

**IFRS 16 Valuation Impact**

What you need to know now

August 2019



# Introduction

The International Accounting Standards Board (IASB) issued **IFRS 16: Leases in 2016**. The standard is effective for financial periods beginning on or after 1 January 2019. IFRS 16 replaces the previous leases standard, IAS 17: Leases, and sets out the principles for recognition, measurement and disclosure of leases for both the lessor and lessee.

Under IAS 17, a lessee classified a lease as either finance or an operating lease depending on whether or not the lease is economically similar to purchasing the underlying asset. However, under IFRS 16, a lessee will no longer be able to make the distinction between operating and finance leases and all leases will be treated as finance leases, subject to certain exemptions.

The introduction of IFRS 16 will lead to an increase in leased assets and financial liabilities on the balance sheet of the lessee, while Earnings before Interest, Tax, Depreciation and Amortisation (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 the leverage ratio, return on invested capital (ROIC) and implied valuation multiples.

Although the introduction of new accounting policies should not affect the fundamental and economic valuation of a company, we foresee that IFRS 16 will impact key valuations metrics and introduce new attention areas in M&A transactions.

To illustrate the effect of IFRS 16 on valuation metrics, we selected a sample of 75 JSE listed companies across a range of sectors and assessed the impact the new standard will have on implied multiples and leverage ratios. As we analysed EV/EBITDA multiples, we excluded companies in the financial services and real estate sectors.

# Key impact on financials and ratios

From a business valuation perspective, the equity value or market value of the company should not change with the implementation of IFRS 16 as there is no change to the underlying cash flows being generated by the business. However, adopting IFRS 16 will result in the company's net debt and EBITDA increasing, which is likely to complicate the comparability of valuation multiples, particularly in the short term.



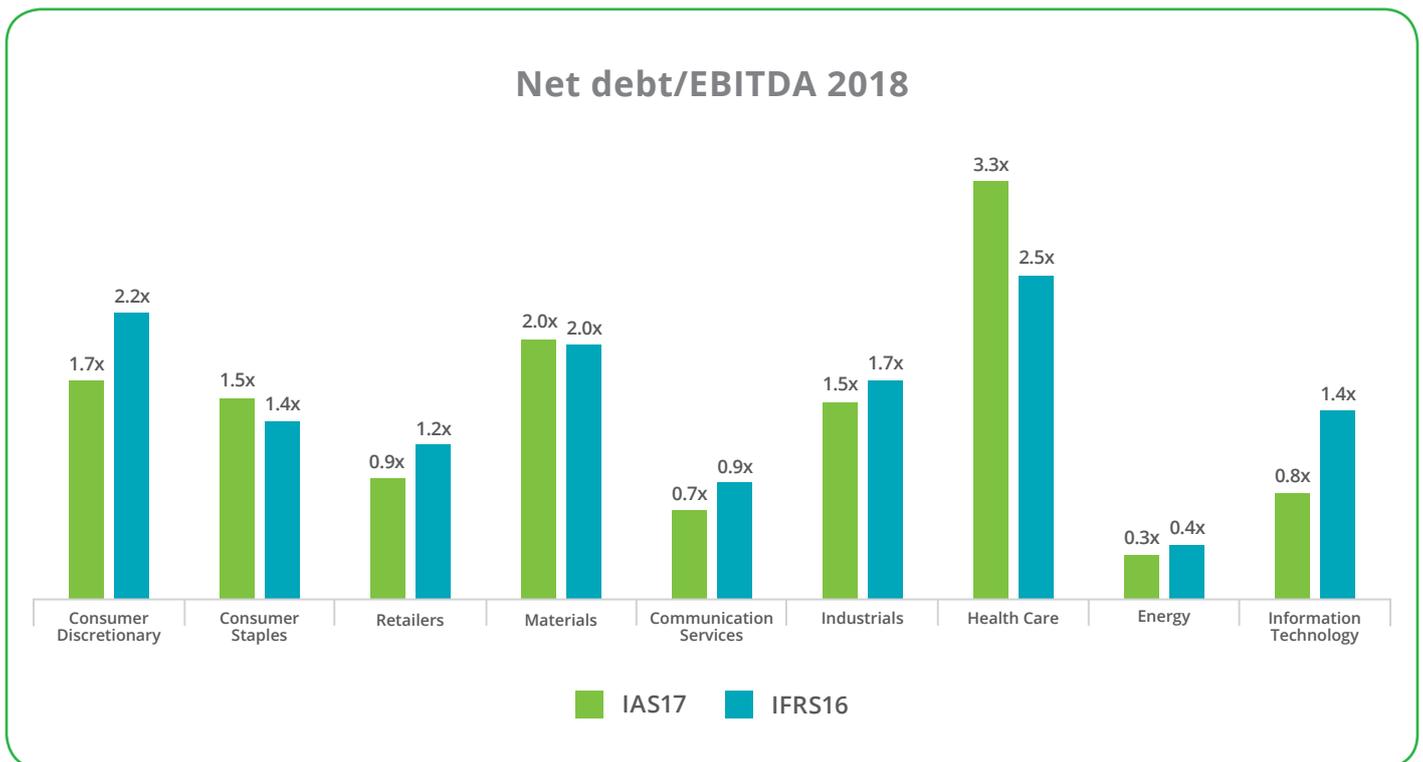
Based on our research of a sample of 75 JSE listed companies, the new accounting treatment will lead to:

