New IFRS 16 Leases standard
The impact on business valuation

Contents

The introduction of IFRS 16 Leases will lead to an increase in leased assets and financial liabilities on the balance sheet of the lessee. What is the impact on business valuation?

Introduction

The introduction of IFRS 16 Leases will lead to an increase in leased assets and financial liabilities on the balance sheet of the lessee, while EBITDA of the lessee increases as well. Accordingly, companies with material off-balance sheet lease commitments will encounter significant changes in their key financial metrics such as leverage ratio, return on invested capital (ROIC) and valuation multiples. Although equity values should not change, enterprise values of companies will increase. Furthermore, although accounting policies should not affect economic valuations, we foresee that IFRS 16 will impact the outcomes of valuations and introduce new attention areas in business valuation and M&A transactions.

The International Accounting Standards Board (IASB) issued IFRS 16 Leases in January 2016, effective for financial periods beginning on or after 1 January 2019. IFRS 16 replaces the previous leases Standard, IAS 17 Leases, and related Interpretations. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, i.e. the customer ('lessee') and the supplier ('lessor').

Currently, based on IAS 17, leases shall be classified as either finance leases or operating leases depending on whether a lease is economically similar to purchasing the asset that is being leased:

- A finance lease is defined as a lease that transfers substantially all the risks and rewards incidental to ownership to the lessee. Legal title may or may not eventually be transferred.
- Conversely, an operating lease is defined as a lease that does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee.

Key impact on financials and ratios

Under IFRS 16 a lessee will no longer make a distinction between finance leases and operating leases; all (material) leases will be treated as finance leases, with the exception of short-term leases and low value leases. In the statement of financial position, the lessee will recognize the asset and the liability for the lease, while in the statement of profit and loss, the lessee will recognize the interest cost and the depreciation of the leased asset instead of the operating lease expenses. The new accounting treatment will lead to:

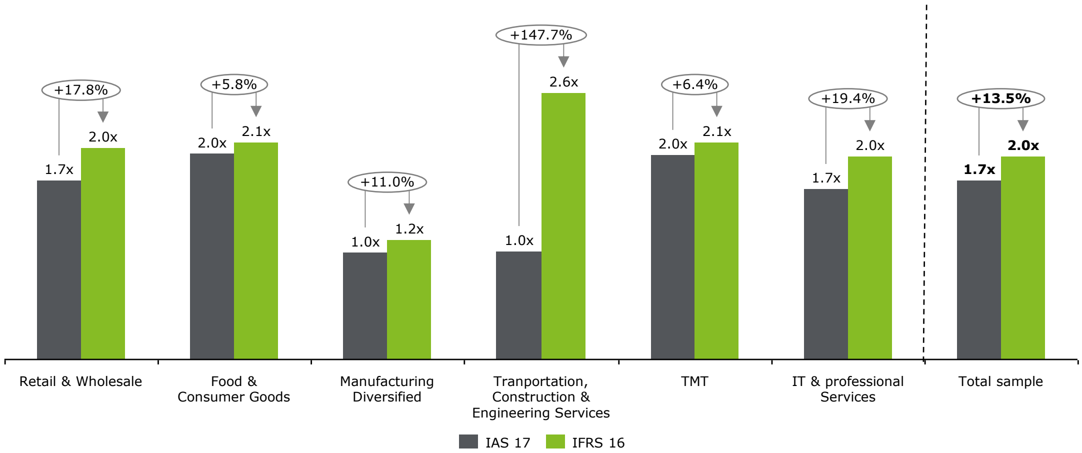
- An increase in net debt. Research on 50 Dutch publicly-listed companies indicates that their combined net debt grows by some EUR 45 billion[1]. This represents an increase in net debt of approximately 30%. We even observe that for 9 out of 50 companies the increase of net debt is over 50%.
- A higher EBITDA[2]. EBIT(A) will also increase, however less substantial, as the majority of the former rental expenses will be reflected in depreciation.
- A higher invested capital for the lessee. This generally lowers ROIC.

