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TRANSACTION ADVISORY

BUSINESS AND VALUATION CONSIDERATIONS IN CONNECTION WITH NEW LEASING STANDARDS

There are numerous valuation and business considerations arising as a result of the new lease standards under IFRS and U.S. GAAP, which came into effect at the beginning of 2019. Under the new standards, most operating leases will be recorded on the balance sheet, similar to capital leases. For companies with material leases, the new lease standards will have a significant impact on reported EBITDA and balance sheets. Bank covenants or other agreements that reference EBITDA, assets, or liabilities may also be affected.

High level, what has changed?

- Effective January 1, 2019, all IFRS and public U.S. GAAP reporting entities are required to capitalize operating leases as right-of-use assets, generally consistent with current accounting for capital/ finance leases. Private U.S. GAAP companies are required to adopt the standard in 2020.
- ASPE remains unchanged.
- There are a few exceptions. Operating leases that are either 1) shorter than one year or 2) have total annual payments of less than $5,000 will generally continue to be expensed.
- EBITDA will increase. Lease assets and liabilities on balance sheets will also increase. Valuation confusion will ensue.
- Reported EBITDA under the new standards will generally be comparable to old EBITDAR (being EBITDA plus rental payments).
- Simplified examples of the balance sheet and income statement impacts are set out below. Detailed examples are set out in Appendices A and B.

Balance Sheet Impact	Old	New	Income Statement Impact	Old	New
Assets under operating lease *	$ -	24.9	Lease/rent expense	$ 10.0	-
Operating lease obligations - current *	$ -	(7.5)	Interest	$ -	2.5
Operating lease obligations - long-term *	$ -	(17.4)	Depreciation	$ -	8.3

** Operating and capital lease assets will be collectively referred to as right-of-use assets. Operating and capital lease obligations will collectively be referred to as lease liabilities.*

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How will the new lease standards impact my business?

- Balance sheets will now reflect operating leases as right-of-use assets, as well as current and long-term lease liabilities. The resulting lease-related assets and liabilities may affect bank covenants such as current ratios, debt-to-equity ratios, and asset coverage ratios, amongst others. Any covenants that reference EBITDA may need to be revisited as well.

  In the near term, it may be possible to simply agree with your bank to continue deducting operating leases from EBITDA and exclude operating lease assets and obligations for the purposes of covenant calculations.

- Rules of thumb EBITDA multiples will likely evolve to reflect that lease payments are no longer deducted from reported EBITDA. EBITDA multiples derived from historical public company or transaction data may not be comparable to reported EBITDA under the new standards unless either 1) lease payments are added back to historical EBITDA and the implied multiples are recalculated, or 2) lease payments are deducted from the subject company's reported EBITDA.
- Shareholder agreements with valuation clauses that reference EBITDA or debt may need to be revised. For example, should operating lease obligations on the balance sheet be deducted as debt, or should operating lease payments be deducted from EBITDA? If operating lease payments and expenses are no longer incorporated in EBITDA, should the EBITDA multiple referenced in the agreement be adjusted?
- Earn-out agreements that reference EBITDA may need to be amended to clarify how EBITDA is going to be determined, particularly where the agreement states EBITDA is to be determined in accordance with IFRS or U.S. GAAP.

When valuing a business, BDO's general recommendation is to reference free cash flow where operating lease payments are deducted from EBITDA, as opposed to attempting to incorporate operating lease obligations in the valuation. This will likely be easier said than done if a company has a large number of leases and/or if companies stop tracking operating versus capital leases such that the quantum of operating lease payments is no longer disclosed or otherwise readily available.

What are the potential valuation impacts of the new lease standards?

- **EBITDA -** Previously, operating lease payments were deducted from EBITDA, notwithstanding that operating lease expenses inherently include a financing charge. Going forward, the new lease standards will result in reported EBITDA actually being EBITDA. As a result, the new lease standards should make EBITDA more comparable across companies, as the decision to finance assets through operating or capital leases (or debt/cash) will no longer impact reported EBITDA.
- **EBITDA multiples -** Previously, where EBITDA was capitalized by an EBITDA multiple to arrive at enterprise value (i.e. the value of a business), the EBITDA multiple recognized the nature and quantum of a subject company's operating leases, including if the company had more or less operating leases than other companies to which an EBITDA multiple was being referenced. Going forward, reported EBITDA will be higher as it will exclude operating lease payments. Operating lease obligations will either need to be treated as debt or otherwise incorporated in the value of a business.