- An increase in net debt with the recognition of incremental lease liabilities. Our research indicates that the combined net debt of our sample of JSE listed companies is likely to grow by some R 288 billion. This represents an increase in net debt of approximately 16% and we observe that for 18 out of 75 companies, the increase in net debt is 50% or higher.

- Higher EBITDA with lease expenses effectively being capitalised and flowing through the income statement as a depreciation and finance charge. Our research indicates an approximate total increase of R 92 billion in EBITDA across our sample of companies, a 10% increase.
- Higher invested capital for the lessee which generally lowers the ROIC.

The impact on net debt and EBITDA is predictably the most significant for companies with many operating leases such as those in the retail, consumer discretionary including hospitality, and communication services sectors.

We also observe, for the majority of sectors<sup>1</sup>, an increase in net debt/EBITDA ratios. The impact is largely dependent 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 term of the lease.



Source: Capital IQ, Annual Reports, Deloitte analysis

Note: The sector classification is as per Capital IQ except for Retailers (consisting of food, home and clothing retailers) which was carved out to show the impact separately.

# Impact on valuations

The introduction of IFRS 16, should not in principle change the fundamental equity value of a company, although the enterprise values of companies will increase. Accounting for a lease as either operating or finance in nature does not alter the economics and cash flow generating capacity of the business. However, as IFRS 16 impacts the implied financial metrics of a company (primarily EBITDA, net debt and therefore implied enterprise value), adjustments and additional considerations are required in the most commonly applied valuation methodologies: (i) Discounted Cash Flow (DCF) approach; and (ii) Market approach based on market multiples.

We have summarised a few implications and considerations segmented into the most commonly applied valuation methods:

- The DCF approach
- The Market approach based on market multiples

As mentioned, IFRS 16 will increase the implied enterprise value of companies as net debt will increase, while the equity value (market capitalisation) should remain the same. In the DCF approach and assuming a Free Cash Flow to Firm (FCFF) model, enterprise values are assessed based on the net present value of expected free cash flows and the impact of IFRS 16 will generally be reflected in the following manner:

- The future FCFF will be higher over the remaining lease period, as rental expenses are excluded from EBITDA.

- The depreciation charge relating to the new finance lease asset is a non-cash item and consequently does not negatively impact FCFF.
- The lease payments are reflected in the cash flow statement through interest payments and redemptions of the lease obligation, however, these are financing items and also do not impact FCFF.

The increase in enterprise value should theoretically be offset by the increase in net debt (representing the NPV of the remaining lease obligation) resulting in the same equity value. However, as we expand on this in the following paragraphs, the introduction of IFRS 16 makes valuations based on the DCF more complex, more sensitive to errors and may presumably lead to unintended changes in the valuation of equity.

Currently, operating lease costs are accounted for as an expense in EBITDA and are therefore deducted in calculating forecast FCFF in the DCF

model. This assumption is held constant in estimating the terminal value which effectively assumes a maintainable level of operating lease costs into perpetuity, irrespective of the current term of the lease.

Post IFRS 16, the costs of leasing are captured in the valuation through the increased net debt resulting from the recognition of lease liabilities. However, the recognition of the liability is limited to the current remaining term of the lease and does not include any renewals.



