An Economic Analysis of Leasebacks

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Abstract. Leaseback decisions by firms involve the simultaneous sale of an asset and a lease agreement with the new owner. Examination of 64 leaseback decisions made by firms during 1979-1987 reveals a significant negative announcement effect. We present a theoretical framework in which all firms prefer to leaseback when there is symmetric information. When there is asymmetry of information between the manager and the market, however, firms with favorable prospects prefer to own the asset. Firms with poor prospects choose to leaseback and capture the associated depreciation tax shield through the sale. Our empirical results indicate that, besides the significant negative announcement effect, firms proposing a leaseback earn negative returns in the three months prior to the announcement. We monitor the performance of these firms for five years after the leaseback decision and compare it to five years before the announcement. There is a significant drop in operating performance as indicated by several key variables such as operating earnings before depreciation and pretax earnings. This is consistent with the hypothesis that firms choose to leaseback when faced with unfavorable future prospects.

Key words: leaseback decisions, announcement effects, information effects

1. Introduction

A leaseback involves the simultaneous sale of an asset and an agreement to lease it from its new owner. The firm continues to make productive use of the asset but does not own it after a leaseback. The transportation industry has followed this practice for a long time with leasebacks involving airplanes, supertankers, etc. Some of these arrangements, however, were pseudo-leasebacks in the sense that a firm owned the asset for all of ten minutes before a sale/leaseback arrangement was signed with, say, a financial institution. Recently, however, the leaseback of an asset, owned for a length of time, has become much more prevalent with leasebacks involving real estate assets, corporate offices, nuclear power plants, and other heavy plants and equipment.

From the corporate finance perspective, an important issue concerns the timing of a leaseback decision. Under what conditions would a firm choose to leaseback an asset rather than continue to own it? Leasebacks resemble voluntary selloffs by firms, which have been shown to be positive net-present-value decisions made by management. Leasebacks also have some similarities to simple leasing decisions, which again are positive net-present-value decisions, where the positive net present value results from the sharing of the associated tax shield between the lessor and the lessee. From this perspective, then, leasebacks can be viewed as positive net-present-value decisions made by firms.

Casual empiricism, though, suggests that leasebacks are generally resorted to by firms under a cash crunch. The news media talk about the liquidity needs of cash-strapped firms
and the attempts by management to show increased earnings and book profits. Also of concern to the financial community is the attempt by management to increase earnings-related salaries at a cost to shareholders.

This article presents both a theoretical and an empirical analysis of the leaseback decision. In our two-date model, we examine two different scenarios. In the first case, we assume symmetric information between the manager and the market. We show that, given a competitive market for leasebacks, all firms would prefer to leaseback rather than to own an asset. Intuitively, firms would prefer to sell the depreciation tax shield in the market rather than take the risk of not being able to use it in the future due to the uncertain payoffs. In the second case, we assume asymmetric information. The manager receives a private signal on the final payoff. In case the signal indicates a large probability of a high payoff, the manager prefers to separate her firm from the pool of average firms. As opposed to this, indication of a low final payoff means a high probability of the tax shield being wasted. In this case, the decision to leaseback, rather than to continue to own the asset, is optimal. The manager, when making the decision to leaseback, is aware that the market can read her information in a fully revealing equilibrium. This can result in a lower stock price today, even after adjusting for the sale of the tax shield, since the market assesses a lower probability of a high payoff. It is, however, optimal to leaseback because the benefit from the leaseback (the sale of the tax shield) exceeds any loss in shareholder welfare due to the reduced stock price today.

We do an empirical analysis of 64 firms that announced a leaseback during the period 1979–1987 after owning the asset for at least one year. The methodology we use to conduct an empirical test of our model is based on a test of signaling models suggested by Thompson (1985) and Acharya (1988). As opposed to a standard event study, this empirical method provides unbiased estimates of excess returns around the announcement date. Consistent with our theoretical model, the evidence indicates a significant negative two-day abnormal return of −0.52% of firms announcing a leaseback. Specifically with reference to our model, there is information in a leaseback announcement about the poor future prospects faced by the firm. A cross-sectional analysis indicates a close relationship between the two-day abnormal returns around the announcement (measured both as a percentage and in dollar amounts) and the firm's implied tax rate as well as the depreciation tax shield foregone due to the leaseback.

To examine the cumulative abnormal performance around the announcement, we also use standard event study methodology. The results indicate that the firms accumulate significant negative abnormal returns in the 60 days prior to the leaseback announcement month. This is consistent with the hypothesis that the firms choosing to leaseback experience a downturn in prospects just prior to the leaseback decision. The leaseback announcement reinforces these beliefs with a significant negative two-day abnormal return of −1.1%.

We monitor the performance of firms that make the leaseback decision for the subsequent five years. This is compared to their performance over the five-year period prior to the leaseback. These results strongly support the hypothesis that the firms experience a substantial decline in performance. Operating income before taxes, pretax income, and total income taxes paid all decline significantly. Further, it is not surprising that there is a decline in the depreciation claimed, in total long-term debt, and in carrying value of equity. The ratio of total long-term debt to carrying value of equity, though, increases. These results lend