Leases – Analytical Approach Discussion Paper

Analytical Treatment of Leases in the Context of IFRS16/ASC842 Implementation

- Accounting changes are causing us to consider reviewing our approach to leases
- Behavioural changes may push operating leases to service contracts, which do not have to be capitalised or disclosed, blurring lines further and reducing comparability
- Market feedback sought on options – continued capitalisation, adoption of minimum contractual NPV or hybrid alternatives

Possible Alternative Lease Adjustments to Balance Sheet Under IFRS16/ASC842

	Current Treatment	Continue Multiple Approach for All Sectors	NPV Approach	Hybrid Approach
Description	Aimed at allowing comparability between entities that buy and rent long-life assets by using a multiple of operating lease cost to replicate ownership. Finance lease liabilities treated as debt.	Continue current multiple approach, applying a multiple to all cash lease costs.	Take IFRS16 right of use liabilities as debt.	Continue capitalising based on a multiple in sectors where the management of physical assets is key, such as retail and airlines. For other sectors, treat leases as any other operating cost.
Pros	Disregards different leasing regimes and accounting decisions regarding operating lease length.	Continues to provide comparability where leases are consistently classified and disclosed between entities.	A detailed estimate of contractual liability based on actual assets, lease lengths and implicit or incremental borrowing costs. Reflects flexibility to a degree.	Provides comparability among like companies in sectors where recasting lease contracts as services is unlikely.
Cons	Can be less relevant when comparing modern businesses in many sectors where outsourcing and asset-light models are an option.	Tighter lease definition may mean economically similar arrangements being classified as leases or service contracts, based on the legal form of the contract. Service contracts do not have to be disclosed so cannot be capitalised. Capitalisation using a multiple would not result in greater comparability if this were the case.	Departs from principle of comparability between companies that buy or rent, and between companies or jurisdictions with different lease terms. Potential for manipulation of lease length based on 'reasonably certain' test for extension options.	Does not differentiate in metrics between companies with radically different asset strategies in 'operating cost' sectors; where relevant, this could be considered qualitatively in sector Navigators. Split between capitalise/do not capitalise sectors may be artificial.

Source: Fitch

Methodology Discussion: This Discussion Paper serves as a basis for discussion with market participants. Fitch will assess based on the result of these discussions whether a change in methodology is warranted or the current approach should be continued, potentially with minor adjustments, due to changes in financial reporting. Any potential changes would likely be the subject of a future public Consultation Draft.

Accounting and Analytical Treatment: Although accounting does not drive Fitch's analytical treatment, the widespread reporting changes related to the introduction of IFRS16 and FASB's ASC842 are an appropriate context for discussion with market participants on Fitch's current lease-related adjustments and whether this methodology should evolve to better facilitate fair comparisons between issuers based on the underlying economic reality.

New Accounting Standards: IFRS 16 and ASC842 will come into force in January 2019 and will require companies to include virtually all leases on their balance sheets (see Appendix 1). This has some commonality with Fitch's current treatment, which capitalises operating leases to calculate a debt equivalent (see Appendix 2), but with the capitalised amount likely to be different as it is based on the present value of lease commitments under existing contracts. Fitch currently uses a multiple-based, ownership-replication approach.

Lease-prevalence Varies by Sector: Adding lease-equivalent debt to financial liabilities is one of the most common analytical adjustments made by all financial analysts, but its relevance varies significantly by sector. Retailing, Transportation and Lodging are three sectors where leasing is particularly prevalent, but with wide variation within each sector, making it particularly important to ensure that the lease-adjustment methodology allows for fair comparison between companies leasing their assets and those owning them.

Leases Versus Service Contracts: In the new accounting standards, the core distinction is between leases and service contracts, rather than between on-balance sheet and off-balance sheet leases. If a contract is considered a lease, it goes on- balance sheet. For a contract to be a lease, there needs to be an identifiable asset controlled by the lessee. This may lead to the reclassification of certain contracts previously considered leases into service contracts, which are treated as operating costs.

Although the distinction between leases and service contracts can be useful in the context of the increasing complexity of the value chains mentioned above, it leaves the door open to specific structuring of contracts to avoid the lease qualification and the resulting inclusion on the balance sheet. The lack of disclosure of most service contracts will make it impossible for investors to opine on the appropriateness of the classification of individual cases as service contracts rather than leases, or adjust accordingly.