[1] Based on an assessment of the operational lease obligations of the largest 50 publicly-listed Dutch companies included in the AEX, AMX and ASCX (excluding financials and real estate companies). Assuming a remaining lease duration for each company based on the total remaining lease obligation, divided by the 2016 lease obligation and assuming a discount rate of 5%.
[2] The combined 2015 EBITDA of the sample increases by some EUR 10bn (15%).

A substantial variance is observed in the sample. The impact on net debt and EBITDA is obviously the largest for companies with many operating leases, for example in sectors like retail & wholesale and transportation (including Ahold, AirFranceKLM and GrandVision).

We also observe - on average – an increase in net debt / EBITDA ratios. The impact depends on the remaining duration of the lease (and current leverage ratio). The incremental net debt / EBITDA on the lease liability will generally be high at start of the lease term, gradually decreasing to zero at the end of the lease term. We estimate a 13.5% increase in the average leverage ratio of the 50 publicly-listed Dutch companies (please see graph below).

Net debt / EBITDA 2016



Source: Bloomberg, annual reports, Deloitte analysis
Note: based on median observation within group

Impact on valuations

The introduction of IFRS 16 should in principle have no impact on fundamental valuations, since the substance of the lease does not change the economics and cash flow generating capacity of the business. However, we expect that IFRS 16 will eventually impact the outcomes of valuations.

Firstly, although equity values should not change, enterprise values of companies will increase. This is the result of a higher EBITDA and Free Cash Flow. For further elaboration, please see the sections on Discounted Cash Flow (DCF) - and Market approach below. Alternatively, the increase in net debt, while equity value remains the same, also implies an increase in enterprise value. Our research indicates that the combined enterprise value[3] of the 50 Dutch publicly-listed companies increases by 6%.

Secondly, IFRS 16 will presumably also impact the outcomes of valuations and introduce new attention areas for practitioners. We have summarized a few implications and considerations, segmented into the most commonly applied valuation methods: (i) the DCF approach and (ii) the Market approach based on market multiples.

DCF approach

As said, IFRS 16 will increase the enterprise value of companies as net debt will increase, while equity value should remain the same. In DCF models – in which enterprise values are assessed based on the NPV of expected Free Cash Flows (FCF) – this will generally be reflected via the following two effects:

- Following IFRS 16 leverage ratios[4] of (peer group) companies, which are used to estimate the target capital structure in the WACC, will increase. A higher leverage, with unchanged observed levered beta's[5], will lead to a lower WACC and a higher net present value of FCF's; and
- After IFRS 16, the future FCF's will be higher over the remaining lease period, as rental expenses are excluded from EBITDA and hence FCF. The depreciation charge is a non-cash item and consequently does not negatively impact FCF. The lease payments are reflected in the cash flow statement via interest payments and redemptions of the lease obligation, however, these are financing items and also do not impact FCF.

The increase in enterprise value should theoretically be exactly offset by the increase in net debt (representing the NPV of the remaining lease obligation) of the company that is being valued. Hence, this would theoretically result in the same equity value. However, the introduction of IFRS 16 makes DCF valuations more complex, more sensitive to errors and will presumably lead to changes in the valuation of equity.

[3] Calculated as the sum of the market cap and net debt.
[4] Leverage measured as Net debt / Enterprise Value.
[5] This would automatically imply lower unlevered betas for the peers. A lower unlevered beta, which is compensated by the increased financial leverage, is also logical as operational leverage on FCF's has decreased after IFRS 16 (as no fixed rental charge is deducted from EBITDA, making EBITDA and FCF less vulnerable). One advantage of IFRS 16 with regard to the assessment of WACC's is the increase in comparability of operating leverage and observed unlevered beta's between (peer) companies that own assets versus (peer) companies that lease assets (real estate as a specific example).

