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IFRS 16—Leases

Introduction

This article discusses the impact of adopting IFRS 16 on the lessees' financial statements. Important considerations for valuation of businesses using both income and market methods and valuation of intangible assets using the Multi-Period Excess Earnings Method ("MEEM") in the post IFRS 16 era will be discussed.

IFRS 16 replaces IAS 17 and is effective for annual reporting periods beginning on or after 1 January 2019. IFRS 16 will have a significant impact on companies that have relied on off-balance sheet financing in the form of operating leases; particularly in the airline, retail, transportation, telecommunication, and energy sectors.

IFRS 16 Basics[1]

According to IFRS 16, a contract is, or contains a lease, if:

> *"it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use."*

IFRS 16 applies to all leases, including subleases, except for the following:

- Leases with a lease term of 12 months or less and containing no purchase options.
- Leases where the underlying asset has a low value when new. According to IASB, an indicative threshold for a low value item is less than $5,000.
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources.

[1] iasplus.com—IFRS 16 Leases.

- Leases of biological assets held by a lessee.
- Service concession arrangements.
- Licences of intellectual property granted by a lessor.
- Rights held by a lessee under licensing agreements for items such as films, videos, plays, manuscripts, patents and copyrights within the scope of IAS 38 Intangible Assets.

Previously, under IAS 17, a lessee would determine a lease to be either an operating lease or a finance lease (also referred to as capital lease) depending on the economic substance of the lease. If a lease was determined to be economically similar to purchasing the underlying asset, the lease was classified as a finance lease and recognised on the lessee's balance sheet. All other leases were classified as operating leases and not reported on the lessees' balance sheet. Operating leases were accounted for with the lessee recognising a rental expense in the income statement.

IFRS 16 eliminates the classification of leases as either operating leases or finance leases for a lessee. Instead, all leases are treated in a similar way to finance leases under IAS 17.

Impact on Lessee and Lessor

Under IFRS 16:

- A lessee is required to recognise (1) a right-of-use ("ROU") asset representing its right to use the underlying leased asset; and (2) a lease liability representing its obligation to make lease payments.
- Lessors will continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting remaining largely unchanged from IAS 17.

Initial Measurement

The lease liability and right-of-use asset are measured as follows on the commencement date of the lease:

Lease Liability—Present value of the lease payments during the lease term. The present value of lease payments should be determined based on the rate implicit in the lease if that can be determined. If this cannot be determined, the incremental borrowing cost of the lessee should be used as the discount rate.

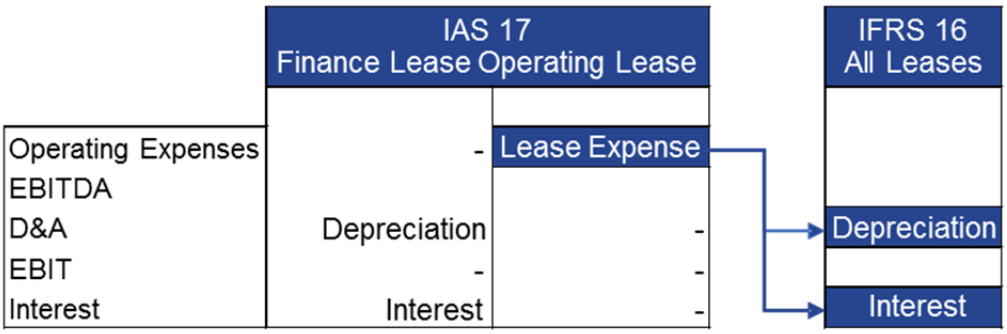
Right-of-Use Asset—Calculated as: (1) the present value of the lease liability; plus (2) any lease payments made to the lessor on or before the lease commencement date; plus (3) any initial direct costs incurred by the lessee; minus (4) any lease incentives received and the initial estimate on restoration costs.

Subsequently, the lease liability should be re-measured to reflect changes in the: (1) lease term; (2) assessment of a purchase option, if any; (3) amounts expected to be payable under residual value guarantees; and (4) future lease payments as a result of change in an index or rate used to determine those payments. A lessee should also recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

After the commencement of the lease, the ROU asset is to be measured by using the cost model i.e. cost less accumulated depreciation and any impairments (subject to a few exceptions).

Impact on Lessee Financial Statements

Profit and Loss Statement



As shown in the illustration above, IFRS 16 impacts the lessee's P&L where they have previously classified leases as operating leases. The lease expense recognised under IAS 17 will now be recognised as depreciation of the right-of-use asset to be recognised on the balance sheet as well as an interest expense. As a result of implementing IFRS 16, operating expenses will be lower, interest expense will be higher, and EBITDA and EBIT will be higher.

Balance Sheet

The impact on the balance sheet will be twofold, the recognition of a right-of-use asset and a lease liability. As a result, companies that have previously had significant off-balance sheet leases will now show higher assets and higher liabilities and lower book value of equity. Compared to IAS 17, the book value of equity will initially be lower due to the fact that under IFRS 16 accounting the expenses (depreciation and interest) are front-loaded compared to IAS 17 where rental expense remained the same throughout the life of the lease.

Cashflow Statement

The total cashflows of a company will not change as a result of implementing IFRS 16. However, IFRS 16 is expected to impact the classification of cash flows generated through operating and financing activities. Compared to IAS 17, cash from operating activities is expected to increase under IFRS 16 as cash outflows related to operating leases will no longer be included within cash from operating activities. The increase in cash from operating activities will be offset by a decrease in cash from financing activities as cash outflows related to principal repayments and interest (interest can be recognised under financing activities under IFRS) on lease liabilities will be recognised within cash from financing activities.