Possible Hybrid Approach: One approach under consideration by Fitch is to continue performing multiple-based lease adjustments, but only in certain sectors, with lease costs treated as operating expenses in other sectors. For example, in the retail sector, where the use of specific long-lived assets is core to a business's operations, where the use of such assets from third parties is unlikely to be restructured as a service agreement, and whether the assets are bought or leased is heavily driven by financing, capitalisation would continue as today.

For classes of assets where the choice is more typically between a lease or a service, comparability is better served by treating cashflows associated with these assets as an operating cost except when a company chooses to own such assets, ie the leasing of telecoms fibre capacity. In sectors where leases were not capitalised, the distinction between asset-heavy and asset-light strategies would become a point of differentiation in the relevant Rating Navigator.

Most Common Analytical Approaches: For operating leases that are not included on the balance sheet, analysts typically adjust the reported debt by some form of Present Value of future lease commitments or by a multiple applied to the yearly rent expense designed to replicate the debt incurred if the company had decided to own the asset rather than lease it. The essential difference is that Present Value focuses on the contractual commitment to pay rents, as it exists at the reporting date; the ownership replication (or multiple) approach takes a more forward-looking economic view, independent of the legal commitment.

US GAAP versus IFRS: Although both accounting standards will treat all leases the same way on the balance sheet, US GAAP maintains a distinction in the income and cashflow statements between operating leases, which are treated as operating costs, and finance leases, for which the rent is split between interest and depreciation components. For IFRS, all rents are split between interest and depreciation components.

Goals

Our aim in our analysis is to best replicate the impact on the core unsecured debtholder of any additional, technically non-debt but contractual payments of a financial nature.

Parameters

There are a number of key conditions any lease treatment should satisfy:

- Allow comparability, to the degree appropriate, between companies that lease assets and those that buy them
- Allow comparability between companies where similar economic arrangements are structured as leases and services
- Reflect the substance of a lease commitment rather than its legal form
- Allow comparability in cashflow and income statement between US GAAP, IFRS and historic statements
- Be simple, understandable and replicable based on publicly disclosed amounts

The Ownership Replication Approach

Rationale for the Ownership Replication Approach

When the asset being leased is fundamental to the continued operation of a company, we generally expect that company to use it for its full economic life. The multiple approach applied to annual lease expenses replicates the debt needed to fund the asset over that lifetime and therefore acknowledges the likely renewal of a shorter lease. In this approach, the economic life of the asset determines the multiple, not the legal maturity of the lease contract. Provided one agrees that leases are essentially an alternative to debt funding of critical and largely fixed assets required for long-term operations, the most important benefit of this approach is that it improves comparability of leverage metrics by neutralising the choice between ownership and leasing and the noise created by the variety of conditions that give rise to varying lease terms.

Limitations of the Ownership Replication Approach

The multiple approach assumes leases must be maintained to ensure continued EBITDAR generation. If, in reality, companies are able to flex their overall lease cost without affecting EBITDAR, then a lower multiple could be justified. This approach also ignores that leases can be renegotiated on a commercial basis without triggering any cross-default with the financial debt strictly defined (ie bonds and loans). Business models are also evolving with more sophisticated distribution of the value chain between companies, making it easier to subcontract part of value creation to a third party under a service contract instead of owning all the assets needed to “manufacture” the product in-house.

The IFRS16/ASC842 Approach

Based on Legal Commitment

The IFRS16/ASC842 (hereafter referred to as ‘IFRS16’) approach to capitalisation is based on a company’s legal commitment at a balance sheet date. The intangible asset, and associated liability, recognised is a ‘right of use asset’. Where a company enters into a lease of an asset for three years, for example, it records an asset based on the net present value (NPV) of three years’ rental payments, and a matching liability. Where there are extension options in a lease that are determined to be reasonably certain to be exercised, these are included in the lease term and NPV calculation. This approach has the benefit of emphasising the amount a company is legally committed to spend and the amount most likely to be included if leases feature as indebtedness in the issuer’s debt financing documents.

