

Company Performance and Leased Assets in Sale-and-Leaseback Transactions

By Itzhak Ben-David

What is the relationship between the types of assets leased and the characteristics and performance of their lessees? Even though properties of leased assets determine the economics of leasing transactions, little empirical research has been dedicated to the topic. In particular, there is virtually no evidence of the relationship between the type of assets that a firm leases and its performance and prospects.

Sale-and-leaseback transaction data makes it possible to track how the type of assets leased relates to the growth prospects of the lessees. Those transactions are especially interesting for the purposes of this study, as the asset base of the firms involved in the transactions remain constant, whereas the financing changes.

Although the firms in the sample mostly engage in sale-and-leaseback transactions because they seek liquidity, a difference can be seen in the types of assets sold. Firms that are in good financial and economic shape use the proceeds to expand their business, often selling specific assets, like specialized equipment. On the other hand, firms with low margins and high leverage sell and lease back general assets, like offices. On average, firms that sell general assets decline in growth after the transaction, whereas firms that sell specific assets are, on average, in a strong growth stage.

These results are interpreted as reflecting an outcome of market forces. Because the expected costs of redeploying assets vary across assets and firms—depending on the degree of specificity of the assets and the probability of default—poorly performing firms may find it too expensive to lease very specific assets and may prefer other financing arrangements. Hence, good firms can afford leasing specific assets, whereas bad firms can afford leasing only general assets. This information can help lessors understand better

the economics of the leasing market when pricing leasing contracts.

GENERAL AND SPECIFIC ASSETS

“Specific assets” is the term used to describe assets that are designed and fitted to serve the needs of a specific user. Because of their specificity, these assets have low value in an alternative use. Examples of specific assets are machinery fitted specially for a plant, or communication equipment that was designed to meet the requirements of a specific service provider.

On the other hand, “general assets” can be used by a broad range of users with few if any adjustments, such as trucks, airplanes, or offices. Some assets may be general within an industry, but specific between industries, such as refrigerated trucks. Other assets have much broader use, like headquarters and offices; these assets can be used across a broad range of industries without material adjustments.

Why should a lessor care about the specificity of the asset that it finances? Because the more specific an asset is, the harder it will be to refit it for resale. When pricing lease contracts, the lessor takes into consideration the possibility that the asset would revert to it at some point in the future: either at the end of the lease or, in the case of forced foreclosure, due to inability to pay the lease payments. If an asset is highly specific, buyers will pay low prices for it at the time of a resale.

To compensate for this loss of value in adverse situations, lessors would demand high price at the outset. In turn, if the leasing price is too high, potential lessees might prefer to own their specific assets rather than to lease them. General assets, like trucks or ships, have liquid secondary

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markets, so the potential loss for the lessor is relatively small.¹

LEASING AND GROWTH PROSPECTS

Lessors care more about growth prospects when the chances of bankruptcy of the lessee are high. If a firm is in good financial health and the chance of default is miniscule, then the value of its leasing claims should be almost insensitive to the growth rate. This situation changes when there is a chance that the firm will fail to fulfill its obligations under debt or leasing contracts. In those cases, growth prospects effectively increase the chances of the firm to escape bankruptcy, hence reducing the expected costs of reselling the firm's assets by creditors.

ANALYSIS OF SALE-AND-LEASEBACK TRANSACTIONS

This study uses a sample of sale-and-leaseback transactions to explore the relationship between growth prospects and the type of assets in leasing contracts. These transactions are ideal for the study, given that firms do not change their asset composition throughout the transaction. The data on sale-and-leaseback transactions was collected from international news items published by the news service LexisNexis in 1995, and 2000 to 2002. In these periods, there were news items about 638 transactions overall.

The sample is restricted to firms traded in the U.S. stock market and to news items that explicitly mention the type of the asset sold. Only 169 transactions satisfied these conditions. Note, however, that we use a broader subset of firms when analyzing the use of the proceeds from the transaction.

Overall, the data is biased toward large transactions, such as firms' announcements about transactions that involve sale-and-leaseback of offices, plants, airplanes, and utilities infra-

structure. Although some equipment transactions are included in the data, it is likely that many equipment transactions are not reported to the public due to their small scale. This selection in the data, however, should not hinder the analysis or the results. The economic rationale that drives real estate transactions should be applicable also to other tangible assets, including assets in smaller-scale transactions.

Why Do Firms Engage in Sale-and-Leaseback Transactions?

