Leasing, Ability to Repossess, and Debt Capacity

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Abstract

This paper studies the role of leasing of productive assets. When capital is leased (or rented), it is more easily repossessed and hence leasing has higher debt capacity and relaxes financing constraints. However, leasing gives rise to an agency problem with regard to the care with which the leased asset is used or maintained. We show that this implies that more credit constrained firms lease capital, while less credit constrained firms buy capital. Our theory is consistent with the explanation of leasing provided by leasing firms, namely that leasing “preserves capital,” which is generally considered a fallacy in the academic literature. We provide empirical evidence that small and credit constrained firms lease a considerably larger fraction of their capital than larger and less constrained firms.