Comparability a Concern

The potential comparability problem associated with the NPV approach can be illustrated by considering two retail chains leasing a comparable store portfolio in two different jurisdictions. In jurisdiction A, it is common practice for leases to be three years from inception; in jurisdiction B, seven years is the norm. Ignoring discounting effects, and assuming that all leases start at the same time with an annual lease cost of USD100 million, jurisdiction A’s retailer would capitalise and recognise as debt USD300 million and jurisdiction B’s retailer USD700 million. Economically, however, to continue to generate comparable operating cashflows, both companies would need to maintain similar levels of rental expenses; so, the company in jurisdiction A would need to renew the majority of its leases after the initial lease period expires. The debt recorded on balance sheet is very different despite the underlying economics being the same. This logic is why we have favoured the multiple approach over an NPV model in the past.

The ‘reasonably certain’ condition for including extensions in the lease term also introduces the potential for manipulation.

Hybrid Models

Both the NPV and capitalisation models have advantages and disadvantages, but both are vulnerable to a scenario where a company redraws its contracts in such a way that they are classified as services rather than leases. IFRS16 applies a control model for the identification of leases, distinguishing between a service and a lease on the basis of whether there is an identified asset controlled by the customer.

This brings the decision of whether something is a lease or not into the realms of accounting choice rather than economic reality. For example if a contract that was originally a lease of a particular rail carriage for a year was structured instead as the provision of one carriage’s worth of capacity between two specified points between certain hours of the day every day for a year, the contract would cease to be a lease and become a service. This is more relevant under IFRS16 because the lease would have to be capitalised, increasing reported debt, whereas a service is unlikely to even be disclosed separately in the financial statements. (Conversely, a lease treatment may be desirable, as it may improve a company’s EBITDA by some definitions; see below).

What the Industry Says – Leasing Companies

Current feedback from leasing companies suggests that there is no indication the new accounting standards will lead to a material change in terms of contract structure and characteristics for the most commonly leased assets, such as transportation assets, heavy machinery and shorter life assets like office equipment. This feedback has remained consistent over time and has not changed now that we are nearing implementation of the new standards. Although redenomination of leases into service contracts is theoretically possible for some of these asset types, this appears less of a risk for the moment.

Leverage Adjustments

An ideal treatment would make Fitch’s credit metrics indifferent between a company that has purchased its fixed assets, leases them or uses them under a service contract or via an outsourced arrangement.

In reality, given the likely lack of disclosure of services or outsourced arrangements, it may be impossible to construct one adjusted leverage measure that satisfies the goal of comparability. One way to provide meaningful differentiation is to consider the underlying asset and its role in the business, and making lease adjustments only where the nature of the asset is such that control of the asset is integral to the business’s operation, and where the usage of an asset owned by a third party is unlikely to be structured as a service contract. This would likely see lease adjustments made only for limited, capital-intensive sectors, including retailers, hotels, airlines and shipping.

At one end of the spectrum would be a supermarket leasing large out-of-town stores. To date, we have seen no attempts to restructure such leases as services; changing premises can be costly and disruptive, and utility to the tenant depends on the use of a particular location. A retailer’s stores, whether bought or leased, are integral to their EBITDA, so the continued application of a lease-term neutral multiple approach may be appropriate here.

At the other end of the spectrum is a lease of telecoms capacity between points A and B. The termination of traffic between these points could be done in a number of ways, including a lease of physical infrastructure, such as a fibre cable (a lease), a rental of capacity on a fibre cable (possibly a service), or by transacting with a third party to deliver the traffic in an unspecified way (a service). It could also be done by building physical infrastructure. While infrastructure differences can be important, there are many ways for a telco to achieve the same goal and therefore the lease cost is more like an operating cost. Here, there is a reasonable case for saying that, whatever form the contract takes, it is essentially service-like, with the choice likely to be influenced more by operational considerations than financing. The best tool to allow comparability between the different legal forms may simply be to treat everything, including contracts classified as leases, as if they were services (ie operating costs).

This approach would suggest capitalising leases based on a multiple of lease cost in sectors where long-lived assets, such as real estate, airplanes or ships, form a core part of the business and where ownership versus lease is primarily a financial decision, without the possibility of service substitution, and for most other leased assets simply treating them as operating costs, which would mean reversing the IFRS16 accounting treatment.

