Impact on valuation due to changes in lease accounting

Valuation insights

Implementation of the new lease accounting standards

The International Accounting Standards Board (IASB) issued IFRS 16 Leases in January 2016, effective for financial periods beginning on or after 1 January 2019. IFRS 16 replaces the previous leases standard, IAS 17 Leases.

Similarly, The Accounting Standard Board in India issued an exposure draft on IndAS 116 Leases, which was approved by the Ministry of Corporate Affairs on 30 March 2019, effective from 1 April 2019. IndAS -116 replaces the IndAS-17 Leases.

Key differentiator between old and new lease accounting standard

IAS 17/IndAS 17 (old lease accounting standard)

- Classification of Lease into **financial lease** (on balance sheet) and **operating lease** (off balance sheet)
- For operating leases, lessee was required to recognise the lease payments as **rental expenses** in P&L.

IFRS 16/IndAS 116 (new lease accounting standard)

- **Single lessee accounting model**
- **Recognition of right to use and lease liabilities** in the balance sheet and consequently recognising **depreciation** on right to use assets **and interest** on lease liabilities in income statement of lessee.
- Recognition and measurement exemption are available for **low-value assets and short-term leases** (lease term of 12 months or less).

Introduction of IndAS 116 and its applicability from 1 April 2019 has changed the way financial statements are read and interpreted for analysis. For all these years, everyone was familiar with the concept of operating lease and finance lease where in case of operating leases, the lease expense would be recognised as a rental expense for determination of EBITDA. In case of finance lease, it would be treated as an asset with corresponding debt in the balance sheet and the income statements being impacted on account of interest expense.

With IndAS, all the leases are to be treated as finance lease only with few exceptions such as short-term leases and low value lease.

In order to assess what could be the impact of adoption of the new lease accounting standard on the valuation exercise, it is important to understand the key factors involved in the right to use (ROU) and lease liability calculation and determination of finance cost in the income statement of the subject company proposed to be valued.

Recognition of ROU and lease liability

Right of use asset is recognised and measured at cost, consisting of initial measurement of lease liability plus any lease payments made to the lessor at or before the commencement date less any lease incentives received, initial estimate of the restoration costs and any initial direct costs incurred by the lessee. In subsequent years, the right-of-use asset is amortised.

Lease liability is initially recognised and measured at an amount equal to the present value of minimum lease payments during the lease term. In subsequent periods, the lease liability is measured using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee's incremental borrowing cost is considered.

ROU

Lease Liability → $\sum_{i=1}^{n} i$ **= Lease Liability (Y1)+Lease Liability (Y2) +…. Lease Liability (Yn)**

Discount rate

Add: initial estimate of the restoration costs and any initial direct costs incurred by the lessee

Less: Lease incentives received from lessor

Add: Lease payments made to the lessor at or before the commencement date

Impact on valuation

From a business valuation perspective, the equity value or market value of the subject company should not change with the implementation of new lease accounting standard as there is no change to the underlying cash flows being generated by the business. However, adopting new lease accounting standard will result in the subject company's net debt and EBITDA increasing, which may practically impact the outcomes of valuations.

As an immediate impact, although equity values should not change, enterprise values of companies will change. This could result in higher EBITDA and free cash flow.

Impact on discounted cash flow (DCF) method

The valuation may get impacted under the DCF method mainly due to change in free cash flows, discount rate, tax adjustments and terminal period assumptions. The possible impacts are discussed below:

Increase in enterprise value due to following impacts

Impact on free cash flows

The future free cash flows to the firm (FCFF) will be higher over the remaining lease period, as rental expenses are no longer deducted from EBITDA leading to increase in EBITDA.

The depreciation charge is a non-cash item and consequently, does not negatively impact the cash flows.

The lease payments are reflected in the cash flow statement via interest payments and redemptions of the lease obligation, however, these are financing items and hence, do not impact FCFF.

Impact on discount rate

Leverage ratios i.e., D/E and D/TC of (peer group) companies which are used to estimate the target capital structure in the Weighted Average Cost of Capital (WACC), will increase. Even the subject company's leverage ratios will increase. A higher leverage, may lead to a lower WACC and a higher net present value of FCFF.

