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Corporate Sale-and-Leasebacks and Shareholder Wealth

MYRON B. SLOVIN, MARIE E. SUSHKA, and JOHN A. POLONCHEK*

ABSTRACT

In this paper, we examine the market valuation effects of corporate sale-and-leasebacks. Specifically, we test whether such transactions offer a net benefit to lessees or lessors by evaluating the impact on share prices from announcements of sale-and-leasebacks of major corporate assets. Our evidence indicates that the announcements are associated with positive abnormal returns to lessees. We conclude that this positive market reaction results from an overall reduction in the present value of expected taxes occasioned by the transactions. Our evidence also suggests that the gains from sale-and-leasebacks accrue solely to lessee firms.

THERE IS CONSIDERABLE LITERATURE focusing on securities issuance and the impact of corporate financing decisions on the value of the firm. The empirical evidence (summarized in Smith (1986)) indicates that stock price reactions to announcements of equity-type securities issues are significantly negative, while returns to announcements of debt issues are generally nonpositive but not significantly different from zero. These results have been rationalized by Miller and Rock (1985) and Myers and Majluf (1984) on the basis that managers possess private information about future expected cash flows. Thus, the market adjusts firm value in response to announcements of external financing.

We examine the market valuation effects of corporate sale-and-leasebacks. Practitioners argue that these transactions serve legitimate commercial needs and generate mutual tax advantages.¹ This activity involves a decision that is widely interpreted in the finance literature as a form of external financing and a substitute for security offerings. Indeed, the theory of leasing suggests that each dollar of leasing replaces one dollar of debt capacity. The goal of the analysis is to gauge whether the events release new information about the value of the firm. Specifically, we examine whether leasing offers a net benefit to lessees or lessors by evaluating the impact on share prices of announcements of sale-and-leasebacks of major corporate assets. Our empirical results indicate that sale-and-leaseback transactions enhance lessee value but have no significant effects on lessors.

In a sale-and-leaseback, a firm sells an asset it owns to another party and simultaneously leases the asset back from the new owner. The lessee receives

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¹Much of the practitioner literature focuses on questions of disclosure. The 1976 Financial Accounting Standards Board Statement No. 13 standardized the accounting procedures for leasing and created an emphasis on making such fixed obligations an integral part of financial statements.

funds in the amount of the current market value of the asset while retaining the use of the asset as an input to the firm's productive activities. The new owner (the lessor) obtains title to the asset and the benefits of ownership, including relevant depreciation allowances and tax credits.² In economic terms, however, such transactions are a form of debt financing.³ Thus, the buyer is in essence a lender and, except for the presence of a remainder interest in the property, can be viewed as having made a secured loan.

A major disagreement in the academic literature is whether leasing can alter the market value of a firm. Logically, a market valuation effect at the announcement of a sale-and-leaseback can occur in a competitive market only if the circumstances of the lessor and lessee differ in some way since real production activities are unaffected. Although other motives for such transactions are cited in the practitioner literature, previous academic work focuses on the potential for differences in applicable tax rates for lessees and lessors to create value enhancement.⁴

Our analysis utilizes an event study of sale-and-leasebacks with particular attention to effects on the lessee firm's share price. We also consider the impact of leasing on lessors, where possible, but the data available for that side of the transactions are limited. We focus our attention on the sale-and-leaseback of assets previously owned and utilized by the lessee firm. This insures that the announcement of a sale-and-leaseback releases no new information about the operating asset base of the lessee. In contrast, the leasing of a new asset would represent both a financing and a capital budgeting decision which would complicate the interpretation of any announcement effect on market valuation.

Specifically, we focus on the sale-and-leaseback of major office buildings or related structures in which the firm leases back the space involved. We also examine a separate sample of announcements of the sale-and-leaseback of aircraft to test the robustness of our results. Finally, we examine another sample of aircraft leases which qualified under the safe harbor provisions of the Economic Recovery Tax Act of 1981. Unlike the first two samples, these are not true leases but simply a means to allow firms to transfer unusable tax benefits (investment tax credits and accelerated depreciation allowances) to other corporations in exchange for cash. Safe harbor leases provide a mechanism for a firm that is not generating taxable income to recapture tax benefits directly without having to structure the transaction as a true lease. This set of events provides an indication of the value of potential tax benefits and a basis of comparison for the sale-and-leaseback results. Safe harbor rules were in effect from 1981 to 1983.

