IFRS 16

Implications for Business Valuation

IFRS 16 is replacing IAS 17

New standard effective for financial periods beginning on or after 1 Jan 2019[1]

	IAS 17	IFRS 16[2]
Definition of lease	• Distinction between **operating** and **finance** lease • Defining question: are all **risks and rewards** of ownership of the asset transferred to the lessee?	• **No distinction** • All material leases as **finance leases**, save for short-term and/or low value leases
B/S impact	• **Operating** lease: no assets / liabilities recognized • **Finance** lease: leased assets and leased liabilities	• **Right-of-use asset** and **lease liability** for most leases
P&L impact	• **Operating** lease: payments on a straight-line basis • **Finance** lease: depreciation for leased asset; and effective interest rate method for leased liability	• **Depreciation** for right-of-use assets • **Effective interest rate method** for lease liability
CF impact	• **Operating** lease: operating cash flow • **Finance** lease: refer to IFRS 16	• **Principal** portion: financing cash flow • **Interest** portion: financing/operating cash flow depending on entity's policy

1. For example, companies having a June financial year basis will need to adopt these standards by 30 June 2020.
2. This document focuses on the impact on lessee accounting and leases classified as operating lease before adoption of IFRS 16.

Source: Deloitte, PwC

Impacts on financial metrics

Balance Sheet

IFRS 16

Right-of-use	Lease liability
Asset	Liability
	Equity

- ↑ Total Asset / Enterprise Value (EV)
- ↑ Net Debt
- → Equity value

Income Statement

IAS 17	IFRS 16
Revenue	Revenue
Lease payment[1]	
EBITDA	EBITDA
	Depreciation
EBIT	EBIT
	Interest
EBT	EBT

- ↑ EBITDA
- ↑ EBIT (less substantial c.f. EBITDA)
- → EBT

Cash Flow Statement

IAS 17	IFRS 16
Operating	Operating
Lease payment	**Interest**[2]
Financing	Financing
	Principal
Investing	Investing
Total	Total

- ↑ Free cash flow to the firm (FCF)
- ↑ Operating cashflow
- ↓ Financing cashflow

1. Previous lease payment and the new depreciation are generally recognised on a straight-line basis. However, interest on lease liability would be higher in early stages of the lease. The resulting sum of depreciation and interest would be higher than previous operating expense in early stages of an individual lease and lower in latter stages, causing a front-loading effect on EBT.
2. IFRS 16 allows interest portion of lease payment to be classified as either cash flow from operating or financing activities depending on entity's policy.