Valuation practitioners would need to 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 forecast FCFF, this could lead to an overstatement of value, primarily for companies with very short remaining operational lease terms.

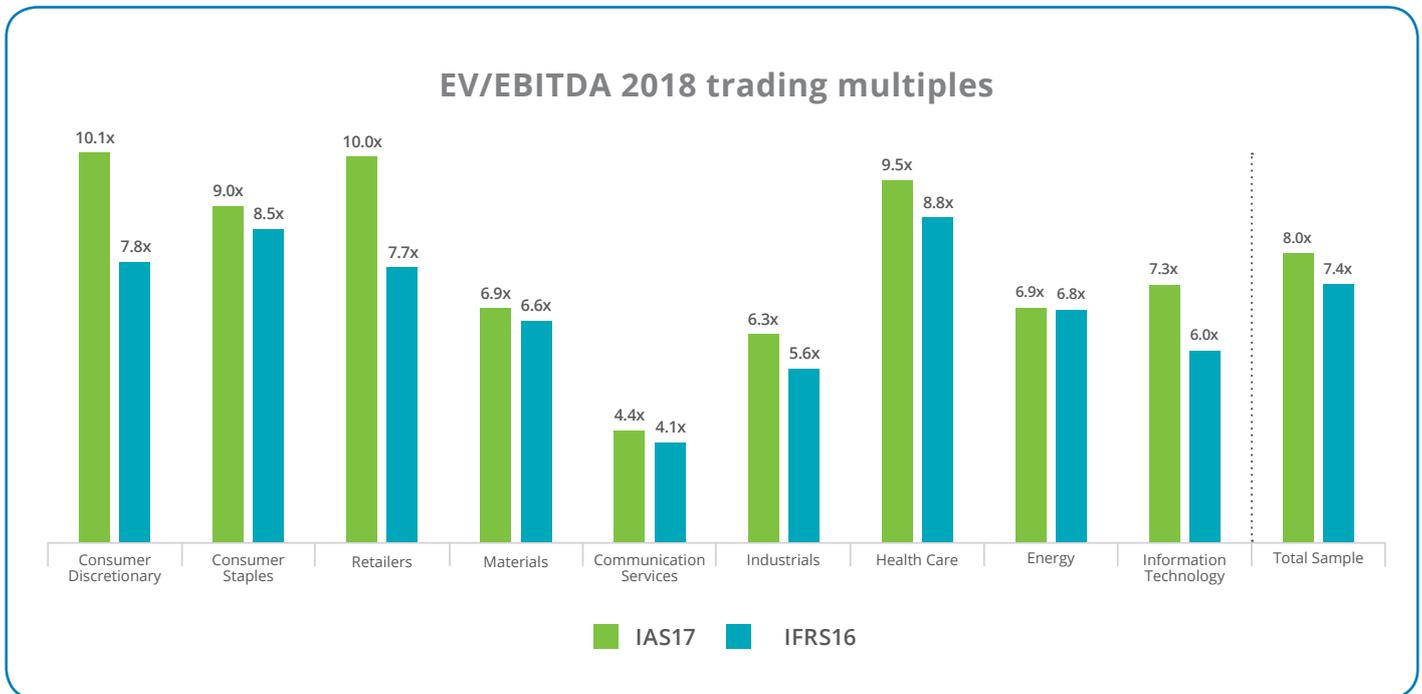
These considerations and attention areas already apply to dealing with finance leases in valuations, a topic which is often underexposed by practitioners.

**Market approach**

Market multiples such as EV/EBITDA are commonly applied in valuations either as the primary approach or to benchmark the valuation results under the DCF approach. With the adoption of IFRS 16, EV/EBITDA multiples are impacted because:

- Enterprise Values increase due to capitalisation of the present value of future lease payments<sup>2</sup> (resulting in higher financial debt).
- EBITDA increases: due to the removal of operational lease expenses.

Based on our research, the vast majority of EV/EBITDA multiples are expected to decrease. We estimate that the median EV/EBITDA<sup>3</sup> 2018 trading multiple of the 75 publicly-listed companies in our research would decrease by approximately 7.7% post IFRS 16. A substantial variance is observed in the sample, with a decrease in EV/EBITDA trading multiples of over 20% for companies with many operating leases (including retail companies).