Previous literature has pointed out several potential motivations for firms to engage in sale-and-leaseback transactions. Based on a small set of transactions, Barris² reports the following motives for sale-and-leaseback transactions:

- a. raising funds
- b. diversifying funding sources
- c. improving efficiency
- d. enhancing occupational flexibility
- e. disposing of low-yield assets

Ezzell and Vora³ present evidence that sale-and-leaseback transactions are driven by tax-saving and reducing expected bankruptcy costs.

Nature of Assets Sold

To analyze the nature of the assets sold in the sale-and-leaseback transactions, we categorize the assets into broad categories. From the news reports, it was possible to identify several classes of assets:

- a. communication equipment (including communication towers, fiber optics networks)
- b. distribution centers (including warehouses)
- c. other equipment
- d. plants
- e. power plants
- f. headquarters
- g. offices

- h. general real estate
- i. retail (including restaurants, malls)
- j. transportation (including vehicles, vessels, aircraft)

For the purpose of the analysis, the first five items were considered specific assets, and the remaining items were treated as general assets.

How the Proceeds Are Used

Figure 1 breaks down the intended uses of the proceeds from the transactions. Most firms in the sample are motivated to engage in sale-and-leaseback transactions to overcome liquidity constraints: such as repaying debt (51.3%) and investing or expanding the business (23.5%). These results suggest that firms prefer leasing to borrowing because they can attain a higher loan-

to-value ratio by giving away the ultimate ownership of the asset to the lessor. Only 1.0% of the firms report that their motive for the sale-and-leaseback transaction is related to tax planning.⁴

Firms that engage in sale-and-leaseback transactions use the proceeds for a variety of corporate purposes. Figure 2 (next page) investigates the relationship between the type of asset sold and the intended purpose of the funds received. First, the sale-and-leaseback transactions are clustered by the type of assets sold and their specificity (rows). Then transactions are grouped according to the declared use of the funds. For example, uses like investment in expanding the business and acquisition are clustered as being motivated by “financing expansion.” The column heading “repaying debt” includes purposes that suggest situations of financial distress, debt

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Figure 1

TRANSACTION DECLARED MOTIVES

Declared Motivation	Number of Observations	Percent
Reduce debt	153	51.3%
Expansion	70	23.5%
Maximize the value of property assets	10	3.4%
Chapter 11 reorganization	9	3.0%
Increase liquidity	9	3.0%
Debt restructuring	7	2.3%
Financial distress	7	2.3%
Reduce operating costs	5	1.7%
Free up capital	4	1.3%
Working capital	4	1.3%
Concentrate on core activities	3	1.0%
Tax	3	1.0%
Downsizing	2	0.7%
Invest in core business	2	0.7%
Operational flexibility	2	0.7%
Reduce exposure to asset type	2	0.7%
Financial flexibility	1	0.3%
Improve capital adequacy	1	0.3%
Maintenance	1	0.3%
Management focus	1	0.3%
Pay dividends	1	0.3%
Reduce asset base	1	0.3%
Total	298	100.0%

Figure 2

ASSETS CLASSIFIED BY THEIR SPECIFICITY AND TRANSACTION DECLARED MOTIVE

	Repaying Debt	Neutral Motives	Financing Expansion
General Assets			
Headquarters	38 (23%)	7 (22%)	1 (2%)
Retail	18 (11%)	3 (9%)	8 (13%)
Aircraft	15 (9%)	3 (9%)	
Offices	12 (7%)	2 (6%)	5 (8%)
Hotel	11 (7%)	2 (6%)	3 (5%)
Medical center	6 (4%)	1 (3%)	5 (8%)
Restaurants	6 (4%)		3 (5%)
Vessels	3 (2%)	1 (3%)	3 (5%)
Vehicles	4 (2%)		1 (2%)
Power station	3 (2%)	1 (3%)	
Flight simulator	2 (1%)	1 (3%)	1 (2%)
Nursing home	3 (2%)		1 (2%)
Other	6 (4%)	1 (3%)	7 (11%)
Subtotal	127 (76%)	22 (69%)	38 (61%)
Specific Assets			
Plant	20 (12%)	7 (22%)	9 (15%)
Distribution center	11 (7%)	2 (6%)	7 (11%)
Communication network	5 (3%)	1 (3%)	1 (2%)
Gas network			2 (3%)
Other	5 (3%)		5 (8%)
Subtotal	41 (24%)	10 (31%)	24 (39%)
Total	168 (100%)	32 (100%)	62 (100%)

repayment, and debt reorganization. Lastly, motives such as tax or accounting motives are classified as neutral motives. According to these three classification groups, most transactions (64%) are related to repaying debt, another 24% are related to expanding the business, and 12% are associated with neutral motives.