² See Del Cotto (1981) for an analysis of the tax status of sale-and-leasebacks. Del Cotto argues that, since the sale-and-leaseback is simply a financing transaction, the accepted tax treatment of these transactions is misguided.

³ There is, however, little empirical evidence on the degree to which leasing and debt are perfect substitutes. One of the few studies in this regard is by Bowman (1980), who demonstrates that there is a positive and significant relationship between systematic risk and the use of leasing for a cross-section of firms. This leads Bowman to conclude that both debt and leasing affect systematic risk and that, as a result, the financial market regards debt and leasing as close substitutes. However, this does not address the issue of whether they are close substitutes in terms of the signal content to the financial market.

⁴ Smith and Wakeman (1985) discuss some nontax factors that can influence the decision to lease.

In comparison to the negative effects generally observed in response to security issuance announcements, our empirical findings indicate that the impact of announcements of sale-and-leasebacks of major corporate assets on shareholder wealth of lessees is positive and statistically significant. We find a significant positive market reaction for sale-and-leasebacks of both buildings and aircraft. In contrast, we find no gains to lessor firms. Moreover, we find positive and statistically significant returns for lessees in safe harbor transactions which do not involve external financing. This suggests that the valuation effect on the share prices of lessee firms is the result of tax considerations and not of monitoring services of the type that Fama (1985), James (1987), and Slovin, Sushka, and Hudson (1988) argue are impounded in bank loans. Overall, these results suggest that the financial market views sale-and-leaseback transactions as offering distinct benefits to nonfinancial lessee firms and that the transactions enhance equity values.

In Section I, we review the theory of leasing and the characteristics of sale-and-leaseback transactions. We describe criteria used to develop the sample in Section II and discuss the methodology in Section III. Empirical results are detailed in Section IV, and conclusions are drawn in Section V.

I. The Theory of Leasing and Sale-and-Leasebacks

In general, previous theoretical work generates conflicting views on the valuation effects of leasing. Miller and Upton (1976) analyze the leasing decision using capital budgeting techniques within a perfect markets framework and conclude that no financial advantages accrue from leasing. From this perspective, leasing is a window-dressing activity that generates no positive net present value. Lewellen, Long, and McConnell (1976) and Myers, Dill, and Bautista (1976) explore whether there are risk-adjusted advantages to leasing in a world of taxation. The two papers demonstrate that there can be a nontrivial tax advantage from leasing, where the direction of the tax effect depends on the specific asset life and relevant depreciation and capitalization rates. Thus, under a feasible set of circumstances, the government may suffer a loss in the present value of taxes, and there is a potential for gains in valuation for the firms involved.

This line of theoretical work argues that sale-and-leaseback transactions may provide mutual tax advantages that are not available through the use of other forms of external financing. The seller (lessee) can take advantage of the full deductibility of rental payments which are ordinary and necessary business expenses under the tax code. In particular, the seller may be able to deduct rental payments equal to the full fair market value of the property (including the land). Moreover, if the property has appreciated in value, the rental deductions intrinsic to a sale-and-leaseback will in effect allow for depreciation to be based on the full market value of the property, rather than its lower historical cost. Such a situation involves nonstandard elements of taxation which may not have equal value for all firms. The importance of these elements is the fulcrum of the debate as to whether leasing can generate significant value enhancement for firms.

As a caveat, Lewellen, Long, and McConnell argue that, if such gains exist,

they are likely to be ephemeral in a competitive market. Moreover, they assert that, for leasing arrangements involving unique assets dedicated to specific purposes, potential tax gains are likely to be more than offset by the transactions costs associated with the lease contract. On the other hand, Myers, Dill, and Bautista are more optimistic about the potential for net gains, especially when the opportunity cost of capital is relatively high (because the potential gain is a positive function of interest rates). The empirical implication is that announcements of such transactions can lead to positive valuation effects. Given this difference in views about the economics of leasing, the question of whether sale-and-leasebacks are value increasing becomes an empirical one. Specific hypotheses about the valuation effects of sale-and-leasebacks, however, require recognition of the literature on asymmetric information and securities issuance.