  As previously noted, EBITDA multiples derived from historical public company multiples or transactions will need to be adjusted if being applied to EBITDA that excludes operating lease payments, or vice versa. Rules of thumb EBITDA multiples will likely evolve.

- ASPE reporting entities will likely increasingly reference EBITDAR if comparing balance sheet or valuation metrics with IFRS and U.S. GAAP reporting entities. Anyone unfamiliar with ASPE will need to be informed that ASPE has not adopted the new lease standards.

Potential valuation approaches and considerations are set out below.

EBITDA-based valuations

Continue to deduct operating lease payments from EBITDA (the old rules)

- This approach would in theory eliminate most of the issues associated with the new lease standards. Any operating lease assets and obligations reported on the balance sheet could simply be disregarded.

Potential challenges:

- Ratio and multiple analyses for publicly traded companies may be difficult if EBITDA and financial positions of public companies are not adjusted appropriately.
- EBITDA multiples referenced in the investment community may evolve over time to reflect the impact of the new lease standards on EBITDA.
- It may be difficult to quantify the EBITDA and lease obligation impacts for operating leases going forward, as companies may not separately track or disclose operating versus capital leases and the associated payments.

Do not deduct operating lease payments from EBITDA (the new rules)

Option 1: Deduct operating lease obligations and adjust the EBITDA multiple:

- Reported operating lease obligations would be treated similar to bank debt and capital lease obligations, and deducted in determining equity value.
- EBITDA multiples would need to be lowered and continually adjusted depending on the remaining terms of the leases to account for the economic obligation to continually make lease payments upon expiry of the current leases.

Option 2: Do not deduct operating lease obligations and adjust the EBITDA multiple:

- A simplified example of removing a $10 lease payment from EBITDA on the EBITDA multiple is set out below (see Appendices A and B for details).

Reconciliation of Indicated Equity Values		
EBITDA multiple - old rules	5.00	A
EBITDA - new rules	30.00	B
EBITDA - old rules	20.00	C
	1.50	D = B / C
EBITDA multiple - new rules	3.33	= A / D

Potential challenges:

- It will be difficult to ensure there is no overlap of lease payments on existing leases (captured in the lease obligation being treated as debt) and future leases (reflected in the EBITDA multiple).
- If multiples are not continually adjusted, companies may have a bias to enter into shorter operating lease terms to minimize the associated operating lease obligation. In doing so, they would not capture the economics of the cash flows underlying the lease unless the multiple is adjusted. It will also make comparability more difficult if two similar companies have different terms on their operating leases.

Cash flow-based valuations

Continue to deduct operating lease payments in determining free cash flow (the old rules)

- As with an EBITDA-based valuation, deducting operating lease payments in determining free cash flow would likely resolve most of the issues associated with the new lease standards. Any operating lease assets and obligations reported on the balance sheet would simply be disregarded.

Potential challenges:

- Operating lease liabilities would need to be excluded from the capital structure in determining the WACC (unlevered) capitalization multiple or discount rate.
- It may be difficult to determine the quantum of operating lease payments and the corresponding assets/liabilities to be disregarded, as companies may not separately track or disclose operating versus capital leases.

Do not deduct operating lease payments in determining free cash flow (the new rules)

- The lease liability would need to be deducted, like debt, in calculating equity value.
- An additional obligation for the requirement to continue making lease payments after the term of the existing leases should be quantified and deducted. Alternatively, the sustaining capital expenditure assumption would need to incorporate future operating lease payments required to operate the business once the terms of the leases contemplated in the lease liability expire.

Potential challenges:

- If using a discounted cash flow or capitalized cash flow approach, a company's WACC will need to be adjusted to reflect the inclusion of operating lease obligations in the capital structure.
- The tax deductibility of operating lease payments may be more difficult to capture.

Appendices C and D illustrate the potential impact on a notional EBITDA-based valuation if no adjustment is made to the EBITDA multiple. Appendix E reconciles the differences between Appendices C and D.

BDO generally recommends referencing free cash flow when valuing a business, where actual operating lease payments are deducted in arriving at free cash flow as opposed to deducting operating lease obligations in arriving at equity value (which is often the case for capital lease obligations). There will be a number of tax challenges as well, since we are not aware of any pending tax rule changes that will harmonize the tax treatment of operating leases with the new accounting treatment. We anticipate that operating lease obligations will be treated as debt/capital lease obligations, with no other value adjustment, only in rare circumstances (recognizing there are notable economic differences between operating and capital leases).

