

Convertible Lease, Risky Debt and Financial Structure with Growth Option

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Abstract : The basic objective of this paper is twofold. It resides in designing a model for a contingent convertible lease contract that can ensure the financial stability of a company and recover the losses of the parties to the lease in the event of default. It also aims to compare the convertible lease contract on inefficiencies resulting from the debt-overhang problem and asset substitution with other financing policies. From this perspective, this paper highlights the interaction between investments and financing policies in a dynamic model with existing assets and a growth option where the investment cost is financed by a contingent convertible lease and equity. We explore the impact of the contingent convertible lease on the capital structure. We also check the reliability and effectiveness of the use of the convertible lease contract as a means of financing. Findings show that the rental convertible contract with a sufficiently high conversion ratio has less severe inefficiencies arising from risk-shifting and debt overhang than those entailed by risky debt and pure-equity financing. The problem of underinvestment pointed out by Mauer and Ott (2000) and the problem of overinvestment mentioned by Hackbarth and Mauer (2012) may be reduced under contingent convertible lease financing. Our findings predict that the firm value under contingent convertible lease financing increases globally with asset volatility instead of decreasing with business risk. The study reveals that convertible leasing contracts can stand for a reliable solution to ensure the lessee and quickly recover the counterparties of the lease upon default.

Keywords : contingent convertible lease, growth option, debt overhang, risk-shifting, capital structure

Conference Title : ICAMF 2023 : International Conference on Advances in Mathematical Finance

Conference Location : Paris, France

Conference Dates : March 27-28, 2023