Currently, the expenses for operating leases are included in (deducted from) EBITDA and consistently incorporated in the future FCF's (also in the terminal value). This is a relatively simple approach to properly reflect the negative value of leasing into perpetuity. After IFRS 16, the negative value of the leasing is included in the valuation by the increased net debt for the lease obligation, however only for the remaining lease period. This complicates the DCF approach and increases the sensitivity for errors, amongst others in view of the following:

- The depreciation related to the lease should not be offset by Capex (as this is already reflected in the lease obligation). However, Capex is sometimes – for simplicity purposes – assumed to equal depreciation[6]. This could then lead to undervaluation, primarily for companies with very long remaining operational lease terms.
- Alternatively, one should properly incorporate the negative impact of future cash outflows relating to continuation of leasing from the moment that the lease expires. If this is not explicitly reflected in the future FCF's this could lead to overvaluation, primarily for companies with very short remaining operational lease terms.

These considerations and attention areas obviously already apply to dealing with finance leases in valuations, a topic which is often underexposed by practitioners.

Market approach

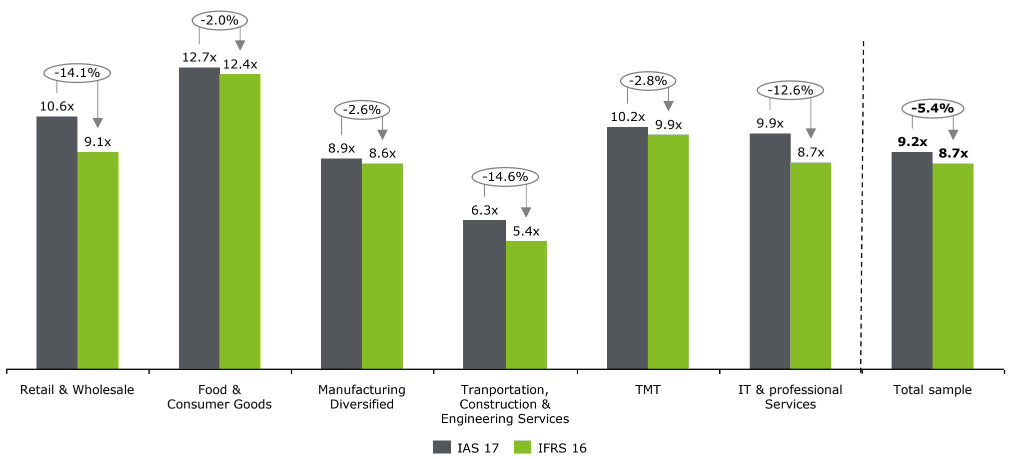
Valuations based on market multiples are also likely to be affected by the switch to IFRS 16, as it influences valuation multiples. EV/EBITDA multiples are impacted because:

- Enterprise Values increase under IFRS 16 compared to IAS 17, due to capitalization of the present value of future lease payments (expressed by the higher financial debt); and
- EBITDA decreases, due to the removal of operational lease expenses.

As both the numerator and the denominator increase, post IFRS 16 EV/EBITDA trading multiples may be either lower or higher than under IAS 17, but in any case will not remain unaffected (in case a company has operating leases)

The vast majority of EV/EBITDA multiples will decrease. We estimate that the median EV/EBITDA 2016 trading multiple[7] of the 50 publicly-listed companies in our research would decrease by some 5% post IFRS 16. Obviously, a substantial variance is observed in the sample, with a decrease in EV/EBITDA trading multiples of over 25% for companies with many operating leases (including retail companies).

EV / EBITDA 2016 trading multiples



Source: Bloomberg, annual reports, Deloitte analysis
Note: based on median observation within group

[6] Particularly in the terminal value period
[7] EV/EBITDA trading multiples have been based on sum of Market Capitalization and net debt positions (according to Bloomberg) as per year-end 2015, divided by the 2016 EBITDA as expected by equity analysts (Bloomberg BEST estimates).

