the assumption of market efficiency. Following the publication of my own paper on the long-run performance of initial public offerings (Ritter (1991)), many papers have examined corporate financial decisions where existing shareholders can create value for themselves not only by having the firm undertake positive NPV projects, but also by timing external financing decisions to take advantage of time-varying relative costs of debt and equity caused by market inefficiencies. Many studies have found long-run abnormal returns following corporate events, unlike the zero average abnormal returns that should characterize an efficient capital market.

Capital structure remains one of the most important focuses of corporate finance research. In this volume, a number of articles with a strong behavioral finance viewpoint are reprinted. **Graham and Harvey (2001)** survey practitioners about their views on capital structure, securities issuance, payout policy, and other central questions of corporate finance. In

general, the practitioners' opinions reflect tax and other traditional textbook views of the forces shaping these financial decisions. But the respondents also report strong support for market timing based upon temporary misvaluations, a consideration dismissed in most textbooks.

Heaton (2002) develops several predictions based on the simple, but plausible, assumption that managers are overoptimistic about their abilities and their firm's prospects. He predicts that managers are loath to issue equity because they think that their firm is undervalued, and that they are inclined to acquire other firms because they think that their superior managerial abilities will create value.

Baker and Wurgler (2002) demonstrate that a firm's debt ratio today is heavily dependent on its market-to-book ratios in the distant past. They interpret this finding as consistent with firm's successfully timing the market to take advantage of overvalued equity, whereas in a Myers and Majluf (1984) asymmetric information world with rational markets, the announcement of a stock price issue would cause the market price to fall to the point where there is no longer an overvaluation to exploit. Baker and Wurgler and Welch (2004) both argue that, as with the pecking order theory of capital structure, inertia is of first-order importance in explaining observed capital structures. Welch emphasizes that when a firm's stock price increases, lowering the ratio of debt to the market value of equity and debt, firms do little to offset the decline in the debt ratio, even over many years. Baker and Wurgler emphasize that when a firm's stock price increases, it is likely to issue equity rather than debt, lowering the debt ratio not just temporarily but, for all practical purposes, permanently.

While an active literature in recent years deals with the determinants of capital structure, relatively little work considers what managers *should* consider in setting capital structure. This paucity of analysis is apparent in textbooks, which contain few prescriptions on how to determine the optimal debt ratio for a firm with specific characteristics. One of the few papers that tackles the difficult issue of what managers should do is **Stein (1996)**. If there are market inefficiencies that permit a manager to, in some circumstances, issue overvalued stock or buy back undervalued equity, Stein identifies the managerial decision rules. He argues that what a manager should do depends upon 1) whether the firm is financially constrained or not, and 2) whether managers have a short-term or long-term objective function. If a firm is financially constrained, then repurchasing undervalued stock may mean foregoing a positive net present value investment opportunity.

Although some of the most exciting recent work on capital structure and securities issuance has dropped the assumption of market efficiency, traditional approaches remain relevant. While the traditional static model of capital structure that trades off the tax advantage of debt financing and the costs of financial distress has been with us for some time, most textbooks have little to say about the empirical estimates of these two factors. Recently, however, two important studies have attempted to remedy this deficiency.

Graham (2000) estimates that the present value of the tax benefits to debt financing for a typical U.S. corporation is in the vicinity of 10 cents per dollar of debt, although taking personal taxes into account halves the number. These estimates are far below the statutory corporate tax rate of 35%, but reliably above zero.

Andrade and Kaplan (1998) study highly levered transactions in which the buyers overpaid and quickly defaulted even though the companies' operations were still fundamentally sound, and estimate financial distress costs to be 10 to 20 percent of firm value. These estimates are higher than previous estimates in the capital structure literature. However, Andrade and Kaplan argue that the *expected* costs of financial distress for most public companies must be modest (if not minimal), as the probability of financial distress is very small for most public companies.

