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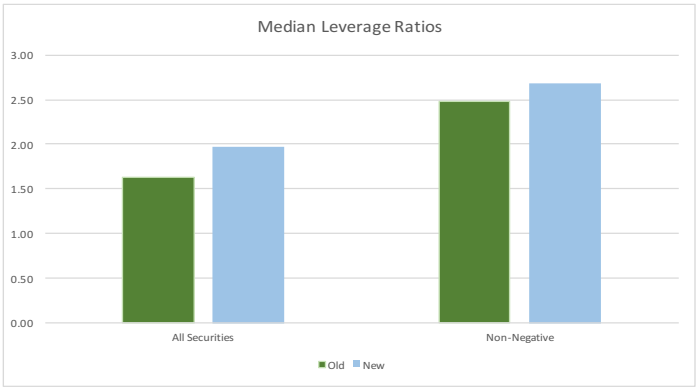
Lease Accounting: How the New Standard Impacts Financial Statement Optics

Accounting changes rarely cause one to sit up and take notice, yet the Financial Accounting Standards Board's (FASB) Accounting Standards Update 2016-02, Leases (Topic 842) has broad implications to the look and feel of the corporate balance sheets of lessees. Leasing is utilized by many entities. It is a means of gaining access to assets, of obtaining financing, and/or of reducing an entity's exposure to the full risks of asset ownership. Previous lease accounting was criticized for failing to meet the needs of the users of financial statements. In particular it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there had been long-standing requests from many users of financial statements to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities. Many of the criticisms associated with previous guidance on leases related to the accounting for operating leases in the financial statements of lessees, the disclosure of which was relegated to the "Notes to Consolidated Financial Statements" section of Forms 10-K and 10-Q.

It is important to note that this accounting change (like most others) does not change the economics of a business; however there can be stark changes that manifest themselves on the balance sheets of many companies that are worth noting. Effective for fiscal years beginning after December 15, 2018, (including interim periods within those fiscal years), the core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from previous GAAP. Specifically, the principal difference from previous guidance is that the lease assets and lease liabilities arising from operating leases should be recognized in the statement of financial position. What this means for most companies is that to the extent that they enter into operating lease arrangements, their overall liability profile increases, optically leading to an assessment of higher risk if other factors are left unadjusted. Historically, a conventional way to assess the leverage within an organization was to calculate the debt ratio, defined as (Debt ÷ Earnings Before Interest Taxes Depreciation and Amortization (EBITDA)), with a lower ratio indicating a more conservatively capitalized profile. With the new accounting change the numerator rises, and without adjustments made to the denominator, this new debt ratio will inflate. By adding back the related expense (rent) to EBITDA – much like the interest related to debt obligations is added back – one can dampen the impact of this accounting change. We'll call this "new" ratio Debt/EBITDAR. However, what we have seen in the early days of the standard is that even adjusted ratios showcase higher, as we convey below.

Our analysis shows that the median debt ratio increases from 1.62x under the historical convention to over 1.97x using the new Debt/EBITDAR calculation – a 21.6% increase[1]. However, we believe that this understates the typical leverage profile of the constituents as a number of debt ratio calculations result in a negative number when a company does not earn a positive EBITDA(R). We will exclude these companies with negative ratios for our analysis in the remainder of this report. Using this new list of companies[2], we can see that the median leverage increases from 2.48x to 2.68x, an 8% increase.