What the Industry Says – REITs
Initial feedback to our REIT teams suggests that real estate leases are unlikely to be reinstated as service contracts. This reflects the terms of the mortgage financing underlying many of these assets, local property laws and the importance to lessees of having access to specific premises.

Asset Heavy vs Asset Light

Telecoms provides a good example of the deficiency of the 'operating cost' model. Some providers have been forced or chosen to separate their networks from the rest of their businesses. Asset-light models clearly present a different risk profile than more traditional asset-heavy models; for example, they have less flexibility in maintenance/upgrading, or the theoretical possibility to lose access to critical assets.

This distinction needs to be incorporated into analysis in some way, based on the impact on individual sectors. Were the hybrid model to be adopted, then it would likely be accompanied by the explicit consideration of asset-light versus asset-heavy strategies in sector Ratings Navigators.

For some sectors, such as telecoms, another possible way to cover all eventualities is to use EBITDA or FFO less maintenance capex as a performance indicator and in the denominator of some leverage ratios. All non-discretionary asset costs are accounted for in this measure, whether they are lease costs, services or capital expenditure. In sectors such as telecoms with relatively scalable and predictable capex, the measures are likely to be comparable; in industries where capex is more lumpy they may not, in which case depreciation could be used as a proxy for ongoing maintenance capex needs.

Income statement and cashflow implications

IFRS16 will have profound implications on the income statement and cashflow statement:

- Lease charges will be shown as depreciation of the capitalised right-of-use asset in the income statement. This will have an impact on many companies' calculation of EBITDA, which will rise
- Cash lease costs will most likely be shown as financing outflows in the cashflow statement, although IFRS provides flexibility in certain circumstances
- Interest in the income statement, and potentially the cashflow statement, will include the interest element of the imputed debt associated with the right-of-use asset

Under ASC842, the existing distinction between finance (Type B) and operating leases (Type A) will be retained for income and cashflow statement presentation. In the below discussion, which focuses on the changes IFRS16 may require, relevant adjustments would be made to ensure comparability between the two sets of standards.

Fitch has used EBITDAR (EBITDA before rents) as one of its key measures of profitability, and this measure will remain unchanged (in effect if no adjustment is made, EBITDA would equal EBITDAR since rents would be shown as interest and depreciation). One option for the income statement is for Fitch simply to collapse these two measures into one.

However, while collapsing the two measures would provide comparability between companies that rent and those that buy, it would not address the distinction between companies that rent and those who enter into service contracts. The only measure that encapsulates all three options is EBIT, and it is possible this could become more of a focus in Fitch's analysis. While a useful long-term indicator, EBIT has limited short-term utility in industries with lumpy capex that can cut back on investments drastically in a cyclical trough but that still have to recognise depreciation, although our additional focus on both free cash flow and on multiple years of forecasts can partly mitigate this limitation.

Similar problems arise in the cashflow statement, where Fitch's key Funds Flow from Operations (FFO) measure, based on operating cashflow before working capital movements, will be inflated under IFRS16 if no adjustment is made. This is a core measure of the amount of cash a company generates after unavoidable costs, and should be adjusted to deduct cash lease expenses. Under IFRS16, these have to be disclosed in aggregate.

Fitch's FFO measure is after the payment of cash interest, to provide a practical measure of a company's commitments in the short to medium term. It is likely Fitch will continue to adjust its ratios to show cash interest paid only here.