Financial slack is an important choice variable for a firm in the presence of agency problems or, more generally, asymmetric information. Opler, Pinkowitz, Stulz, and Williamson (1999) investigate the determinants and implications of corporate cash holdings. They interpret their findings as consistent with excessive caution on the part of corporate managers, with only slight tendencies to boost payouts or spend cash on acquisitions. As of the writing of this introduction, there is much speculation in the financial press as to why Microsoft has accumulated a cash hoard approaching \$40 billion.

Securities Issuance

Mayers (1998) applies Schultz's (1993) analysis of unit equity offerings as staged financing to the convertible bond market. Both Schultz and Mayers argue that, if managers have a tendency to invest capital that is provided to them, value can be created by contracts that force the exercise of the abandonment option when a firm's future prospects look bleak. With unit equity offers, unit holders will only exercise the warrants, and in so doing provide additional capital, if the stock price is above the exercise price at maturity. With convertible bonds, the firm will be forced to pay back the principal at maturity unless the stock price is high enough that convertible bondholders decide to convert their bonds into stock instead. Both papers are examples of agency-theoretical thinking applied to rationalize financial instruments that are observed in practice.

The asymmetric information framework heavily influenced the academic literature on securities issuance throughout the 1980s and into the early 1990s. In recent years, agency issues have come to the fore. Partly this reflects the role of investment bankers and their analysts in the stock market bubble of the late 1990s. The papers by **Dunbar (2000)**, **Krigman, Shaw, and Womack (2001)**, and **Loughran and Ritter (2002)** all discuss interactions between equity issuers and their investment bankers.

The academic literature on how companies going public choose their lead underwriter has long assumed that maximizing expected proceeds was an important part of firms' objective functions. The hypothesis that issuers would avoid underwriters that underpriced more than the minimum amount needed to attract investors continued to be the dominant academic framework until Dunbar showed that underwriters employing *Institutional Investor* all-star analysts subsequently gained market share. Krigman, Shaw, and Womack's survey evidence confirms this finding, and recent empirical work by Loughran and Ritter (2003) and Cliff and Denis (2004) suggests that choosing an underwriter based on expected analyst coverage became even more important in the late 1990s. Cliff and Denis show that underwriters with highly ranked

analysts are compensated via greater underpricing of these issues, rather than higher direct fees. Loughran and Ritter argue that the underpriced IPOs were allocated to clients willing to provide commission business in return. I predict that the interaction of analyst recommendations with corporate financing activity will continue to be a major topic of research for years to come.

Ritter and Welch (2002) survey the recent IPO literature, and argue that research on share allocation is the most important current research topic in this area. Jenkinson and Jones (2004), using data from the U.K., report that there is little evidence supporting the book-building theories that dominate the academic literature. These articles are part of the larger debate about whether the high IPO underpricing in 1995-2000 is largely due to agency problems between issuing firms and underwriters (Loughran and Ritter) or can be explained in terms of rational tradeoffs between underpricing, gross spreads, and other considerations (**Ljungqvist, Jenkinson, and Wilhelm (2003)**).

Payout Policy

Payout policy reflects two choices: how much to pay out, and in what form to pay it out. In the United States, until 1984 these two issues were largely one and the same, since repurchases were relatively uncommon. But starting in 1984, repurchases increased substantially. In other countries, repurchases are also more common than they used to be, although they are still prohibited in some countries due to concerns about stock price manipulation or preferential treatment of some shareholders. The articles by **Dittmar (2000)** and **Jagannathan, Stephens, and Weisbach (2000)** examine the form of cash payouts to shareholders. Both articles conclude that there is not a single reason determining the form of payout, although both managers and investors view dividends as permanent commitments and share repurchases as transitory cash disbursement mechanisms.

Both Dittmar and Jagannathan *et al.* examine whether executive stock options affect the form of payout. Executive stock options are almost never dividend protected, and consequently an option will fall in value if a dividend is paid whereas it will not fall in value if cash is used to repurchase shares. Lanen, Lambert, and Larcker (1989) appear to be among the first to address this asymmetry as a determinant of the form of payout, but it was not until almost a decade later, after the granting of executive stock options had exploded, that other academics began to focus on this issue.