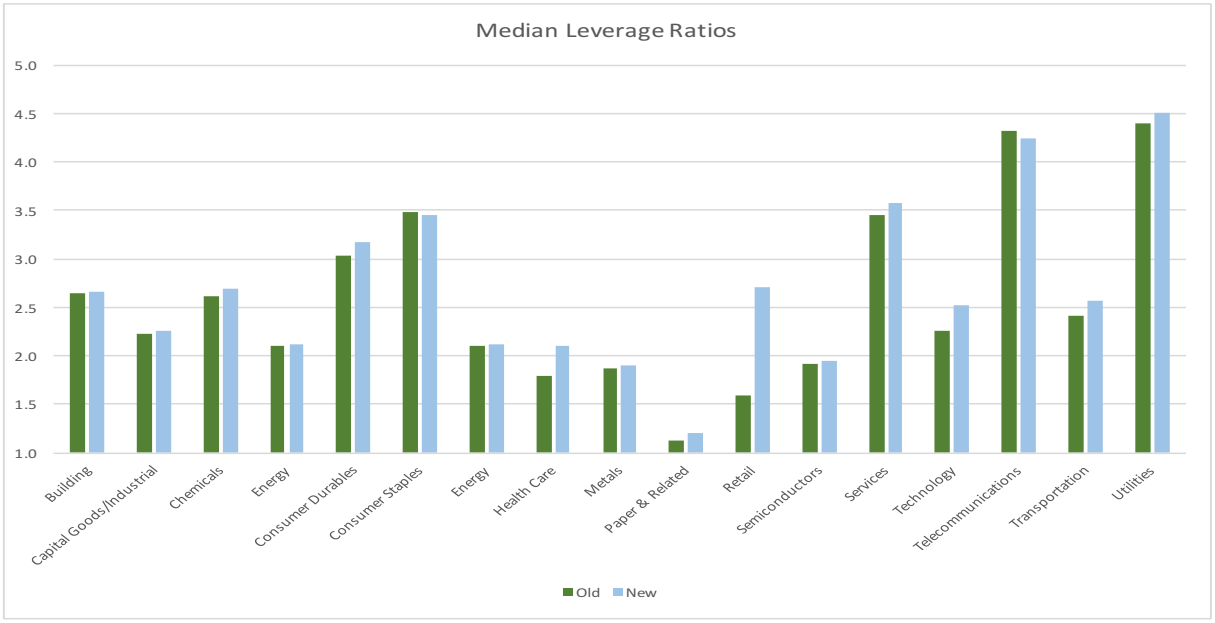
CHART 1



Source: FactSet Research Systems Inc.

While we didn't observe a meaningfully different relative increase when segmenting the universe by company size, there are some very notable observations when we separate the companies by industry. Not surprisingly, the Retail industry is perhaps the heaviest user of leases as the vast majority of brick and mortar retailers lease their footprint. While many of these companies may have had a zero Debt/EBITDA ratio before this accounting change, the story looks completely different when leases are included. We've noted instances of individual companies increasing from zero under the old convention (as they hold no "traditional" debt) to over 4x using the new calculation that includes leases. Retail as a whole saw the median ratio increase from 1.58x to 2.71x after the adjustment, an increase of 71% and over 1.1 turns! A chart of the changes by industry is demonstrated below.

CHART 2



Source: FactSet Research Systems Inc.

It's also not a surprise to see the relatively stable Telecommunications and Utilities sectors as the most highly leveraged sectors in both scenarios. However, the lease accounting change had only a minimal impact on their median ratios; that is, they each saw less than a +/- 3% change. Moreover, a number of other industries saw minimal changes as the utilization of leases may often be limited to the corporate headquarters or a few small facilities or offices. And while the ratios increased in nearly all industries, a few showed slight decreases, presumably due to the variance in lease structures. That is, long-term leases likely have a more pronounced impact on the increase in the ratio whereas very short-term lease structures could potentially dampen the result.

While Topic 842 has formalized the accounting treatment of operating leases, this is something that we at Isthmus Partners have been incorporating into our work for some time. Analysis of the Balance Sheet is crucial to determining the financial well-being of any potential investment, so for years we've been making our own adjustments to include leases in a variety of places throughout our investment process. Historically, companies were required to disclose the next five years of minimum lease payments (MLP), plus a total for all payments thereafter in the footnotes of their annual SEC filings. We've utilized this information to calculate the present value (PV) of future minimum lease payments, thereby giving us an estimate of the amount that the company would carry on the Balance Sheet if those operating lease payments were capitalized. We've treated this amount similarly to other debt on the Balance

Sheet because, as we've shown above, looking at a traditional leverage ratio like Debt/EBITDA can cloud the analysis if a firm is a heavy user of off-Balance Sheet financing. Thus, we've traditionally included an adjusted ratio – specifically (Debt + PV of MLPs)/(EBITDA + rent expense) – in our analysis of the financial health of a firm.