Valuation Considerations

Discounted Cashflow Method ("DCF")

As a result of IFRS 16 the NPV of free cashflows to the firm ("FCFF") are expected to be higher resulting in a higher Enterprise Value ("EV"). The higher NPV of FCFF is a result of a higher EBITDA and lower WACC absent any adjustments in market pricing metrics observed. The WACC is expected to be lower as a result of a higher D/E mix in the capital structure of peer group companies used to determine the target capital structure. Although the Enterprise Value will increase, equity value should remain unchanged i.e. theoretically the increase in enterprise value should be offset by the increase in net debt.

Valuations using the DCF method will become more complicated and susceptible to errors as a result of IFRS 16. Several areas for consideration when valuing a company using the DCF method are discussed below.

Capturing Cashflows Related to Leases into Perpetuity

As mentioned earlier, prior to IFRS 16 all lease expenses for operating leases were captured in operating expenses and hence, included in the determination of EBITDA. Consequently, lease expenses were consistently incorporated into the free cashflow forecasts of the Company. However, post IFRS 16 there will no longer be an operating expense for leases, but rather a depreciation (non-cash expense) and interest expense which are not captured within EBITDA. Additionally, the increase in net debt only captures the present value of lease obligations for the remainder of the lease term(s) i.e. the P.V. of lease liability does not capture the future cash outflows reflecting the renewal of the leases in future periods (conceptually, into perpetuity from a valuation perspective). When using the DCF method, care should be taken to ensure cash outflows related to the continuation of the leases into perpetuity are considered in valuing the business.

Capex and Depreciation

A further consideration in using the DCF method relates to capex and depreciation. Prior to IFRS 16, unless a company was forecasted to have significant growth capex, a common assumption used by valuers and analysts was that capex equals depreciation. However, post IFRS 16 this simplifying assumption will no longer be valid. Depreciation related to leases should not be offset by capex as this is already reflected in the present value of lease obligations within net debt. As a result, careful consideration needs to be given to capex when performing company valuations after the implementation of IFRS 16.

Guideline Company Method ("GCM")

Valuation of companies using the GCM is also affected by IFRS 16. Multiples based on Enterprise Value such as EV/EBITDA and EV/EBIT will be affected as EV, EBITDA, and EBIT will all be higher. EV increases as a result of recognising the P.V. of lease liabilities and EBITDA and EBIT increase due to the removal of the lease expense (although EBIT will capture a large portion of previously recognised lease expense through depreciation of the ROU asset). In most cases, EV/EBITDA and EV/EBIT multiples are expected to be lower post IFRS 16 as the relative impact of IFRS 16 on EV is expected to be lower compared to the impact on EBITDA and EBIT. The relative magnitude of change in the Enterprise Value, EBITDA and EBIT post IFRS 16 will vary between companies as the present value of lease liabilities and the value of the right-of-use asset depend on length of the lease(s) and interest rates/incremental borrowing costs which will vary amongst companies. The longer the lease period and the lower the discount rate used to compute present value of lease liabilities, the higher the value of the lease liability and the right-of use asset. Longer lease periods also result in a lower depreciation expense compared to an identical lease for a shorter period.

In valuing companies in 2019, consideration must be given on whether to rely on FY2018/Latest Twelve Month ("LTM") multiples. This is because LTM multiples will not be comparable to FY2019/Next Twelve Month ("NTM") multiples for companies which have decided to apply IFRS 16 using the modified retrospective approach as LTM multiples will not include the impact of IFRS 16 but NTM multiples will. Consequently, it is important for valuers or analysts to determine whether guideline companies have applied IFRS 16 using the modified retrospective or the full retrospective approach.

Guideline Transactions Method ("GTM")

The GTM is based on observed enterprise valuation multiples based on acquisition of firms viewed as meaningful guidelines for a subject enterprise. Commonly valuation practitioners analyse guideline transactions within the industry during relevant years prior to the valuation date to compile a reasonable group of guideline transactions. As a result of IFRS 16 changes, the observed multiples in historical transactions (prior to IFRS 16) will not be comparable to post IFRS 16 profitability measures such as EBITDA or EBIT. It could take several years before a sufficient number of post IFRS 16 transactions have occurred for various sectors to enable valuers to utilise the GTM in valuing companies using traditional enterprise value-based multiples. However, valuers/analysts using the GTM might start applying multiples (based on pre IFRS 16 profitability measures such as EBITDA) to post IFRS 16 profitability measures of the subject company such as "EBITDAal" (EBITDA after leases i.e. including lease related depreciation and interest expense).

Valuation of Intangible Assets Using the Multi-Period Excess Earnings Approach ("MEEM")

The Multi-Period Excess Earnings Method is a form of an income approach often used to value the primary intangible asset of a company. The value of the subject intangible asset is calculated as the sum of the present value of projected cash flow, in excess of returns on contributory assets over the life of the asset. Contributory asset charges are applied for all assets (apart from the asset being valued) which contribute to the income generation of the subject company. Contributory assets include working capital, fixed assets, workforce and other identified intangible assets. Post IFRS 16 a contributory asset charge should also be recognised for the right-of-use asset arising as a result of IFRS 16.

Conclusion

IFRS 16 reflects new requirements for lessees' lease accounting. Adoption of IFRS 16 requires significant work for many lessees and results in various areas which must be carefully considered especially when valuing companies using DCF, GTM and GCM valuation methods.