In addition, figure 2 indicates that firms that sell general assets tend to repay debt with the proceeds rather than financing expansion. On the other hand, firms that sell specific assets are more likely to use the proceeds to finance expansion than to repay current debts. To illustrate this point, consider headquarters (general assets) that firms sell. Headquarters represents 23% of the assets

sold by firms that intend to repay debts with the proceeds but only 2% of the assets sold by firms that plan to use the proceeds for expansion.⁵

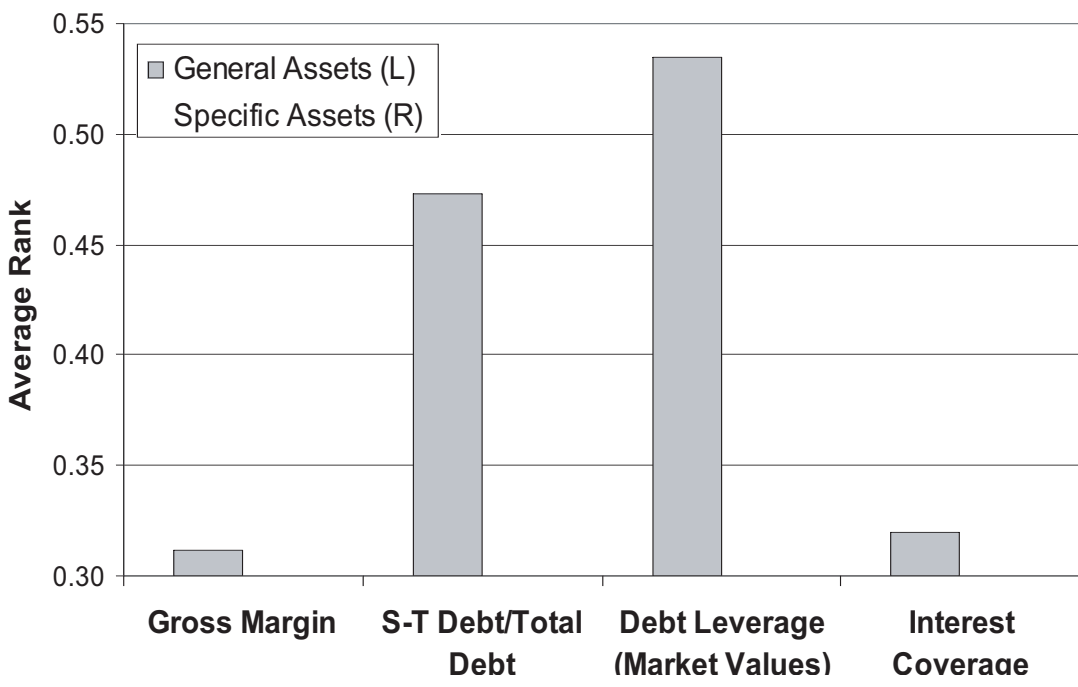
How Does Firm Performance Influence What Assets Get Sold?

A two-step process was used to explore the relationship between firm performance and the type of asset sold in sale-and-leaseback transactions. The first step computed the operational and financial ranking of each firm. Each firm in the sample had its relative rank calculated on the distribution of all public firms, based on operational and financial variables from Compustat database⁶ for the years 1992-2003. As an illus-

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Figure 3

FIRM CHARACTERISTICS, BY ASSET SPECIFICITY



In step two, firms were divided into two groups: firms that sold specific assets (65 firms) and firms that sold general assets (104 firms). For each group of asset type (specific or general), we average the ranking of the firm performance.

tration, if the sales growth of a firm was greater than the sales growth of 90% of the firms in Compustat, the firm was assigned a 90th percentile. To reduce noise, we removed irrelevant effects such as size of the firms, their industry, and the particular year.

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Figure 3 displays the main operational and financial characteristics of the firms that engage in sale-and-leaseback transactions. In general, firms that engage in sale-and-leaseback transactions perform worse than firms that use other types of financing. For example, all firms that engage in sale-and-leaseback transactions have an average percentile ranking of gross margin in the mid 30s, greatly below the median firm. Still, the financial and operational health of firms that sell specific assets is better than those of firms that sell general

assets: the former have higher gross margin, lower debt leverage (in market values), and higher interest coverage. Also, they base their debt financing on long-term debt rather than on short-term debt.