Tax adjustment

Although as per books, rental expenses are not to be considered for operating leases, for income tax purpose, the same is still considered as an expenditure for arriving at the applicable tax.

Impact on terminal period value

Impact on terminal EBITDA

As per the old lease accounting standards, rental expenses were deducted from EBITDA and consistently incorporated in the future cash flows (also in the terminal period). As per the new standard, **the actual cash outflows in the form of rental expenses is not taken into consideration that impacts explicit and terminal period values**.

Impact on terminal capex and depreciation

As per the new lease accounting standard, in the terminal period, since the depreciation is assumed to be equal to the capital expenditure, **the depreciation relating to the lease also gets offset against the capital expenditure.**

One should properly incorporate the negative impact of future cash outflows relating to continuation of leasing from the moment that the lease expires. If this is not explicitly reflected in the future cash flows, it could lead to over valuation, primarily for companies with very short remaining operational lease terms.

The increase in enterprise value should, theoretically, be exactly offset by the increase in net debt (representing the Net Present Value (NPV) of the remaining lease obligation) of the subject company that is being valued. Hence, this may result in the same equity value despite change in lease accounting. However, the introduction of new lease accounting makes DCF valuations more complex, more sensitive to errors and may presumably lead to changes in the valuation of equity.

Case study for impact of change in lease accounting on the DCF method

Two scenario of cash flows and discounted cash flow method are illustrated below to arrive at the equity value under old lease accounting standard and new lease accounting standard. As mentioned earlier, theoretically, there should not be any significant difference but practically it may lead to different results.

Company A has taken a lease property on 1 April 2019, which is categorised as operating lease. The lease is taken for five years from 1 April 2019 with first year rent to be around INR 5 lakh with an escalation of lease rental by 5% year over year. The initial advance payment of INR 1 lakh is paid to the lessor and registration fees of INR 80,000 is borne by the lessee at the beginning of the lease term. (All the amounts in the illustrations are in INR.)

As per the old lease accounting standard

The rental expenses were shown in the projected period as per the lease terms. The initial advance paid and direct costs including registration fees etc. will form part of the income statement in the year when they are incurred.

Income Statement as per old standard	FY20	FY21	FY22	FY23	FY24
Revenues	**20,000,000**	**27,000,000**	**34,560,000**	**43,200,000**	**49,680,000**
% growth		35%	28%	25%	15%
Gross Profit	**5,000,000**	**7,560,000**	**10,368,000**	**15,120,000**	**15,897,600**
% gross profit margin	25%	28%	30%	35%	32%
Rental expense	600,000	525,000	551,250	578,813	607,753
Registration fee	80,000				
Personnel expense	1,000,000	1,350,000	1,728,000	2,160,000	2,484,000
% of personnel expense	5.0%	5.0%	5.0%	5.0%	5.0%
EBITDA	**3,320,000**	**5,685,000**	**8,088,750**	**12,381,188**	**12,805,847**
EBITDA margin	17%	21%	23%	29%	26%
Depreciation non-cash	500,000	525,000	555,000	590,000	627,500
EBIT	**2,820,000**	**5,160,000**	**7,533,750**	**11,791,188**	**12,178,347**
% EBIT	14%	19%	22%	27%	25%
Interest expenses	500,000	500,000	500,000	500,000	500,000
EBT	**2,320,000**	**4,660,000**	**7,033,750**	**11,291,188**	**11,678,347**