While repurchases have become commonplace, **Fama and French (2001)** find that a smaller and smaller fraction of publicly traded firms in the U.S. are paying cash dividends. DeAngelo, DeAngelo, and Skinner (2004) document that while fewer firms now pay cash dividends, the inflation-adjusted level of aggregate dividends continues to increase. They show that a small number of large and mature companies accounts for an ever-increasing share of aggregate dividends. Both of these papers document that money-losing firms are unlikely to pay dividends, and that an increasingly large fraction of publicly traded firms in the U.S. have negative earnings. Because aggregate dividend payments have not declined in the last two decades, and share repurchases have increased dramatically, the fraction of corporate earnings paid out to shareholders has been at levels far above historical averages for the U.S.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) address the choice of how much to pay out, using data from dozens of countries. They test whether firms pay dividends in order to establish a reputation for giving investors a fair rate of return (thus allowing firms to raise additional external capital) or because public investors have the legal power to discipline managers who retain, and possibly divert, cash flows. Their evidence does not favor the reputation model of payouts.

Corporate Governance

Agency problems exist between shareholders and debtholders, managers and shareholders, and between minority and controlling shareholders. In recent years, the conflict between minority and controlling shareholders has been the major focus of attention in the academic literature (although the literature on bankruptcy is a notable exception). The three major forces inducing corporate managers to act in the interests of non-controlling investors are product market competition, the market for corporate control, and internal control mechanisms. Jensen (1993) forcefully argues that internal control mechanisms, specifically the board, are largely ineffective at controlling managers.

Following the bursting of the stock market bubble that peaked in March 2000, a number of scandals involving massive accounting fraud by large U.S. corporations came to light. One effect of these scandals was to reduce the hubris that commentators on U.S. capital markets had developed, just as the bursting of the Japanese stock market bubble a decade earlier ended the uncritical lionization of Japanese business practices. The U.S. has seen increased criticism of excessive compensation paid to top corporate executives, calls for greater honesty in accounting by expensing employee stock options, and calls for improved corporate governance following the failure of boards of directors to address these problems adequately at the firm level.

Real world events have a strong influence on academic research, although frequently with a multi-year lag. In the 1980s, a large number of articles were published that focused on takeovers and corporate governance issues. By the late 1980s, almost all U.S. firms had adopted effective anti-takeover provisions and several court rulings upheld state laws favoring incumbent management. As a result, hostile takeovers became almost non-existent in the 1990s, and the market share of this strand of the literature fell dramatically. One rationale for anti-takeover provisions is to increase the bargaining power of incumbent shareholders if a takeover is attempted. Field and Karpoff (2002), however, find that subsequent takeover premiums are no different for the firms that already have these provisions in place at the time of going public than for those that don't.

Most of the empirical articles from the 1980s and early 1990s focused on the U.S., although a subset analyzed the merits of the German-Japanese bank-centered financial system versus the Anglo-American capital markets-centered financial system. In recent years, the literature places more emphasis on comparing countries with the most developed capital markets to countries with less developed capital markets. Partly, this change reflects the growing quantity and quality of research emanating from Asian and European business schools.

But mainly it reflects the impact of a series of influential papers by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, better known as LLSV, some of which are reprinted in this volume. **Shleifer and Vishny (1997)** point out that the financial markets in the U.S., the U.K., Germany, and Japan are among the best-working in the world, and raises the question why the financial markets in so many other countries are not as well developed. They focus on the law and its enforcement across countries, and in a series of empirical papers with LaPorta and Lopez-de-Silanes, Shleifer and Vishny argue that the strength of property rights enforcement explains much of the choice between private versus public capital markets and the ownership structure of the firm. Denis and McConnell (2003) survey the recent literature on international corporate governance. They divide the literature into “first generation” (pre-LLSV) and “second generation” (post-LLSV) papers. The first generation is largely patterned after the U.S. literature that precedes it, whereas the second generation focuses on the impact of different legal environments across countries.