ASSET SPECIFICITY AND GROWTH IN THE SAMPLE DATA

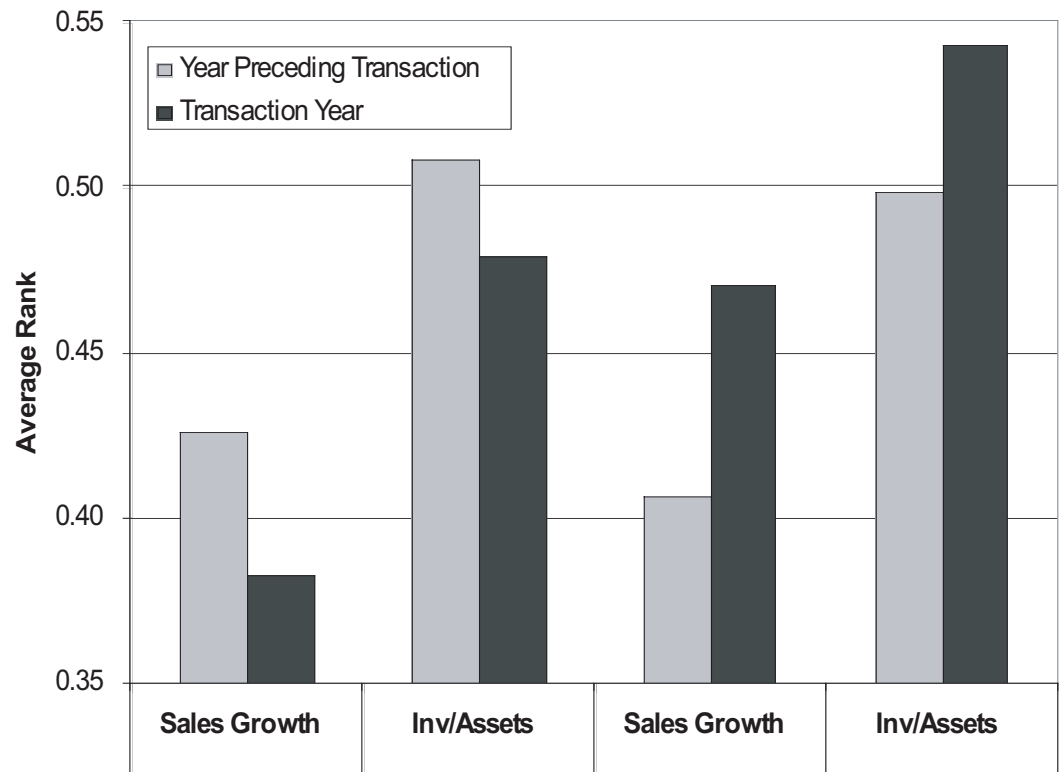
The previous sections showed that, on average, firms that sell specific assets are healthier compared to firms that sell general assets. This section explores whether the type of asset sold can predict the future expansion of the firms that engage in sale-and-leaseback transactions. As before, two expansion variables are used to generate the rankings for firms engaged in sale-and-leaseback transactions: sales growth and investment intensity (annual investment scaled by assets).

Figure 4 presents the average ranking for sales

One possible explanation

Figure 4

FIRM GROWTH, BY ASSET SPECIFICITY



for the results is that both growth prospects and asset type are determined by the industry of the firm. Hence, it is important to study the effect of the industry on the previous results.

growth and investment intensity, by type of asset, before and after the sale-and-leaseback transaction took place. It is apparent that, on average, firms that sold general assets experienced a sharp decline in sales growth. Similarly, after the transaction, their investment intensity declined. Conversely, firms that sold specific assets then expanded their sales relative to their peers; in addition, their investment intensity increased.

One possible explanation for the results is that both growth prospects and asset type are determined by the industry of the firm. For example, if a firm belongs to a growing industry, like high-tech, that firm will have higher growth and its assets may be more specific. Hence, it is important to study the effect of the industry on the previous results.