The average decrease in EV/EBITDA multiples is the result of the NPV of future lease obligations (increase in net debt and hence also in enterprise value) being relatively low compared to the current operating lease expenses (increase in EBITDA). We formulate the following rule of thumb:

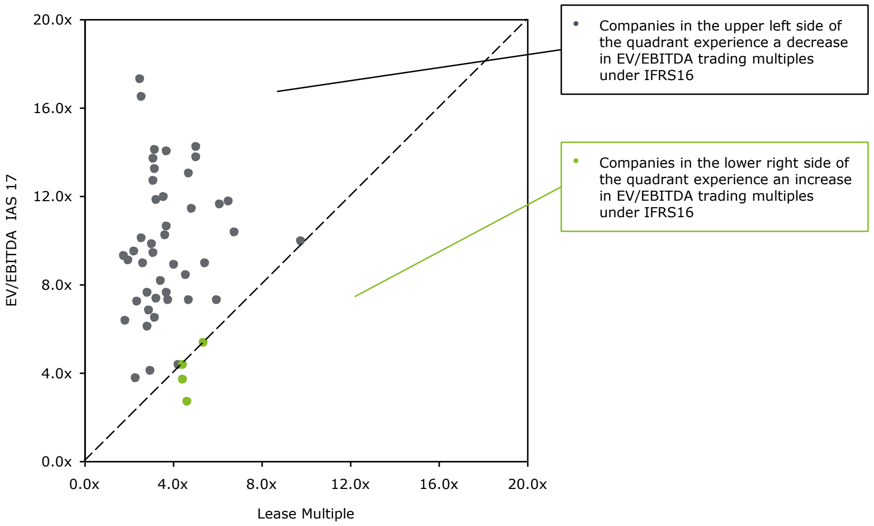
When the ratio NPV lease obligation / current operating lease expenses (also referred to as 'lease multiple') is lower than the current EV / EBITDA trading multiple, the EV/EBITDA trading multiple decreases following the introduction of IFRS 16. Conversely, when the lease multiple is higher than the current valuation multiple, the EV/EBITDA multiple will increase.

The latter is more exceptional and only applies to companies with long average remaining lease terms and / or low valuation multiples[8].

This relationship is illustrated in the graph below, in which all companies in our sample have been plotted based on their 1) current EV/EBITDA trading multiple under IAS 17 and 2) Lease multiple. The (few) companies that are in the lower right side of the quadrant, experience an increase in their EV/EBITDA trading multiples, the ones the upper left side of the quadrant experience a decrease in their EV/EBITDA trading multiples

Contrary to the general decrease in EV/EBITDA multiples, the impact of IFRS 16 on the EV/EBITA or EV/EBIT multiples is less clear. This is understood because the increase in EBIT(A) is lower than the increase EBITDA following IFRS 16 (as a large part of the formal rental charges is reflected in depreciation under IFRS 16). We observe that the median EV/EBITA 2016 trading multiples of the sample even slightly increases (as presented in the graph on the next page).

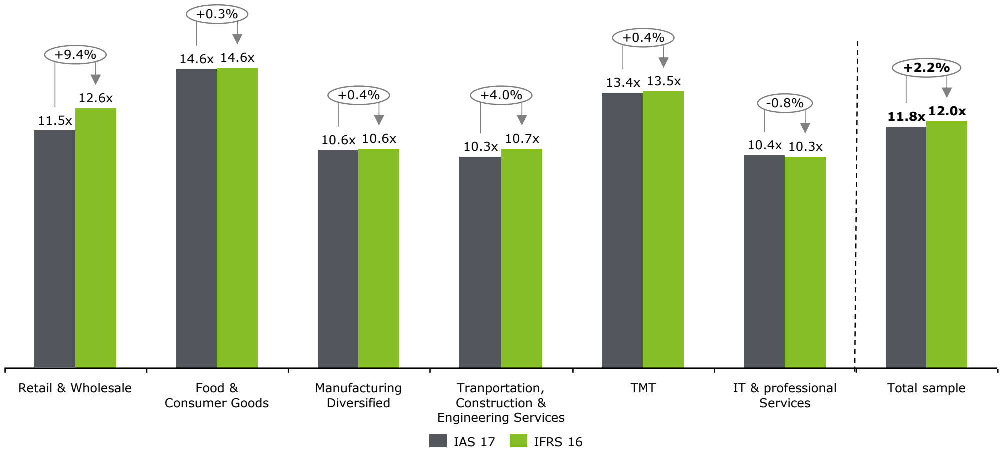
Current EV / EBITDA trading multiple versus lease multiple



Source: Bloomberg, annual reports, Deloitte analysis

[8] This is amongst others the case for AirFranceKLM.