From the perspective of the buyer-lessor, there should be sufficient benefits to make a sale-and-leaseback at least a zero net present value transaction since the event is a voluntary one and such firms can routinely lend in the capital market as an alternative. Thus, it can be argued that a sale-and-leaseback transaction should, at a minimum, not harm the shareholders of the lessor. For the lessee, the question of the predicted sign of the overall valuation effect is more complicated since there are important aspects of a sale-and-leaseback implicit in its role as a financing instrument, aside from its character as a mechanism to capture tax benefits.

For the lessee firm, the securities issuance literature indicates that there is negative information impounded in announcements of external financing regardless of the use of proceeds. Thus, if the sale-and-leaseback of an asset is viewed as a form of collateralized external financing (strict financial leases are perfect substitutes for debt), it should generate nonpositive returns to shareholders.⁵ Consistent with the arguments of Miller and Rock (1985) and Myers and Majluf (1984), the announcement of a sale-and-leaseback may be treated by the market as if the firm announced an issue of collateralized debt and, thus, can be taken as a signal of an unexpected shortfall in the firm's earnings from its current projects; this would have a negative impact on the shareholder wealth of the lessee. Since our sample of events involves announcements by firms that already utilize the asset in their production plans (so that there is no simultaneous announcement of the purchase of a new capital asset), the securities issuance literature would predict a negative announcement effect for sale-and-leasebacks.

Given that the leasing literature indicates that tax factors may have a positive influence on lessee firm valuation, it can be hypothesized that the announcement of a sale-and-leaseback should be perceived by financial market participants as at least as favorable a signal as a lessee firm's announcement of a collateralized debt issue. The empirical results indicate that the announcement of the issuance of straight corporate debt induces a negative, but not significant, average prediction error and a negative and significant effect for completed offerings of straight debt (as reported by Mikkelsen and Partch (1986), for example). Eckbo (1986)

⁵ Since sale-and-leasebacks are in effect fully collateralized debt, there are unlikely to be monitoring services of the type impounded in bank loans. See also Stulz and Johnson (1985) for an analysis of the impact of secured debt on firm value.

has demonstrated that the issuance of mortgage bonds, a financial instrument similar to a sale-and-leaseback of a building, generates negative and (marginally) significant announcement returns. Thus, it can be hypothesized that, if there are positive net tax gains expected to accrue to the lessee, the announcement of a sale-and-leaseback by a nonfinancial firm should induce a return that is less negative than for a mortgage bond offering.

Thus, leasing theory indicates that the market valuation effect on the lessee firm of the announcement of a sale-and-leaseback may be either positive or zero in accordance with whether or not tax factors can generate gains to such transactions. Securities issuance considerations suggest that the financial market should regard a sale-and-leaseback announcement by the lessee firm as an unfavorable signal, generating negative abnormal returns. Based on these considerations, the predicted overall effect of announcements of sale-and-leasebacks on the shareholder wealth of lessees is ambiguous. The empirical issue here is whether sale-and-leaseback transactions are expected to generate positive tax gains and, if so, whether the magnitude of such gains is sufficient to counteract the negative effect typically associated with announcements of other types of external financing.

II. The Sample

To test these hypotheses, we obtain a sample of corporate sale-and-leaseback announcements over the period 1975–1986. We searched the *Wall Street Journal Index*, *Standard and Poor's Reports*, and corporate annual reports for evidence of sale-and-leasebacks of buildings and similar structures by industrial (nonfinancial) corporations. Firms are retained in the sample if they meet three criteria: 1) security returns are available on the daily Center for Research in Securities Prices (CRSP) File; 2) an unambiguous announcement date is identifiable; and 3) there are no contemporaneous corporate announcements reported in the *Wall Street Journal* during the event window.