Source: Capital IQ, Annual Reports, Deloitte analysis

Note: The sector classification is as per Capital IQ except for Retailers (consisting of food, home and clothing retailers) which was carved out to show the impact separately.

The most significant decrease in the sector average multiple was 22.7%, observed for retailers. The average decrease in multiples in the consumer discretionary sector, which included hospitality and education groups amongst others, was similar at 22.5%.

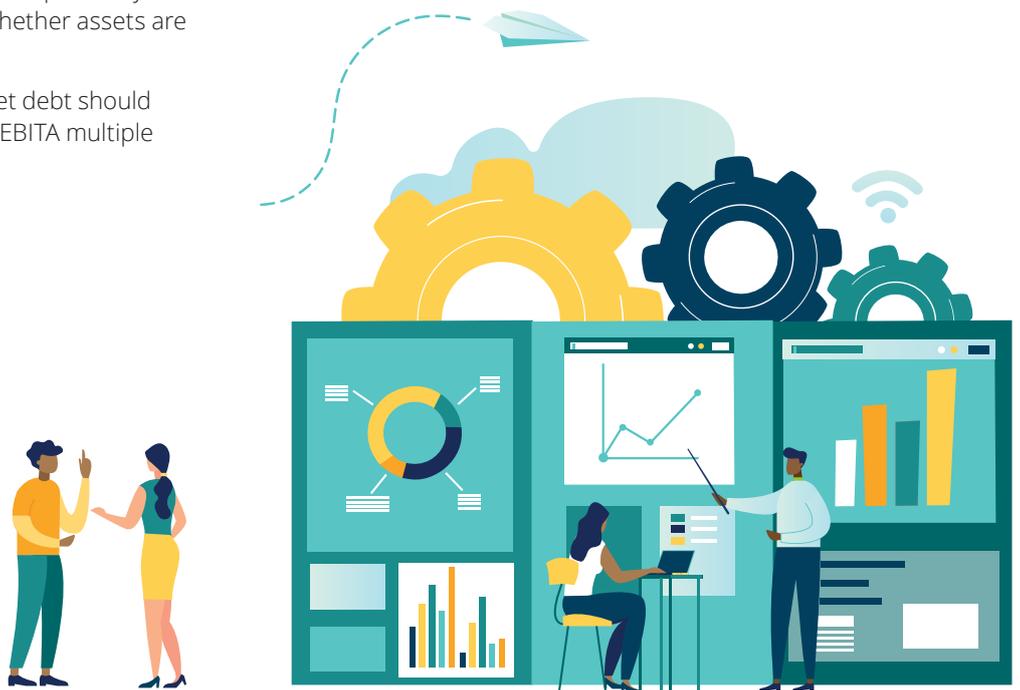
Although EBITDA remains comparable between peers and target companies, the impact of IFRS 16 on EV/EBITDA multiples may vary resulting in the outcome of market approach valuations being affected if an appropriate adjustment is not made. This is due to the increased net debt relating to the remaining lease obligations.

For sectors with material leases, the average remaining lease term reflected in the net debt of the peers should be compared with the target company. Where significant differences exist in the exposure to leases, an EV/EBITDA multiple may lead to a more appropriate result.

# Conclusion

In conclusion the introduction of IFRS 16 adds an additional level of complexity in valuations and we emphasise the following key areas of impact and consideration:

- The lease obligations and average remaining lease term of the target should be analysed;
- In DCF valuations, lease expenses should be treated as an operating cash outflow or adequately reflected in net debt;
- The terminal value should appropriately consider the required continuation of leases after the expiry of current agreements;
- In market approach valuations, the comparability of the target and peers should consider whether assets are owned or leased; and
- When using EV/EBITDA multiples, net debt should appropriately be adjusted or an EV/EBITA multiple should be considered.



<sup>1</sup> We note that companies with net cash positions have been excluded from this net debt/EBITDA analysis.

<sup>2</sup> This is based on the operational lease obligations of a sample of 75 publicly-listed companies on the JSE (excluding financials and real estate companies). The remaining lease duration for each company was assumed to be the total remaining lease obligation, divided by the 2018 lease obligation, assuming a discount rate of 10.25%.

<sup>3</sup> EV/EBITDA trading multiples were based on enterprise value, i.e. the sum of market capitalisation and net debt (according to Capital IQ) as at 31 December 2018, divided by the 2018 EBITDA.

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