	Current model (accounting and Fitch)	ASC842 Type B (Operating) Lease *Unadjusted*	IFRS16 and ASC842 Type B (Capital) Lease *Unadjusted*	Potential Adjs to IFRS16/ Type B	IFRS16/ Type B Adjusted
Revenue	100	100	100		100
Other Costs	-49	-49	-49		-49
EBITDAR	51	51	51	0	51
Lease Expense	-20	-20		-20	-20
EBITDA	31	31	51	-20	31
Lease Amortisation	0	0	-17	17	0
EBIT	31	31	34	-3	31
P&L Interest - Debt related	-1	-1	-1		-1
P&L Interest - Lease related	0	0	-5	5	0
EBT	30	30	28	2	30
EBITDA	31	31	51	-20	31
Cash Interest Expense (incl. Lease Related)	-1	-1	-6	5	-1
Funds Flow from Operations (FFO)	30	30	45	-15	30
Working capital	0	0	0		0
Cash Flow from Operations (CFO)	30	30	45	-15	30
Capex	0	0	0	0	0
Dividends	-30	-30	-30		-30
Free Cashflow	0	0	15	-15	0
Repayment of Capital Element of Leases			-15	15	0
Change in cash	0	0	0	0	0
Illustrative Fitch Credit Metrics					
EBITDAR Margin (%)	51	51	51		51
EBITDA Margin (%)	31	31	51		31
FFO Margin (%)	30	30	45		30
FFO Fixed Charge Cover	2.4	2.4	8.4	-	2.4
New Metrics for Consideration					
EBITDAR/(Rent+Interest+Depreciation)	2.4	2.4	2.2	-	2.4
EBIT/(Interest+Interest Component of Rent)	31.0	31.0	5.6		31.0
EBITDA/Interest Paid	31.0	31.0	8.4		31.0

Source: Fitch

Coverage

To differentiate sectors where leases are a true alternative to ownership from those where leases are more of an operating cost, the existing interest coverage ratios (EBITDAR or FFO pre-interest and rent divided by interest paid + rent) could be changed as follows:

For sectors where leases are an alternative to ownership

EBITDAR (or FFO pre-interest and rent) divided by Rent + Interest + Depreciation (or Maintenance Capex)

Additionally, to focus on interest coverage but still factor in asset intensity, the following ratio could also be used:

EBIT (or FFO – maintenance capex) divided by Interest + Interest Component of the Rent

The existing ratio is biased against a company that leases, as the rent includes a depreciation component; for a company owning, only the interest component is included. The proposed ratio resolves this by either including the ‘principal’ investment an owning company would have to make (using as a proxy depreciation/maintenance capex) or by removing principal altogether from coverage metrics (ie only taking the interest element of the rent).

For sectors where leases are an alternative to operating costs

EBITDA or (FFO post rent but pre-interest) / Interest Paid

As the rent is akin to an operating cost under this model, a more basic unadjusted coverage metric could be more of a focus.

Cash Flow Statement

For sectors where leases are an alternative to ownership, signing a new lease is equivalent to buying an asset and funding it with debt. For a company deciding to buy the asset, this would be reflected in capex and an equivalent amount of Cash Flow from Financing.

For sectors where leases are not an alternative to ownership, rents would be fully reclassified as an operating cash flow.

Questions For Discussion

- Do you think a PV-based approach is more appropriate than an ownership replication-based approach when adjusting financial liabilities for leases? Is there a significance in the relationship between balance sheet lease indebtedness (currently only from capital or finance leases) and cross-default clauses that would privilege this view?
- Would you expect leverage thresholds to be more stringent if Fitch moved to a PV-based or an operating-cost approach?
- Does a hybrid approach, with certain types of assets capitalised and certain assets not capitalised, make sense? Would real estate, airplanes, ships and carriages be an appropriate set of assets to use the multiple approach? What others may apply?
- Should the decision to capitalise or not be made at the sector or asset level?
- Should we make a distinction between operating (ie profit generating) and non-operating assets (for example, although both are property assets, rents related to a head office for a TMT company would be expensed, but rents paid by a retailer for a supermarket would be capitalised)?
- Should EBITDA be computed before or after rental costs? Does it add value to maintain EBITDA and EBITDAR as separate measures?
- Is EBIT (adjusted for non-operating income/expense) a reliable measure of company performance, and would it help to use this as a proxy for a post-maintenance capex cash flow?
- Should coverage ratios include full rents paid or the interest component of the lease only? Is the additional precision meaningful?
- Should the cash flow statement be adjusted to include lease costs as an operating cash outflow in certain cases and capex in other cases? Would the complexity and variability of this adjustment outweigh its utility to investors?