Corporate governance is of particular concern in the rapidly growing countries of East Asia, and **Claessens, Djankov, and Lang (2000)** examine the effects of separation of ownership and control for East Asian firms. They find that the managements of East Asian corporations are separated from ownership, but not from control, due to complex pyramid structures and cross-holdings. They report that more than two-thirds of East Asian firms are controlled by a single shareholder.

A vast literature investigates managerial ownership and insider trading. In the U.S., insider transactions have long been required to be disclosed by the Securities and Exchange Commission, which also requires disclosure of derivative transactions by executives, such as buying put options or contributing shares into an “exchange fund.” Before November 2002, derivative transactions were not required to be filed electronically. This and other disclosure shortcomings imply that a portion of insider selling has not been reliably and consistently reported. **Bettis, Bizjak, and Lemmon (2001)** track down derivative transactions that shield insiders from the economic consequences of a stock price decline. For a small set of firms with complete data, they find that top executives in the U.S. have 25% less exposure to the wealth consequences of a share price decline than conventionally calculated.

Diversification and Internal Capital Markets

The modern literature on internal capital markets and financial constraints started with Fazzari, Hubbard, and Petersen (1988), who find that a firm’s investment in year t is strongly related to its operating cash flow in year t . The authors interpret their evidence as showing that firms act as if external capital markets perform poorly in allocating funds to the highest valued uses. If this is so, the conglomerate form of organization can create value via capital allocation. Building on Oliver Williamson’s work from the 1970s, **Stein (1997)** shows that under certain circumstances internal capital markets are more efficient in allocating resources than external capital markets. More specifically, headquarters can allocate resources to their best use if managers have the information, incentives, and authority to engage in “winner-picking” among several divisions that compete for scarce corporate resources.

Despite these theoretical arguments for why diversification by firms can create value, Lang and Stulz (1994) and Berger and Ofek (1995) document that diversified firms sell at a discount relative to “pure play” undiversified firms. Berger and Ofek measure the sum of stand-alone values for individual business segments to the firms’ actual values, and report a 13% to 15% average loss from diversification during 1986-1991. They show that overinvestment and cross-subsidization contribute to the value loss and that tax benefits of diversification are too small to offset the value shortfall.

These empirical papers initiated a stream of research addressing why internal capital markets might generate an inferior allocation of capital. **Rajan, Servaes, and Zingales (2000)** argue that efficient internal capital market models do not explain the misallocation of resources to divisions with poor opportunities. Lamont (1997) examines the investment of non-oil divisions of oil companies and suggests that “socialism” is rampant in diversified firms as divisions with robust cash flows subsidize those with poor cash flows. Rajan, Servaes, and Zingales develop a theoretical model in which divisions in a firm influence the distribution of resources through negotiations. Their model demonstrates that internal power struggles can distort resource allocation decisions. They test the predictions of the model and show that the value of a diversified firm declines as the diversity of resources and opportunities between divisions increases.

Recently, a number of papers argue that the lower value associated with diversified firms and the decision to diversify may not be causally related but merely reflect firms’ endogenous choices. Lamont and Polk (2002) examine the valuation effects on individual diversified firms when there are changes in the investment of other firms in a division’s industry. They conclude that diversification destroys value, even after controlling for potential endogeneity problems. **Graham, Lemmon, and Wolf (2002)** adopt another approach, however, and present evidence that much of the discount is due to the acquisition of underperforming divisions. If mature firms with few other growth opportunities diversify by acquiring castoffs from other firms, one would expect to see low valuations (discounts) even though diversified firms do not create the inefficiencies. Campa and Kedia (2002) also conclude that the diversification discount is attributable to self-selection. Villalonga (2003) summarizes the issues, and concludes that there is little reliable evidence showing a statistically significant diversification discount that is directly attributable to management actions.

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