Next, we developed a sample by conducting a similar search in the various publications for announcements of sale-and-leasebacks of aircraft. In addition, we obtained a sample of announcements of special leasing transactions of aircraft that are not true leases but are qualified transactions for the sale of tax benefits permitted under the safe harbor leasing provisions of the Economic Recovery Tax Act of 1981. In each case, we generate samples of aircraft transactions that meet the criteria applied to sale-and-leasebacks of buildings. The events in our samples represent announcements of contracts or agreements in principle between the two parties involved in the transaction and thus can be viewed as the equivalent of completed debt offerings from the point of view of the securities issuance literature.

These procedures produce a sample of 59 sale-and-leasebacks of structures by industrial firms. The distribution of these announcements over time, as well as other descriptive data for the sample, is shown in Table I. For 44 of the announcements, the transaction price was reported in the *Wall Street Journal*. The mean value of the transactions is \$102 million. The mean value of the ratio

Table I
Sample Distributions of Announcement Year and Reported
Transaction Prices of Sale-and-Leasebacks over the Period 1975–
1986

The events in the samples represent announcements reported in the *Wall Street Journal* of sale-and-leasebacks of structures and aircraft by nonfinancial corporations with returns on the CRSP file. Fifty firms and nine airline companies are represented in the samples of structures and aircraft transactions, respectively.

Panel A. Yearly Distribution of Events													
Total	Type of Asset	Years											
		1975	76	77	78	79	80	81	82	83	84	85	86
59	Structures	0	0	0	1	1	3	7	9	8	11	7	12
14	Aircraft	1	0	0	0	0	0	3	1	1	1	5	2

Panel B. Distribution of Reported Transaction Prices			
Price Range (\$ Millions)	Structures (<i>N</i> = 44)	Aircraft (<i>N</i> = 9)	
$P < 10$	2	1	
$10 < P < 25$	9	2	
$25 < P < 50$	9	2	
$50 < P < 100$	13	2	
$100 < P < 200$	3	2	
$200 < P < 300$	3		
$300 < P < 400$	3		
$400 < P$	2		

Panel C. Distribution of Prices as Fraction of the Value of Equity of Lessees		
	Structures	Aircraft
Maximum	0.94	0.81
Mean	0.22	0.43
Median	0.15	0.60
Minimum	0.03	0.02

of the transaction prices to the concurrent market value of the equity of the lessee is 0.22, indicating that the transactions can be viewed as significant elements of external financing for the firms involved. Fifty separate firms are represented in the sample.

The distribution of the sample of aircraft sale-and-leasebacks is also shown in Table I. The sample is smaller, but the mean size of the nine transactions for which price data are available is fairly large at \$81.7 million. Since the mean value of the ratio of aircraft transactions prices to the market value of the equity of the lessee airline is 0.43, these transactions are important external financing events. Five firms are represented once in this sample, three firms twice, and one firm three times.

We are unable to generate a sample of lessors for the sale-and-leasebacks of buildings. For twenty of the announcements, no information about the buyer was disclosed, and, in the remaining cases, the lessors were not publicly traded firms. For aircraft sale-and-leasebacks, however, there are eight cases in which the buyers are identified in the announcement and listed on the CRSP file. The set

of safe harbor leases for aircraft occurred over the short period of time that these leases were permitted. Of the ten transactions, four were announced in 1981 and the remainder in 1982.

III. Methodology

Average daily prediction errors measured around the date of publication in the *Wall Street Journal*, denoted as day $t = 0$, are calculated to analyze announcement impacts. The prediction errors are obtained by using the market model. In this model, R_{it} is defined as the arithmetic return and A_{it} as the adjusted (excess) return for security i on day t . Adjusted returns for each security, i , and for each day in the event period are measured as

$$A_{it} = R_{it} - \bar{R}_{it}, \quad (1)$$

where $\bar{R}_{it}$ is the conditional expected return for security i on day t derived as the predicted value

$$\bar{R}_{it} = \hat{a} + \hat{b} R_{mt}, \quad (2)$$

where the coefficients $\hat{a}$ and $\hat{b}$ are obtained from an OLS regression estimated over the pre-event period ($t = -215$ to -96) and R_{mt} is the event-day return on the CRSP equally weighted index. Adjusted returns are averaged over all securities for each day in the relevant event subperiod to obtain the mean adjusted return, $\bar{A}_t$, defined as

$$\bar{A}_t = \frac{1}{N} \sum_{i=1}^N A_{it}, \quad (3)$$

where N is the number of firms.