Key takeaways:

- At first glance, the simplest approach to address the potential valuation issues associated with the new lease standards may be to continue deducting operating lease payments from EBITDA and/or cash-flow, and simply disregard the associated operating lease assets and obligations on the balance sheet. However, this approach will likely have practical challenges as 1) operating leases and capital leases may not be tracked separately and 2) EBITDA multiples may evolve such that they are no longer applicable to companies netting lease payments from EBITDA.
- Valuation approaches may evolve to reflect the impacts of the new leasing standards.
- There are clearly going to be a number of nearer-term accounting, tax, and valuation headaches as the new lease standards are adopted.

Relevant accounting standards:

- For BDO's IFRS accounting guidance, please read IFRS 16.
- For BDO's U.S. GAAP guidance, please read U.S. GAAP – ASC 842.
- ASPE in Canada remains unchanged. Comparing or combining financial statements under IFRS or U.S. GAAP to ASPE may be more difficult.

How can BDO help?

Our team of Valuations & Accounting Advisory professionals can assist with:

- Determining lease assets and liabilities for IFRS and U.S. GAAP reporters, including discount rate determinations.
- Accounting determinations, such as low-value lease exemptions or lease classification analyses (lease vs. non-lease).
- Reconciling the potential valuation impacts of the new leasing standards to legacy approaches, including shareholder agreement considerations.
- Quantifying pro-forma changes to EBITDA and debt covenants, including assisting with covenant renegotiations.

In addition, BDO's Consulting team has developed **BDO LEAD**, an integrated lease management software platform that tracks and values leases. Non-audit clients can outsource their lease accounting requirements to BDO or, alternatively, your organization can license BDO LEAD.

Appendices

Appendices A to E illustrate the balance sheet, income statement, and potential valuation impacts of a three-year operating lease with annual payments of $10 and a discount rate of 10%. We assume the operating lease would need to be renewed when it expires, and have used an illustrative "old rules" EBITDA multiple of 5.0x.

Appendix A - Illustrative Balance Sheet

	Year 0, Old Rules	Year 0, New Rules	Year 1	Year 2	Year 3	Year 4 (renewal)
Current assets	100.0	100.0	100.0	100.0	100.0	100.0
Operating asset	-	24.9	16.6	8.3	-	16.6
Total assets	100.0	124.9	116.6	108.3	100.0	116.6
Accounts payable & accrued liabilities	50.0	50.0	50.0	50.0	50.0	50.0
Current portion of lease obligation	-	7.5	8.3	9.1	-	8.3
Current liabilities	50.0	57.5	58.3	59.1	50.0	58.3
Long-term debt	25.0	25.0	25.0	25.0	25.0	25.0
Long-term portion of lease obligations	-	17.4	9.1	0.0	-	9.1
Total liabilities	75.0	99.9	92.4	84.1	75.0	92.4
Retained earnings	25.0	25.0	24.2	24.2	25.0	24.2
Liabilities & retained earnings	100.0	124.9	116.6	108.3	100.0	116.6
Ratios:						
Current	2.0	1.7	1.7	1.7	2.0	1.7
Debt/EBITDA	1.3	1.7	1.4	1.1	0.8	1.4
Debt/Equity	3.0	4.0	3.8	3.5	3.0	3.8
Asset coverage	2.0	1.5	1.6	1.7	2.0	1.6
Note 1						
Operating lease asset			24.9	16.6	8.3	24.9
Amortization expense			(8.3)	(8.3)	(8.3)	(8.3)
Closing book value of operating lease asset			16.6	8.3	-	16.6
Note 2						
Operating lease obligation			24.9	17.4	9.1	24.9
Interest expense			2.5	1.7	0.9	2.5
Operating lease payments			(10.0)	(10.0)	(10.0)	(10.0)
Closing book value of liability			17.4	9.1	0.0	17.4
Current portion (paid down in current year)			8.3	9.1	-	8.3
Long-term portion			9.1	0.0	-	9.1
			17.4	9.1	-	17.4

As set out above, the new rules have an immediate impact on a business's financial ratios; they can vary significantly depending on the remaining lease term.