Balance Sheet as per old standard	FY20	FY21	FY22	FY23	FY24
Share Capital	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Reserves and Surplus	5,320,000	9,980,000	17,013,750	28,304,938	39,983,284
Shareholders Equity	**6,320,000**	**10,980,000**	**18,013,750**	**29,304,938**	**40,983,284**
Short term borrowings	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
Lease liabilities					
Total borrowings	**5,000,000**	**5,000,000**	**5,000,000**	**5,000,000**	**5,000,000**
Sources of Fund	**11,320,000**	**15,980,000**	**23,013,750**	**34,304,938**	**45,983,284**
Property, Plant and Equipment	9,500,000	9,475,000	9,520,000	9,630,000	9,752,500
Right to Use assets					
Total Fixed Assets	**9,500,000**	**9,475,000**	**9,520,000**	**9,630,000**	**9,752,500**
Current Assets	4,444,444	6,000,000	7,680,000	9,600,000	11,040,000
Current Liabilities	3,888,889	5,250,000	6,720,000	8,400,000	9,660,000
NCWC	**555,556**	**750,000**	**960,000**	**1,200,000**	**1,380,000**
Cash and Cash equivalent	1,264,444	5,755,000	12,533,750	23,474,938	34,850,784
Application of funds	**11,320,000**	**15,980,000**	**23,013,750**	**34,304,938**	**45,983,284**

As can be seen above, the old lease accounting standard did not have a requirement of showing ROU asset and lease liabilities. Accordingly, same has been kept blank in the balance sheet under the old lease accounting standard.

Based on the above, the equity valuation is arrived at by arriving at free cash flows and discount rate as shown below:

Particulars		FY21 12m	FY22 12m	FY23 12m	FY24 12m	Terminal Period
Net Sales		**27,000,000**	**34,560,000**	**43,200,000**	**49,680,000**	**52,164,000**
Growth Rate %			28.0%	25.0%	15.0%	5.0%
EBITDA		**5,685,000**	**8,088,750**	**12,381,188**	**12,805,847**	**12,897,200**
EBITDA Margin %		21.1%	23.4%	28.7%	25.8%	24.7%
Less: Depreciation		525,000	555,000	590,000	627,500	627,500
Earnings Before Interest and Tax (EBIT)		**5,160,000**	**7,533,750**	**11,791,188**	**12,178,347**	**12,269,700**
Less: Taxes		1,298,669	1,896,094	2,967,606	3,065,046	3,088,038
Gross Free Cash Flows to the Firm (Post Tax)		**3,861,331**	**5,637,656**	**8,823,581**	**9,113,301**	**9,181,662**
Add: Depreciation		525,000	555,000	590,000	627,500	627,500
Less: Change in NCWC		194,444	210,000	240,000	180,000	69,000
Less: Capital Expenditure		500,000	600,000	700,000	750,000	627,500
Net Free Cash Flows to the Firm		**3,691,887**	**5,382,656**	**8,473,581**	**8,810,801**	**9,112,662**
Terminal Value	**5.0%**					**78,557,430**
Present Value Factors	**16.6%**	0.926	0.794	0.681	0.584	
Present Value of Free Cash Flows to the Firm		**3,419,000**	**4,275,125**	**5,771,924**	**5,147,193**	**45,892,566**

Sum of Present Value of Free Cash Flows to the Firm	18,613,242
Present Value of Terminal Cash Flows to the Firm	45,892,566
Enterprise Value	**64,505,808**
Add: Cash & Bank	1,264,444
Less: Debt	5,000,000
Net Equity Value (INR)	**60,770,253**

For simplicity sake, IT depreciation has been considered to be equal to book depreciation in the above illustration.

Discount rate:

Particulars	Values
Levered beta of comparable companies	1.20
D/E of comparable companies	0.40
Select Asset Beta	0.92
Selected D/E Ratio based on projected period	0.26
Re-levered Beta	1.10
Cost of Equity	18.9%
After-Tax Cost of Debt	7.5%
WACC	16.6%

Based on the above, the equity value of Company A is arrived at **INR 60.8 million**.

As an alternate scenario, equity value is derived by applying the principles of the new lease accounting standard, which is explained hereunder:

The projected rental expenses can be estimated based on 5% escalation to the INR 5 lakh rental for FY20 as per the terms of the lease. Based on the same, lease liability can be calculated by present valuing the lease rental expenses by considering lender's borrowing rate (assumed 10%) as a discount rate. Further, ROU can be estimated by considering any direct costs, initial advance payments done by the lessee to the lessor and restoration costs, if any. In this illustration, initial advance paid by lessee to the lessor is considered at INR 1 lakh and direct cost (mainly registration cost) of INR 80,000 is assumed. Based on above inputs, Lease liabilities and ROU asset values are determined as depicted in table below:

Deriving lease liabilities

Deriving opening balance of lease liabilities	FY20	FY21	FY22	FY23	FY24
Lease payments	500,000	525,000	551,250	578,813	607,753
Escalation %		5%	5%	5%	5%
Present value factor @ 10%	0.91	0.83	0.75	0.68	0.62
Present value of lease payments	454,545	433,884	414,162	395,337	377,367
Opening balance of Lease Liability		**2,075,296**			

Projected Lease liabilities	FY20	FY21	FY22	FY23	FY24
Opening balance	**2,075,296**	**1,782,825**	**1,436,108**	**1,028,468**	**552,503**
Add: Notional Interest @ 10%	207,530	178,283	143,611	102,847	55,250
Less: Redemption	500,000	525,000	551,250	578,813	607,753
Closing balance	**1,782,825**	**1,436,108**	**1,028,468**	**552,503**	**-**
Depreciation on lease asset	**451,059**	**451,059**	**451,059**	**451,059**	**451,059**

Deriving ROU

Particulars	Amount in INR
Lease Liability	**2,075,296**
Add: Initial advance payment	100,000
Add: Registration fees	80,000
ROU Opening balance	**2,255,296**

Particulars	FY20	FY21	FY22	FY23	FY24
Opening gross block of ROU	**2,255,296**	**2,255,296**	**2,255,296**	**2,255,296**	**2,255,296**
Addition					
Closing gross Block	2,255,296	2,255,296	2,255,296	2,255,296	2,255,296
Accumulated Depreciation @ 20%	451,059	902,118	1,353,177	1,804,237	2,255,296
Depreciation using SLM	**451,059**	**451,059**	**451,059**	**451,059**	**451,059**
Net Block of ROU	**1,804,237**	**1,353,177**	**902,118**	**451,059**	**-**

Based on above derivations of the lease liabilities, notional interest, ROU and depreciation, the projected income statement and balance sheet are derived as per the new lease accounting standard as shown below.

The projected income statements and balance sheets will appear as below based on the new lease accounting standard:

Income Statement as per New Standard	FY20	FY21	FY22	FY23	FY24
Revenues	**20,000,000**	**27,000,000**	**34,560,000**	**43,200,000**	**49,680,000**
% growth		35%	28%	25%	15%
Gross Profit	**5,000,000**	**7,560,000**	**10,368,000**	**15,120,000**	**15,897,600**
% gross profit margin	25%	28%	30%	35%	32%
Rental expense	0	0	0	0	0
Personnel expense	1,000,000	1,350,000	1,728,000	2,160,000	2,484,000
% of personnel expense	5.0%	5.0%	5.0%	5.0%	5.0%
EBITDA	**4,000,000**	**6,210,000**	**8,640,000**	**12,960,000**	**13,413,600**
EBITDA margin	20%	23%	25%	30%	27%
Depreciation non-cash	951,059	976,059	1,006,059	1,041,059	1,078,559
EBIT	3,048,941	5,233,941	7,633,941	11,918,941	12,335,041
% EBIT	15%	19%	22%	28%	25%
Interest expenses	707,530	678,283	643,611	602,847	555,250
EBT	**2,341,411**	**4,555,658**	**6,990,330**	**11,316,094**	**11,779,791**

Balance Sheet as per New Standard	FY20	FY21	FY22	FY23	FY24
Share Capital	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Reserves and Surplus	5,341,411	9,897,070	16,887,400	28,203,494	39,983,284
Shareholders Equity	6,341,411	10,897,070	17,887,400	29,203,494	40,983,284
Short term borrowings	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
Lease liabilities	1,782,825	1,436,108	1,028,468	552,503	-
Total borrowings	6,782,825	6,436,108	6,028,468	5,552,503	5,000,000
Sources of Fund	13,124,237	17,333,177	23,915,868	34,755,997	45,983,284
Property, Plant and Equipment	9,500,000	9,475,000	9,520,000	9,630,000	9,752,500
Right to Use assets	1,804,237	1,353,177	902,118	451,059	-
Total Fixed Assets	11,304,237	10,828,177	10,422,118	10,081,059	9,752,500
Current Assets	4,444,444	6,000,000	7,680,000	9,600,000	11,040,000
Current Liabilities	3,888,889	5,250,000	6,720,000	8,400,000	9,660,000
NCWC	**555,556**	**750,000**	**960,000**	**1,200,000**	**1,380,000**
Cash and Cash equivalent	1,264,444	5,755,000	12,533,750	23,474,938	34,850,784
Application of funds	**13,124,237**	**17,333,177**	**23,915,868**	**34,755,997**	**45,983,284**