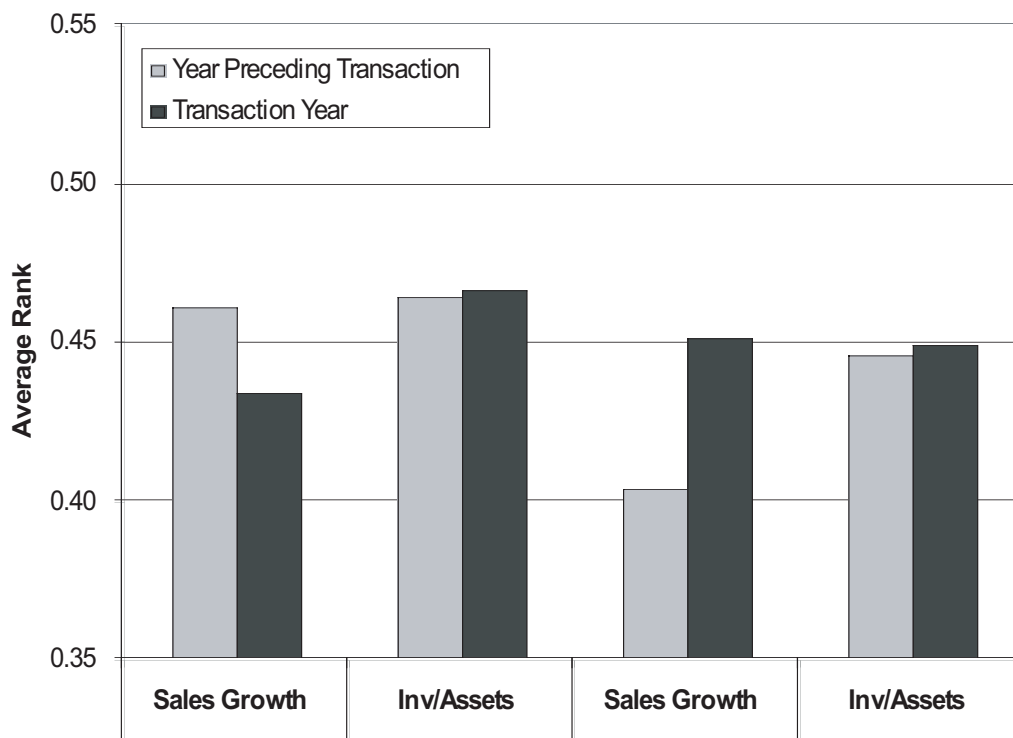
To clarify the matter, the analysis is repeated, this time with firms ranked within their own

industry (using the two-digit Standard Industrial Classification). The results were compared to the results to the results from the previous stage. In the current analysis, a firm in the 90th percentile of sales growth grows faster than 90% of the firms within its industry. Again, we compare the average percentiles of firms that sell specific assets to the average percentile of firms that sell general assets.

The results of the analysis are presented in figure 5 (next page), which shows that the types of assets that firms sell do not indicate their future investment intensity compared to other firms within the same industry. The difference in investment intensity comes from the difference in industries. On the other hand, the type of asset sold indicates the sales growth prospects of the firms even within the same industry. Firms that sell specific assets grow faster, on average, than do firms that sell general assets.

Figure 5

FIRM GROWTH WITHIN INDUSTRY, BY ASSET SPECIFICITY



Poor-performing firms can afford financing only general assets. For the well-performing firms, the story is reversed. Their chances of default are small, and so are the chances of asset reversals.

CONCLUSION

The evidence presented in this study suggests that although most firms engaging in sale-and-leaseback transactions seek liquidity, these firms fall into two groups. One group is composed of fast-growing firms that use the proceeds from the asset's sale to finance their expansion; the assets sold by these firms are specific to the selling firm. The other group is composed of poorly performing firms that seek liquidity to pay off existing creditors. These weak firms usually sell general assets, which are cheaper to redeploy in a case of bankruptcy.

A plausible explanation of the results of the study is that lessors avoid financing specific assets of poor-performing firms, i.e., the relationship between asset specificity and performance is driven by demand of assets by lessors rather than supply of assets by lessees.⁷ Specific assets entail loss to lessors in the event of default because of the

high costs associated with refitting specific assets to a new user. Thus, when the probability of bankruptcy of a firm is high, lessors are disinclined to finance specific assets. As a consequence, poor-performing firms can afford financing only general assets. For the well-performing firms, the story is reversed. Their chances of default are small, and so are the chances of asset reversals. Hence, lessors are comfortable with financing specific assets for healthy firms.

The study helps lessors understand better how the leasing market functions with respect to asset specificity and expected redeployment costs. The study indicates that asset specificity indeed plays a major role in shaping leasing contracts. Nonetheless, lessors should be aware that the degree of specificity of assets is also determined by the industry that the firm belongs to, and some of the effects described in this work (e.g., the relationship between asset specificity and investment intensity) are attributable to the prospects of the industry, rather than to the prospects of individual firms.

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Endnotes

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⁴ This evidence does not imply, however, that other firms do not have hidden tax motives but abstain from reporting about them. In addition, it is plausible that several motives overlap for some firms.

⁵ This fact can itself become a research topic: Why do some firms hold onto their headquarters until they are in financial distress? According to the transaction costs economics theory, general assets such as headquarters are most likely to be owned by a third party.

⁶ Compustat is a database of all publicly traded firms that report their financials to the Securities and Exchange Commission.

⁷ The alternative explanation for the results is that supply of assets drives the relationship between asset specificity and firm performance. This explanation is, however, less appealing, as it suggests that poor performing firms have less specific assets to offer to lessors; hence, we do not observe these transactions.



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