Related Research

Corporate Rating Criteria (May 2018)

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APPENDIX – LEASE ACCOUNTING

The table below summarises the key differences between current lease accounting, and accounting under the IFRS16/ASC842

	Current operating lease accounting	IFRS16/US GAAP (ASC 842) type A (finance/capital lease)	US GAAP type B (operating lease)
Statement of Financial Position	Currently, operating leases are not recognised on balance sheet. A note to the financial statements includes lease commitments as an off-balance sheet disclosure.	All leases under the new standards will be recognised on balance sheet. The treatment would be similar to finance/capital leases. "Right-of-use" asset and "Lease" liability would be recognised on the balance sheet. Right-of-use asset would be amortised and assessed for impairment similar to other non-financial assets. Under IFRS, there will be one model for all leases whereas under US GAAP a distinction would be maintained between finance/capital leases (type A) operating leases (type B).	Similar to IFRS16 and US GAAP type A lease: all operating leases under US GAAP will also be recognised on balance sheet at net present value. Unlike IFRS16, type B leases will be presented and disclosed separately from type A leases. The liability amortisation would be similar to finance/capital lease. The operating "right-of-use" asset would be amortised with reference to the associated lease liability.
Statement of Comprehensive Income	An annual charge for operating leases is recognised in income statement (included in operating cost) and deducted before arriving at EBITDA.	In the income statement lease costs will be shown as depreciation and interest cost. EBITDA will, unless adjustments are made, be higher compared to current lease accounting.	Similar to current operating lease treatment.
Statement of Cash Flows	Operating lease charge is included in operating cash flows.	Lease costs are included in financing cash flows (interest + repayments), leading to a higher operating cash flow compared to the current treatment.	Similar to current operating lease treatment.

Source: Fitch

Illustration: The hypothetical example below represents a company with paid-up capital of USD400,000, debt of USD100,000 and cash balance of USD500,000. The company earns annual EBITDA of USD31,000 and annual operating lease payments of USD20,000. The free cash flows are fully distributed to shareholders. The example ignores tax considerations and assumes a discount rate of 6% with a lease term of five years. The negative retained earnings represent a cut to annual dividends due to faster recognition of total expense (amortisation + interest).

	Current model - operating lease					IFRS 16 & US GAAP type A model					US GAAP type B model				
Statement of Financial Position	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**
Right-of-use assets	-	-	-	-	-	67,398	50,548	33,699	16,849	-	69,302	53,460	36,668	18,868	-
Cash and cash equivalents	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000
	500,000	**500,000**	**500,000**	**500,000**	**500,000**	**567,398**	**550,548**	**533,699**	**516,849**	**500,000**	**569,302**	**553,460**	**536,668**	**518,868**	**500,000**
Lease liabilities	-	-	-	-	-	69,302	53,460	36,668	18,868	-	69,302	53,460	36,668	18,868	-
Debt	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Share capital	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000
Retained earnings	-	-	-	-	-	-1,904	-2,912	-2,969	-2,018	-	-	-	-	-	-
	500,000	**500,000**	**500,000**	**500,000**	**500,000**	**567,398**	**550,548**	**533,699**	**516,849**	**500,000**	**569,302**	**553,460**	**536,668**	**518,868**	**500,000**
Statement of comprehensive income	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**
Revenue	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Cost of goods sold (non-lease)	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000	-49,000
EBITDAR	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**
Lease Operating Cost	-20,000	-20,000	-20,000	-20,000	-20,000						-20,000	-20,000	-20,000	-20,000	-20,000
EBITDA	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**
Lease Amortisation						-16,849	-16,849	-16,849	-16,849	-16,849					
Operating Profit	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**	**34,151**	**34,151**	**34,151**	**34,151**	**34,151**	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**
Finance charge (interest)	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000
Finance charge (lease)	-	-	-	-	-	-5,055	-4,158	-3,208	-2,200	-1,132	-	-	-	-	-
Profit before tax	**30,000**	**30,000**	**30,000**	**30,000**	**30,000**	**28,096**	**28,992**	**29,943**	**30,950**	**32,018**	**30,000**	**30,000**	**30,000**	**30,000**	**30,000**
Statement of cash flows	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**
EBITDAR	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000	51,000
Lease payments	-20,000	-20,000	-20,000	-20,000	-20,000	-	-	-	-	-	-20,000	-20,000	-20,000	-20,000	-20,000
Operating cash flows	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**	**51,000**	**51,000**	**51,000**	**51,000**	**51,000**	**31,000**	**31,000**	**31,000**	**31,000**	**31,000**
Investing cash flows	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Dividends	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000
Principal element of capitalised leases	-	-	-	-	-	-14,945	-15,842	-16,792	-17,800	-18,868	-	-	-	-	-
Interest element of capitalised leases	-	-	-	-	-	-5,055	-4,158	-3,208	-2,200	-1,132	-	-	-	-	-
Cash interest on borrowings	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000	-1,000
Financing cash flows	**-31,000**	**-31,000**	**-31,000**	**-31,000**	**-31,000**	**-51,000**	**-51,000**	**-51,000**	**-51,000**	**-51,000**	**-31,000**	**-31,000**	**-31,000**	**-31,000**	**-31,000**
Opening cash and cash equivalents	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000
Closing cash and cash equivalents	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**	**500,000**