The null hypothesis to be tested is that the adjusted return is equal to zero for each event subperiod and for each relevant portfolio. The test statistic is the ratio of the adjusted return to its estimated standard deviation, where the standard deviation is estimated from the time series of adjusted returns. For any event day (or event subperiod), the t -statistic is

$$\bar{A}_t / S(\bar{A}_t), \quad (4)$$

where

$$S(\bar{A}_t) = \sqrt{\left[\sum_{t=-215}^{-96} (A_t - \bar{A})^2 \right] / 120} \quad (5)$$

and

$$\bar{A} = \frac{1}{120} \sum_{t=-215}^{-96} \bar{A}_t. \quad (6)$$

If the $\bar{A}_t$ are independent, identically distributed, and normal, the test statistic is distributed as a Student- t under the null hypothesis.

IV. Empirical Results

The event study results are reported in Table II. In the first column, the results indicate that, for lessee firms engaged in the sale-and-leaseback of structures, the average two-day prediction error is a positive 0.85%, with a t -statistic of 1.98 which is significant at the 5% level. All of the other daily returns outside of this event window are small so that there does not appear to be any leakage of information prior to the announcement. The pre-event period returns are positive but not significant. Thus, there is no evidence that these firms are suffering financial distress during the three-month period prior to the announcement.

The findings suggest that financial market participants view the sale-and-leaseback of a structure as a positive event. The contrast with the empirical results for the issuance of debt is clear. Mikkelson and Partch (1986) report abnormal returns of -0.23% (t -statistic of -1.40) for announcements of straight debt and abnormal returns of -0.39% (t -statistic of -2.21), for announcements of issues that are ultimately completed. The latter figure is more relevant for comparison purposes since the sale-and-leaseback announcements reported in the *Wall Street Journal* generally indicate an agreement in principle, which can be construed as essentially a guarantee that a transaction will take place. Eckbo (1986) reports an announcement return of -0.20% (t -statistic of -1.67) for mortgage bonds which can also be viewed as a close substitute for sale-and-leasebacks.

Table II
Average Prediction Errors (in Percent) for Sale-and-
Leaseback Events over the Period 1975–1986
(t -Statistics in Parentheses)

Announcement day is $t = 0$, the publication date of the relevant *Wall Street Journal* article. The prediction errors are obtained by using the market model in which predicted errors are obtained from an OLS regression estimated over the pre-event period ($t = -215$ to -96). The t -statistic is the ratio of the adjusted return to its estimated standard deviation, where the standard deviation is estimated from the time series of adjusted returns for the pre-event period ($t = -215$ to -96). The ten safe harbor lease announcements all occur during the time period they were permitted, 1981 and 1982.

	Sale-and- Leasebacks of Structures	Sale-and- Leasebacks of Aircraft		Safe Harbor Leases of Aircraft
	Lessees (1)	Lessees (2)	Lessors (3)	Lessees (4)
Sample Size	59	14	8	10
Interval				
(-60, -2)	2.92% (1.24)	1.12% (0.21)	1.89% (0.44)	-1.57% (-1.95)
(-1, 0)	0.85% (1.98)	2.29% (2.28)	-0.34% (-0.43)	3.66% (2.46)
(1, 15)	-0.19% (-0.16)	-2.75% (-1.12)	-1.08% (-0.50)	-2.93% (-0.72)

Thus, while the relevant figures for debt financing reported in the literature are consistently nonpositive, we find that the impact of the announcement of a sale-and-leaseback of a building is significantly positive. If a sale-and-leaseback impounds private information of an unexpected shortfall of corporate cash flows and the need for the firm to obtain external financing, it is more than counteracted by the gains impounded in the transaction itself. We conclude that, in the case of sale-and-leasebacks, the existence of significant positive gains indicates that these are value-increasing transactions. We are led to conclude that this positive market perception results from an overall reduction in the present value of expected taxes induced by the transactions.

