Determinants of Corporate Leasing Policy: Discussion
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DISCUSSION

GREGORY D. HAWKINS: All too often we analyze the leasing decision as the simple choice of leasing a specific asset or outright purchase of the asset financed by issuing a mortgage-type loan. The terms of both the lease and the "equivalent loan" are usually assumed to be known, predetermined outside the scope of the immediate leasing decision. Initially, such analysis focused on taxation differentials to explain both the existence of leases and their optimal use. More recently, valuation and use based upon more complex leasing contracts and relying on differences other than taxes have been analyzed.[1] This valuation approach to the leasing problem depends upon two assumptions: (1) contract provisions are exogenous to the valuation, and (2) the decision is distinctly lease or borrow/buy.

Smith and Wakeman is a valuable, but preliminary, attempt to loosen both assumptions. Indirectly, through the richness of leasing contracts discussed, the authors show that the leasing decision is not distinctly lease versus borrow/buy. The optimal decision or policy is drawn from a complex set consisting of various financing arrangements. The leasing policy of a firm can be broadly viewed as a continuum of choices which include the borrow/buy alternative. As the provisions change, the ownership (and possibly financing) provided by a particular leasing arrangement move from one extreme resembling equity to the other of all debt. From this viewpoint the results of Ang and Peterson are not difficult to understand; debt and leasing are compliments, not substitutes.

As far as I am aware nobody has explicitly explored the implications of the continuum of ownership involved in different leasing arrangements. The difference between net and service leases is the clearest example of changing degrees of ownership. However, to date the issue has been primarily viewed through the option to purchase at the conclusion of the lease period or through the amount of debt associated with the borrow/buy decision.

The primary contribution of Smith and Wakeman is the attempt to endogenize the provisions of leasing arrangements. In the spirit of Smith and Warner, the present paper essentially views leasing provisions as another tool in the arsenal of corporate control. Depending upon the nature of the asset, lessee, or lessor, various contractual provisions are necessary to maintain the value of the asset. The primary hypothesis of Smith and Wakeman is the possibility of predicting which provisions will be used in a particular lease based upon the characteristics of the asset, lessee, and lessor. Presumably the hypothesis can be empirically tested against the extant set of leasing contracts.

Even though the intent and effort of Smith and Wakeman are laudable, there are several problems which should be addressed in future work. In setting up the hypothesis and then "testing" it against actual contracts, the authors have not addressed the uniqueness of a particular contract. It is quite possible that several different contracts are sufficient to either achieve a given level of control or maintain asset value. If so, the "test" may be biased by a general sort of

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[1] Relevant references and citations are in Smith and Wakeman.

misspecification. Without a more formal model, detecting such misspecification is difficult.

Testing is more difficult in the case of leasing than in the similar exercise with corporate bond covenants in Smith and Warner. The "data base" is not as well defined for leases. Smith and Warner could obtain a list of specific bond covenants which by its nature was relatively complete. No such list of leasing arrangements is provided or available. Instead, we must put our faith in the authors and hope that the range of leases and provisions they use is sufficiently broad for them to capture the relevant factors. Furthermore, even though this is not the case with the present authors, without a well-defined data base it is possible to ignore contracts which do not fit the hypothesis and thereby bias the results. The reader should be wary whenever duplication of the data for purposes of verification or testing alternative hypothesis is difficult.

One last problem concerns the assumptions underlying the hypothesis. A formal mathematical model is typically derived, subject to "certain continuity conditions." In Smith and Wakeman, it is not clear that sufficient continuity exists to make the model practicable. For example, the section on net-versus-service leases would seem to imply that if a lessee is to use an asset for practically its entire economic life, then a net lease is quite likely. However, elsewhere in the paper we are told that leasing is unlikely in such a case. Where the choice between net and service leases "jumps" to not leasing is not clear. Such continuity problems make predictions based on the hypothesis difficult.

In conclusion, Smith and Wakeman's attempt to explain the diversity of leasing contracts is a valuable first step. A more formal, mathematical model would make it possible to check the uniqueness and continuity conditions of the hypothesis. However, given our current state of knowledge, it is difficult to imagine even the form of a model which captures the multitude of factors and relationships hypothesized in the current paper.