Additionally, there are many instances across the spreadsheets that make up a significant portion of our decision-making tools where we've added this present value of minimum lease payments to total debt to account for the cost of these contractually obligated future payments in today's dollars. For example, our proprietary backtesting module (ExRI[SM]), monthly idea generating screens and Discounted Cash Flow (DCF) valuation model all include the PV of MLPs in Invested Capital. Moreover, much like interest expense is added back when calculating Net Operating Profit Less Adjusted Taxes (NOPLAT), we add back the financing portion of rent expense to NOPLAT as well. Those familiar with Isthmus Partners' investment philosophy know well our affinity for Return on Invested Capital (ROIC), and because we define ROIC as (NOPLAT ÷ Invested Capital), we have always believed that adjusting these important financial metrics for leases were important modifications to make in presenting economic reality. Similarly, we value the spread of ROIC over the weighted average cost of capital (WACC), which is a weighted average of the firm's cost of debt and equity; again we've included the PV of MLPs into the weight of debt used in that formula. And finally, we deduct the PV of MLPs from enterprise value (just like debt) when calculating the value of a firm's equity in our DCF model. Going forward we will continue to utilize the same framework in our investment process with one slight change. Now that we will be given a company's estimate of its future lease liabilities, which inevitably contains better information than what we can pull from historical filings, we will use this lease liability line item on the Balance Sheet in lieu of our prior method of calculating the PV of MLPs.

Conclusion

Topic 842 and our findings above attempt to quantify the magnitude of this accounting change. In our minds this confirms the economic reality that has existed all along; that is, the presence of this heavily utilized off-Balance Sheet technique has masked the levels of fixed commitments for many firms in quite disparate magnitudes. We believe that credit analysts and rating agencies will not meaningfully alter their views at the company (and sector) level, since factoring in lease obligations has been a technique regularly employed in these spheres and the accounting change does not impact the cash flow dynamics of a firm. It follows then that we also believe that this change will not increase the cost of debt. Logically, then, one might ask, "What could change?"

We believe a more liberal perspective on what constitutes an excessive debt ratio will ensue, since the optics of the balance sheet will have changed (i.e., more "leverage" as a multiple of adjusted cash flow) without a corresponding change to the economic reality of firms. We have begun to incorporate this adjusted view at the screening level in sourcing candidates for our domestic equity strategies, knowing that our credit-related scrutiny of firms (fixed charge and liquidity analysis) will endure once we advance individual companies through our fundamental review process. This adjustment will allow us to retain a viable universe filled with high-quality companies from which further work may be conducted. From there we will, as always, continue to employ our conservative strategy – rooted in valuation and ROIC versus its spread to the cost of capital – to build enduring portfolios for our clients' assets.

[1]Universe Calculation - Beginning with our entire Small Cap and Large Cap universes, collectively US listed common stocks above $100 million in market capitalization per FactSet, we cut out any company that has its most recent fiscal year ending before 12/15/2018 as those companies are not required to comply with ASU 2016-02, Topic 842 until their next fiscal year. Then, in order to keep homogeneity between the numerator and denominator of the new Debt/EBITDA equation, we kept only companies for which FactSet had data for both Lease Liability and Rent Expense. [Debt figures are as of the most recent fiscal quarter. EBITDA figures used are the trailing twelve months as of the most recent fiscal quarter. Rent expense figures are as of the most recent fiscal year. The lease liability includes short term and long term Operating Lease liabilities as of the most recent fiscal quarter.] These adjustments left us with 1813 companies out of the original 2751.

[2]When we exclude companies with negative ratios as outlined above, the universe shrinks to 1334 out of the original 2751.