Source: Deloitte, PwC

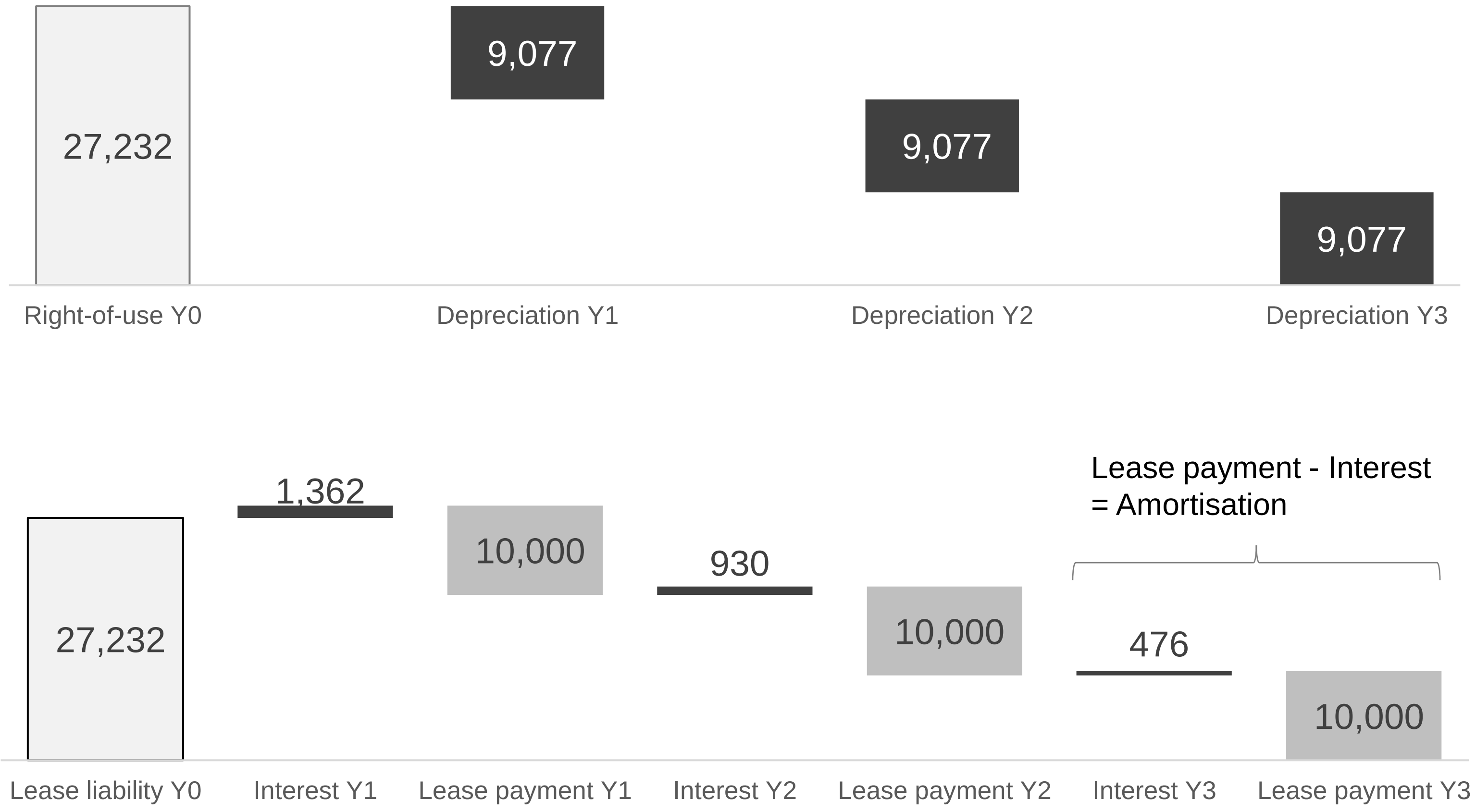
Illustration of accounting treatment

Year 0

Term of lease: 3-year
Lease payment: $10,000 annually
Interest rate: 5% p.a.
Present value: $27,232

Year 1 to Year 3

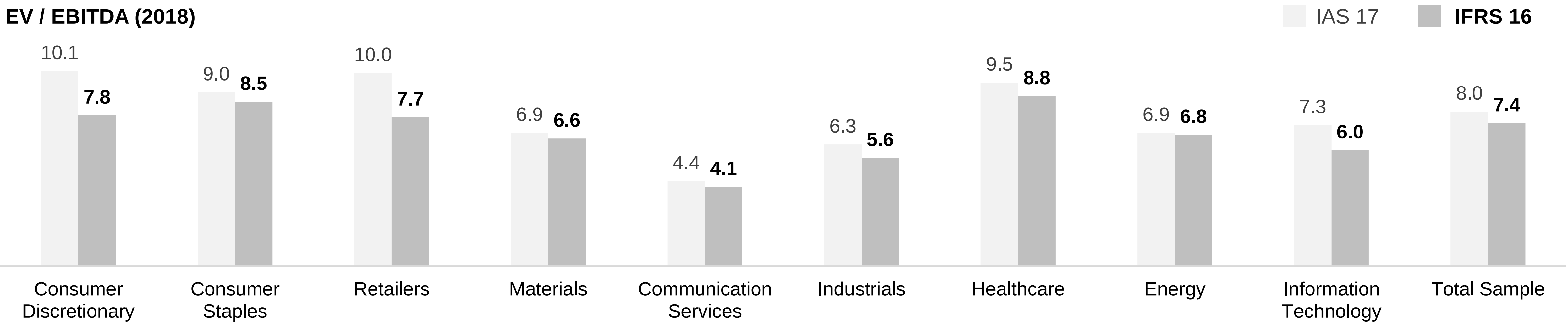
- Balance Sheet
  - **Right-of-use** asset depreciated linearly
  - **Lease liability** amortized based on effective interest rate method
- Profit & Loss
  - Lease payment recognized as both **depreciation** and **interest** expense
- Cash Flow Statement
  - **Lease payment** recognized as financing cash flows (principal and interest)
  - **Note:** sum of lease payments (CF items) equals to sum of depreciation and interest (P&L items) over the lease period