Source: Fitch

Key points to note:

- Under the new accounting method, the right-of-use asset is initially capitalised on the balance sheet under IFRS and US GAAP at the same amount (the present value of future lease payments). However, the way the asset is depreciated varies between IFRS16 and US GAAP Type A (finance), where the asset is depreciated straight line, and US GAAP Type B (operating) where the depreciation of the asset reflects the reduction in the value of the right of use asset.
- The IFRS and type A treatments result in a change to net profit compared to the current model and type B. Profit is lower in earlier periods due to the front-weighting of the interest element of lease financing versus straight-line depreciation of the operating cost.
- In the IFRS16 presentation above, the lease expense never goes through operating cashflow. We believe this is the most likely presentation, although IFRS allows a degree of flexibility in cashflow presentation. In contrast to the example shown here, for US GAAP type A the interest portion of finance leases must be presented as an operating cash outflow.

Appendix 2: Fitch's Current Analytical Approach

Analytical Approach

Fitch views operating leases as a debt-like form of funding for operational assets and adjusts its core leverage and coverage ratios to include the debt-like features of operating leases. Fitch looks to capitalise payments that are a substitute for asset ownership of generally operational assets that are effectively permanent in nature.

Impact on Credit Metrics

Leverage

Fitch capitalises the annual operating lease charge using a multiple to create a debt-equivalent. This represents the estimated funding level for a hypothetical purchase of the leased asset. Even where the asset may have a shorter lease financing structure, Fitch's debt-equivalent assumes a purchase of the asset for its full economic life. This enables a broad comparison between rated entities that incur debt to finance an operational asset and those that have leased it.

The standard 8x multiple is appropriate for assets with a long economic life, such as property, in an average interest-rate environment (6% cost of funding for the corporate). The multiple can be adapted to reflect the nature of the leased assets: lower multiples for assets with a shorter economic life, and mostly in emerging markets, to reflect sharply different interest-rate environments in the countries concerned. Fitch may vary the multiplier where there is a strong expectation that a higher or lower multiple is more appropriate for an individual issuer, market sector or country. The choice of the multiple used, if the result of its use deviates materially from the conventional multiples derived from the two tables on the following page, will be noted in Fitch's research on the issuer and identified as a Criteria Variation.

We do not hold periodic minor resets of derived thresholds. Although today's interest rates are low in various developed markets, many companies' existing long-dated operating leases were incurred during periods of "normal" or were higher than today's interest rates. Since companies have a steady stream of amortising lease profiles, more recent interest-rate changes have not immediately translated into lower operating lease charges.

Relevant Multiple (x) per Interest-Rate Environment and the Leased Asset's Remaining Useful Life

		Interest rate environment				
Leased asset's economic life	**Leased asset's remaining useful life**	**10%**	**8%**	**6%**	**4%**	**2%**
50	25	7.1	8.3	10.0	12.5	16.7
30	15	6.0	6.8	7.9	9.4	11.5
15	7.5	4.3	4.7	5.2	5.8	6.5
6	3	2.3	2.4	2.5	2.7	2.8

Source: Fitch

Fitch, however, differentiates and reviews periodically the multiple used in countries where interest rates are significantly higher or lower that in the reference OECD countries, such as Germany, the US, France, Italy or the UK where the 10-year government bond yield median over the 2000-2015 period ranges typically between 3.5% and 4.5%, which after adding the risk premium for a good-quality corporate risk is broadly consistent with the 6% interest rate environment used for defining the lease multiples.

