

On-Balance Sheet Operating Leases: How They Change Financial Statement Analysis and Valuation

Would You Like Some Rent with That Lease?



Operating Leases: Big Changes This Year!

“Help! Companies are now reporting Operating Leases on their Balance Sheets because of IFRS 16 and ASC 842, two new rules that took effect in 2019.

How does this affect accounting and valuation? Do I add Operating Leases to calculate Enterprise Value now?”

Operating Leases: The Short Answer

- **Main:** Under both U.S. GAAP and IFRS, companies now report Operating Leases as Liabilities on their Balance Sheets, along with “Right-of-Use” Assets corresponding to them on the Assets side
- **U.S. GAAP:** Companies still record Operating Lease Rent as an Operating Expense on the Income Statement
- **IFRS:** Companies now split the old Rental Expense into Depreciation + Interest components on the Income Statement
- **But** despite these changes, most companies’ Net Income and Net Change in Cash figures barely change! It’s still the **same total expense**, just presented differently



Operating Leases: The Short Answer

- **Tricky Part:** Companies are still transitioning, and they're restating their old financial statements differently (or not at all...)
- **Valuation:** You *can* add Operating Leases to calculate Enterprise Value, but you must then **exclude** the IS expenses in the denominator, such as in EBIT or EBITDA
- **U.S. GAAP:** Effectively, you must use EBITDAR or EBITR (???) if you count Operating Leases as Debt in the TEV calculation
- **IFRS:** EBIT is now a problematic metric, and when you use EBITDA, you need to pair it with TEV + Operating Leases in the numerator... also, EBITDA and EBITDAR are now effectively **the same**



The Longer Answer: Outline

- **Part 1:** How these changes work based on a hypothetical airline company's financial statements



- **Part 2:** How real companies (Target in the U.S. and EasyJet in the U.K.) are applying these rules, or transitioning to them



- **Part 3:** Valuation multiples and metrics



- **Part 4:** Summary of operating leases in financial models



Part 1: Airline ABC's Financial Statements

- **Income Statement:** No real changes under U.S. GAAP; under IFRS, old Rental Expense is now split into Depreciation (under OpEx) and Interest Element of Op. Leases in Other Income / (Expense)
- **Effect:** EBIT, EBITDA, and EBITDAR stay the same under U.S. GAAP; under IFRS, EBIT and EBITDA increase and EBITDAR stays the same
- **Balance Sheet:** Under both systems, Right-of-Use (ROU) Assets and Operating Lease Liabilities now show up, and Equity is adjusted
- **Small Differences:** Total amount of ROU Assets may be slightly different due to different methodologies in each system



Part 1: Airline ABC's Financial Statements

- **Cash Flow Statement:** Under IFRS, Cash Flow from Operations increases due to the additional Depreciation
- **But** Cash Flow from Financing falls due to the “Repayment of the Capital Element of Operating Leases,” which offsets Depreciation
- **Net Effect:** Net Income, Net Change in Cash, and Ending Cash stay the same, or close to the same under the old system and new ones
- **Why:** Because these rules just change the *presentation* of the lease expense – not its total amount! \$100 over 10 years is still \$1,000, or \$100 per year



Part 2: What Real Companies Are Doing

- **Target (U.S. GAAP):** They recognize the Lease Assets and Lease Liabilities on their Balance Sheet, and they say explicitly that the Operating Lease Cost is within SG&A on the Income Statement
- **Key Metrics:** They also count Operating Leases as “Invested Capital,” and they add back a portion of the Lease Expense as “Interest” in the NOPAT calculation for ROIC
- **Why?** Mostly for **comparison purposes** to companies that follow IFRS... or companies that use all Capital Leases rather than Operating Leases



Part 2: What Real Companies Are Doing

- **EasyJet (IFRS):** They are increasing Depreciation + Interest on the IS due to these new rules...
- **But** “Rent” is split across Maintenance and Dry Leasing, so both accounts must be reduced
- **Balance Sheet:** Recognizing ROU Assets under PP&E, and recognizing two separate Operating Lease Liabilities now
- **Cash Flow Statement:** Higher Depreciation + Interest, and CFF is lower due to the Repayment of the Capital Element of Op. Leases
- **ROCE:** Slightly different approach... see the next part

easyJet



Part 3: Valuation Multiples and Metrics

- **Valuation:** If you treat Operating Leases as Debt in Enterprise Value, you must add back all corresponding lease expenses on the IS in metrics like EBITDA
- **Implication #1:** Under IFRS, you *need* to add Operating Leases in Enterprise Value unless you want to manually adjust metrics such as EBITDA
- **Implication #2:** Under U.S. GAAP, you could still use traditional metrics like EV / EBITDA and EV / EBIT, but if you add Operating Leases to Enterprise Value, you must use EV / EBITDAR



Part 3: Valuation Multiples and Metrics

- **Returns-based metrics** such as Return on Invested Capital (ROIC) and Return on Capital Employed (ROCE) are tricky because companies define them a bit differently...
- **Invested Capital** or **Capital Employed** are usually defined as Average Shareholders' Equity + Debt – Cash + Operating Leases (or capitalize the leases if not on Balance Sheet yet)
- **But** the Operating Income number you use to calculate NOPAT must exclude the Interest Element of Operating Leases now – even if the company uses U.S. GAAP!
- Take a look at **Target's** and **EasyJet's** filings to see this in action



Part 4: Summary of Op. Leases in Models

- **Projections:** No huge or difficult changes – just project the Lease Expense as usual but split it up differently, and link the Lease Assets and Liabilities to it in some way
- **Valuation:** If you add Op. Leases in the TEV calculation, which you pretty much have to under IFRS, you must pair it with metrics like EBITDAR that exclude all portions of the lease expense on the IS
- **And** under U.S. GAAP, you can use either approach – but make sure you use consistent metrics based on your method!
- **Returns-Based Metrics:** Be *very* careful with ROIC and ROCE now, and make sure the Interest Element is excluded from NOPAT