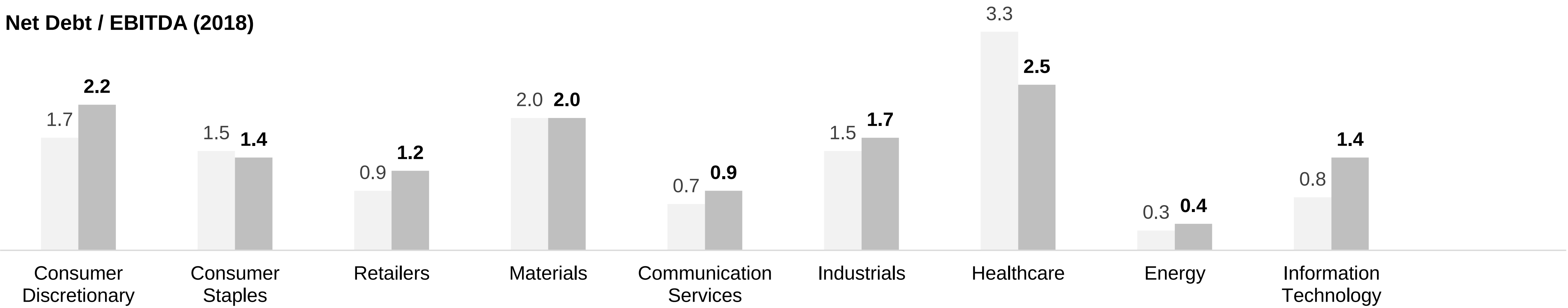
Impacts on trading multiple and leverage ratio

Research on 75 companies listed on the Johannesburg Stock Exchange

EV / EBITDA (2018)



Net Debt / EBITDA (2018)



Source: Deloitte

Potential issues in income approach valuation

Areas where discounted cash flow model can go wrong

Undervaluation

Estimating future capex needs simply as an offsetting amount of lease depreciation

→ **Overstated capex**

Omitting the elimination of operating lease expense from free cash flow to the firm

→ **Understated IFRS 16-based EBITDA**

Ignoring the lease liability as part of net debt in revised WACC calculation

→ **Overstated discount rate (WACC)**

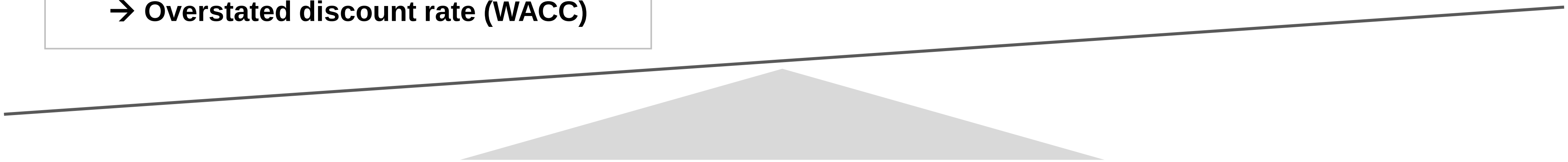
Overvaluation

Failing to incorporate negative impact of future cash flow when lease expires

→ **Overstated free cash flow**

Excluding forecast of increase in new leased assets in the form of lease capital expenditure