EV / EBITA 2016 trading multiple



Source: Bloomberg, annual reports, Deloitte analysis
Note: based on median observation within group

As the impact of IFRS 16 on EV / EBITDA multiples will never be exactly the same between peers and target companies, the results of market based valuations will be affected without proper adjustments.

Furthermore, although value assessments based on market multiples post IFRS 16 should theoretically also result in the same equity value, the outcomes of valuations will change and raise new attention areas in business valuation.

An advantage of IFRS 16 when comparing and valuing companies, of which some own assets and while other lease similar assets, is the comparability of EBITDA, being operating profit before costs for these assets (comparable to EBITDARL[9] under IAS 17). However, when using EV/EBITDA multiples in valuations the disadvantage can be more significant. This mainly relates to the nature of the net debt related to the remaining lease obligation, which might not be comparable between companies. For example, assume a retail company that rents all its premises and shops (A) and a similar company that owns its real estate (B). Both companies have the same EBITDA post IFRS 16[10]. Company A currently has a financial lease obligation based on an average remaining lease term of 4 years. The enterprise values of A and B are the same under IFRS 16 (based on using the same EV/EBITDA multiple). If the net debt related to the financial lease of A is not adjusted for the negative value of the leasing after this period, Company A is overvalued compared to Company B[11]. The same over – or undervaluation could arise if the average remaining operational lease term of the target company materially differs from the peer group (even if all companies lease assets).

For sectors with material leases, we recommend to assess the relative average remaining lease term reflected in the net debt of the peers and compare with your target. Potentially adjust the net debt related to finance leases of peers and target companies in order to have a proper comparison. Alternatively, particularly for target and peer companies where clear differences exist in the ownership of assets and / or the remaining lease term, the use of EV / EBITA multiples could be recommendable and yield better value results.

[9] Earnings before interest, taxes, depreciation, amortisation, rental- and lease expenses.
[10] Under IAS 17 Company A's EBITDA would be lower (with the annual lease charge).
[11] Company B already purchased the real estate to use the assets into perpetuity. Selling and leasing back its real estate (making B more comparable to A) would presumably decrease its net debt position with 10x – 15x rent (depending on the market value of the real estate). Then agreeing on an operational lease contract with the same average remaining lease term (4 years) would make the valuation consistent and lead to a substantially higher valuation of Company B (dissolving the undervaluation).

Conclusion

Companies with material off-balance sheet lease commitments will encounter significant changes in their financial metrics such as leverage ratio and valuation multiples due to the implication of IFRS 16. As our analysis depicts, enterprise values will increase and EV / EBITDA multiples will decrease. The impact of IFRS 16 obviously depends on a company's relative number of existing operational lease agreements and hence varies across industries.

Although accounting policies should not affect economic valuations, we foresee that IFRS 16 will impact the outcomes of valuations and introduce new attention areas in business valuations and M&A transactions. DCF valuations become more complex and are more sensitive to errors. Also, when clear differences exist in the ownership of assets and / or the remaining lease term between target and peer group companies, the use of EV/EBITDA multiples could more easily lead to under – or over valuation.

We amongst others raise the following attention areas and recommendations in business valuation:

- Always gain proper insight in the lease obligations and average remaining lease terms of the subject business;
- In DCF analyses, be alert not to simply set Capex equal to the depreciation that relates to the current lease agreements (as this is already reflected in the net debt);
- In DCF analyses, properly incorporate the negative value effect of the required continuation of leasing after the lease agreements expire (either in the future free cash flows or by separately adjusting net debt);
- Assess the comparability in ownership of assets and the remaining lease terms between target – and peer group companies; and
- Not always simply use EV/EBITDA multiples without further consideration and potentially:
  - Adjust the net debt related to financial leases; and / or
  - Use EV / EBITA multiples.

We welcome the opportunity to further discuss the impact of key attention areas for your specific situation.

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