To test the robustness of the results for the sale-and-leaseback of structures, in the second column of Table II we report the results for the average prediction error associated with 14 sale-and-leasebacks of aircraft. The two-day announcement return is 2.29%, with a *t*-statistic of 2.28. These results suggest that sale-and-leasebacks of aircraft also generate positive gains to lessee firms. The average prediction error for the aircraft sample is larger than that derived from a sample of structures, which is consistent with the fact that on average the aircraft transactions are larger relative to the market value of lessee firms. Application of the standard test for a difference in means, however, indicates that the difference in the returns generated by the two samples is not statistically significant at the usual confidence levels.⁶

Since the evidence indicates that the market attributes economic gains to the lessee firms involved in these events, we investigate whether such gains accrue solely to the lessees or whether gains also accrue to lessors. If the market for this type of lending is fully competitive, potential gains to a lessor will be bid away by other potential entrants. If taxable earnings are a scarce resource, however, it is possible that some of the tax shelter value will be captured by the lessor. As noted earlier, in the case of eight of the aircraft transactions, the lessor was identified in the announcement and was a firm for which returns data are available on the CRSP file. The average prediction error observed upon announcement for this sample of firms is -0.34%, as reported in the third column of Table II, but the associated *t*-statistic of -0.43 does not permit us to reject the hypothesis that these firms earn normal returns upon the announcement of a sale-and-leaseback transaction. Thus, the gains that accrue from sale-and-leasebacks appear to be uniquely a lessee phenomenon.

Finally, we consider a set of ten aircraft transactions which were not structured as a financing mechanism but instead represented a direct sale of tax benefits that qualified as safe harbor leases. These rules, established by the Economic Recovery Tax Act of 1981, permitted firms to treat the transaction as a lease without having to meet the usual Internal Revenue Service requirements for characterizing the transaction as a lease. The safe harbor rules were not applicable with respect to transactions entered into after 1983. Unlike the previous samples we have analyzed, these transactions are not a mechanism for external financing

⁶ See Mood, Graybill, and Boes (1974) for a description of this test. The standard deviations for the two samples are calculated from the firms' daily returns over the two-day announcement period. The calculated *t*-value is 1.44.

but instead represent solely a sale of tax benefits. Since there is no debt-type financing in these transactions, there can be no provision of monitoring services of the type found in bank loans. However, if the positive returns to lessees associated with sale-and-leasebacks are generated by tax gains, returns to lessees involved in safe harbor leasing should be positive.

The average prediction errors for the lessee firms involved in safe harbor leases of aircraft are reported in the fourth column of Table II. The results indicate abnormal returns of 3.66%, a figure that is significant given the t -value of 2.46. Thus, the financial market appears to view these transactions as economically valuable. Moreover, the positive announcement-period returns follow a three-month period of negative abnormal returns that are significant at the 10% level. This is consistent with the presumed intent of safe harbor leases—to permit firms that were unable to utilize tax benefits fully to sell them directly to other firms.

The consistency of the positive abnormal returns to sale-and-leaseback and safe harbor leasing events suggests that there are market valuation implications to the presence of a market for the transfer of tax benefits. Although the returns to safe harbor leasing announcements of aircraft exceed those to true sale-and-leasebacks of aircraft, application of the difference-in-means test indicates that the null hypothesis of the equality of means for the two samples cannot be rejected.⁷

V. Conclusions

We have examined the market reaction to announcements of sale-and-leasebacks by (nonfinancial) corporations. Although these transactions are generally viewed as a form of collateralized debt financing, their announcements generate positive abnormal returns. This suggests that, unlike other types of external financing, these are value-increasing transactions. We are led to conclude that this positive market perception results from an overall reduction in the present value of expected taxes induced by the transactions. Our evidence also suggests that the gains from sale-and-leasebacks accrue solely to lessee firms.

⁷ The calculated t -value for the difference of the returns to safe harbor leasing versus the sale-and-leaseback of aircraft is 0.66.

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