For countries, such as Japan, where the median 10-year government bond yield is closer to 1%, a 9x multiple is more appropriate. At the opposite end, in countries such as South Africa or Russia where the median 10-year government bond yield is above 8%, a multiple of 6x should be used. For issuers with a multinational assets base, Fitch may use a blended approach depending on where countries' leased assets are located. If this level of detail is unavailable or Fitch is aware that the country-specific multiple is not appropriate (for example, when leases are denominated in hard currencies), Fitch may either use the standard 8x multiple or take the multiple of the most relevant country for the issuers if one dominant country of operations can be defined.

Where there is evidence for a class of asset that a company's borrowing costs to acquire the asset would be more reflective of global than local financing costs, both in the same currency, Fitch may use an 8x multiple in jurisdictions where a different multiple is the norm for leased financings. Examples of such asset classes include aircraft and ships, which are typically financed in US dollars in global and local markets. Rating committees will evaluate this on a case-by-case basis and relevant evidence may include consideration of interest rate costs (including lessee premiums) implicit in operating or finance leases and absolute lease payments.

Country-Specific Lease Standard[a] Capitalisation Multiples

8x multiple	7x multiple	6x multiple	Other multiples
APAC			
Malaysia, Thailand, China/Hong Kong, South Korea	Australia, New Zealand	India, Philippines, Sri Lanka, Vietnam	Indonesia: 5x Japan: 9x Singapore: 9x Taiwan: 9x
Americas			
Bolivia, Canada, El Salvador, Guatemala, Panama, US	Argentina, Chile, Peru, Venezuela	Dominican Republic, Mexico	Brazil: 5x Colombia: 5x Costa Rica: 4x
EMEA			
Belgium, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Lithuania, Netherlands, Norway, Portugal, Saudi Arabia, Slovakia, Spain, Sweden, UK	Bulgaria, Greece, Poland, Romania	Azerbaijan, Georgia, Iran, Kazakhstan, Namibia, Russia, South Africa	Switzerland: 9x Luxembourg: 9x Turkey: 5x Ukraine: 5x Belarus: 5x

[a] Standard refers to the multiple applied to assets with a 15-year average remaining life
Source: Fitch

Interest Coverage: Fitch includes the capitalised annual lease charge (its fixed-interest and principal components) in its fixed charge cover ratio, designed to capture such payments. In Fitch's company-specific ratings-case forecast, the projected operating lease payments are based on a going-concern profile rather than on a value based upon decreasing contractual minimum payments. In a small number of cases, minimum lease payment details (typically only 12-18 months' worth) may be used in reviewing the creditor mass for an issuer's debt instrument in Fitch's recovery rating analysis.

When not to Capitalise

Fitch can also choose not to capitalise certain operating leases, acknowledging cases where a lease is more like an operating cost than a payment under a longer-term funding structure. Fitch would consider not capitalising lease commitments in the following cases.

- Leased assets that have a short average remaining useful life of five years or less (implying a multiple of 3.0x to 3.5x). Since rated entities are usually leveraged above 3x, it makes little difference if these types of leased assets are included.
- Leased assets that are linked to a specific concession or contract with a finite term, where the lease obligations on bespoke assets co-terminate with completion or expiry of the contract.
- The rated entity has no choice but to lease fixed assets owned or managed by third parties (airport terminals, national infrastructure access, other "regulated" shared services). This is not intended to capture situations where issuers have spun-off assets into separately traded entities, as for example, with TMT companies and their tower masts. This exception to capitalise lease payments is meant to capture situations where the purchasing of the asset is not an option for sector participants.
- Where the company has demonstrably been able to manage its lease costs to match the stage of the business cycle, making lease payments more akin to a variable operating cost rather than a long-term financial commitment. This may also lead to the capitalisation of a lower, base level of operating lease expenses when the

rentals above that level have proved to be flexibly managed across the cycle.

Impact on Recovery Analysis

Other than where local practices indicate that ongoing costs should be added to senior unsecured claims, Fitch typically treats lease obligations as an element in the ongoing structure of the post-restructuring entity, rather than as a crystallised obligation added to the creditor mass.

Leases with Variable Components

When rental obligations are related to an operational metric of the leased assets, typically the outlet's turnover, and disclosure is both sufficient and reliably consistent, Fitch may reflect the additional flexibility provided by the variable component by discounting the rental amount used in the computation of the debt equivalent.