→ **Overstated free cash flow**



Key takeaways for income approach valuation

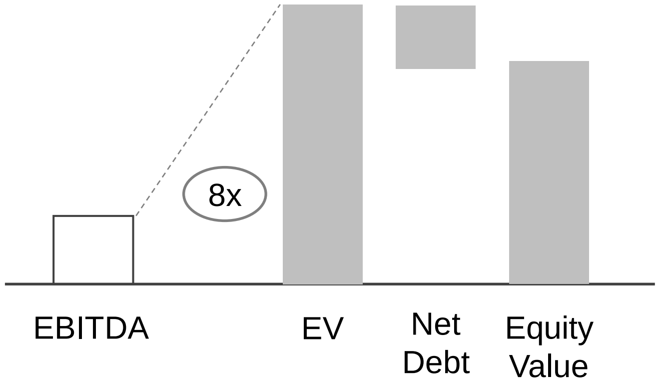
Follow a four-step approach

	1	2	3	4
What?	**Exclude former operating lease expense**	**Include cost of new leased assets in the forecast**	**Include new lease liability and cost of leasing in WACC**	**Include new lease liability as debt and deduct from EV**
Why?	Lease payment represents repayment of finance, not an operating expense or operating cash flow	This leasing capex represents the payments related to future new leased assets	Capitalisation of leases as a source of financing should be included in the DCF valuation discount rate	Using enterprise value DCF model, any value of non-common share claims must be deducted
How?	Do not include lease payment in free cash flow to the firm unless the lease is not subject to capitalisation	Consider past additions to right-of-use assets; forecast future additions based on growth assumptions	Cost of leasing may differ from other source of debt, but using a single average cost of debt is usually sufficient	Deduct IFRS 16 lease liability as an additional debt claim from the EV

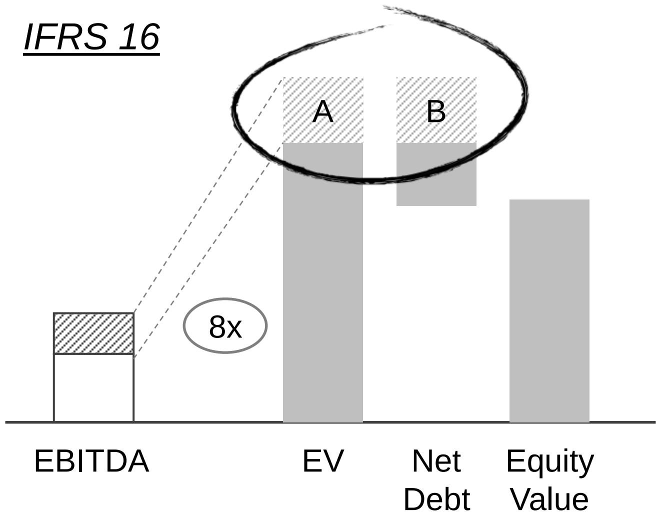
Potential issues in market approach valuation

Increase in EBITDA may not perfectly offset increase in debt

IAS 17



IFRS 16



Increase or decrease in equity value depends on the difference between:

1. Change in EBITDA multiplied by transaction multiple (area A);
2. Change in net debt (area B)

If A > B ➔ **Overvaluation**

If A < B ➔ **Undervaluation**

Watch Out

The higher the multiple offered, the higher the margin of error to the acquirer's detriment due to potential overvaluation

Key takeaways for market approach valuation

EBITDA X **Multiple** – **Net Debt** = **Equity Value**

1

Historical **IAS 17-based trading multiples** become **less applicable** due to distortion of financial metrics

2

Beware not to apply **IAS 17-based multiple** to **IFRS 16-based EBITDA**, and vice versa

3

Note that debt amount does not include **future impact** of **lease renewal** upon expiry

4

Consider **comparability** of assets and **remaining lease terms** between target and peer group companies

5

An **accounting change** does not impact the cash generating ability of a company and thus **should not impact the equity value of a business**

Comparability of multiples will gradually increase as the pre-IFRS 16 adjustments become obsolete

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