Appendix B - Illustrative Income Statement					
	Year 1, Old Rules	**Year 1, New Rules**	**Year 2**	**Year 3**	**Year 4 (renewal)**
Revenues	100.0	100.0	100.0	100.0	100.0
Cost of goods sold	50.0	50.0	50.0	50.0	50.0
Gross profit	50.0	50.0	50.0	50.0	50.0
Rent	10.0	-	-	-	-
Other operating costs	20.0	20.0	20.0	20.0	20.0
Amortization	-	8.3	8.3	8.3	8.3
Interest	-	2.5	1.7	0.9	2.5
Operating costs	30.0	30.8	30.0	29.2	30.8
Net Income before tax	20.0	19.2	20.0	20.8	19.2
Add: Amortization	-	8.3	8.3	8.3	8.3
Add: Interest	-	2.5	1.7	0.9	2.5
Reported EBITDA	**20.0**	**30.0**	**30.0**	**30.0**	**30.0**

Reported EBITDA increases significantly under the new rules; net income before tax fluctuates over the life of the lease as a result of variability in interest expense. Deferred income taxes will cause additional variability on net income.

Appendix C - Illustrative Valuation, Old Rules				
	Year 1	**Year 2**	**Year 3**	**Year 4 (renewal)**
EBITDA, old rules	20.0	20.0	20.0	20.0
EBITDA multiple, old rules	5.0	5.0	5.0	5.0
Indicated enterprise value	100.0	100.0	100.0	100.0
Less: Long-term debt	(25.0)	(25.0)	(25.0)	(25.0)
Less: Lease obligations (current and long-term)	-	-	-	-
Indicated equity value	75.0	75.0	75.0	75.0

Appendix D - Illustrative Valuation, New Rules				
	Year 1	**Year 2**	**Year 3**	**Year 4 (renewal)**
EBITDA, new rules	30.0	30.0	30.0	30.0
EBITDA multiple, assuming old rules multiple still applies	5.0	5.0	5.0	5.0
Indicated enterprise value	150.0	150.0	150.0	150.0
Less: Long-term debt	(25.0)	(25.0)	(25.0)	(25.0)
Less: Lease obligations (current and long-term)	(17.4)	(9.1)	-	(17.4)
Indicated equity value	107.6	115.9	125.0	107.6

As illustrated above, applying the EBITDA multiple used under the old rules to EBITDA reported under the new rules can have a significant impact on value. A reconciliation of this effect is set out in Appendix E below:

Appendix E - Reconciliation of Indicated Equity Values

	Year 1	Year 2	Year 3	Year 4 (renewal)
Indicated equity value - old rules	75.0	75.0	75.0	75.0
Indicated equity value - new rules	107.6	115.9	125.0	107.6
	32.6	40.9	50.0	32.6
Actual lease payments (previously expensed)	(10.0)	(10.0)	(10.0)	(10.0)
EBITDA multiple, assuming old rules multiple still applies	5.0	5.0	5.0	5.0
Impact on enterprise value if lease payment deducted from EBITDA	(50.0)	(50.0)	(50.0)	(50.0)
Elimination of corresponding lease obligation	(17.4)	(9.1)	-	(17.4)
Equity value impact of treatment change	32.6	40.9	50.0	32.6
Enterprise value - new rules	150.00	150.00	150.00	150.00
Enterprise value - old rules	100.00	100.00	100.00	100.00
Impact	50.00	50.00	50.00	50.00
EBITDA - new rules	30.00	30.00	30.00	30.00
EBITDA multiple impact (value impact divided by post treatment EBITDA)	1.67	1.67	1.67	1.67
EBITDA multiple, assuming old rules multiple still applies	5.00	5.00	5.00	5.00
Post EBITDA times adjusted multiple	3.33	3.33	3.33	3.33
EBITDA, post adoption	30.0	30.0	30.0	30.0
Indicated enterprise value	100.0	100.0	100.0	100.0
Less: Long-term debt	(25.0)	(25.0)	(25.0)	(25.0)
Less: Operating lease obligation (included in EBITDA multiple)	-	-	-	-
Indicated equity value	75.0	75.0	75.0	75.0

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The information in this publication is current as of April 17, 2019.

This publication was prepared by Keith Jensen and Brendan le Nobel of BDO's Transaction Advisory team in Vancouver, B.C. This article focuses on the potential valuation and business impacts to lessees; it does not contain accounting or impairment guidance. IFRS is International Financial Reporting Standards. U.S. GAAP is United States Generally Accepted Accounting Principles. ASPE is Accounting Standards for Private Enterprises. ASPE is still commonly referred to as Canadian private company GAAP. EBITDA is earnings before interest, tax, depreciation, and amortization. EBITDAR is EBITDA plus rental payments.

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