Based on the above, the equity valuation of Company A is arrived at after considering certain adjustments that may have an impact due to the new lease accounting policy:

Particulars		FY21 12m	FY22 12m	FY23 12m	FY24 12m	Terminal Period
Net Sales		**27,000,000**	**34,560,000**	**43,200,000**	**49,680,000**	**52,164,000**
Growth Rate %			28.0%	25.0%	15.0%	5.0%
EBITDA		**6,210,000**	**8,640,000**	**12,960,000**	**13,413,600**	**13,693,050**
EBITDA Margin %		23.0%	25.0%	30.0%	27.0%	26.3%
Less: Depreciation		976,059	1,006,059	1,041,059	1,078,559	1,078,559
Earnings Before Interest and Tax (EBIT)		**5,233,941**	**7,633,941**	**11,918,941**	**12,335,041**	**12,614,491**
Less: Taxes		1,317,278	1,921,310	2,999,759	3,104,483	3,174,815
Gross Free Cash Flows to the Firm (Post Tax)		**3,916,663**	**5,712,631**	**8,919,182**	**9,230,558**	**9,439,676**
Add: Depreciation		976,059	1,006,059	1,041,059	1,078,559	1,078,559
Less: Change in NCWC		194,444	210,000	240,000	180,000	69,000
Less: Capital Expenditure		500,000	600,000	700,000	750,000	1,078,559
Net Free Cash Flows to the Firm		**4,198,277**	**5,908,690**	**9,020,241**	**9,379,117**	**9,370,676**
Terminal Value						**89,244,532**
Present Value Factors		0.9305	0.8056	0.6975	0.6039	
Present Value of Free Cash Flows to the Firm		**3,906,431**	**4,760,123**	**6,291,630**	**5,664,023**	**53,894,528**

Sum of Present Value of Free Cash Flows to the Firm	20,622,207
Present Value of Terminal Cash Flows to the Firm	53,894,528
Enterprise Value	**74,516,735**
Add: Cash & Bank	1,264,444
Less: Debt including lease liabilities	6,782,825
Net Equity Value (INR Mn)	**68,998,354**

First cause of concern by deriving the DCF based on the new lease accounting standard is that EBITDA gets inflated and considering average EBITDA margin of the projected period in the terminal period might inflate the valuation.

Secondly, depreciation includes depreciation due to ROU, which is not tax deductible as per the income tax and hence should not form part of depreciation in the DCF to avoid derivation of lower tax expenses for the projected and terminal period. If not done correctly, the tax amount reduces and leads to inflated cash flows for projected as well as terminal period.

Similarly, considering a generic assumption of equating the capital expenditure to the depreciation of the last projected period may not be correct assumption considering that the lease terms may be different and may increase or decrease in perpetuity.

Lease liabilities will be deducted along with the borrowings of Company A to arrive at equity value from the enterprise value but this adjustment is not equivalent to the other adjustments done in the projected period and terminal period and hence can lead to completely different equity value. In the illustration, the difference between the equity value derived based on the Old Lease Accounting Standard is INR 68.3 million and based on the new lease accounting standard is INR 77.5 million leading to an upside in valuation of around 13%. This difference may differ based on the leases held by the subject company.

Discount rate as per the new lease accounting standard impacting D/E of Company A as well as comparable companies considered to arrive at WACC:

Particulars	Values
Levered beta	1.20
D/E of comparable companies	0.70
Select Asset Beta	0.79
Selected D/E Ratio	0.31
Relevered Beta	0.97
Cost of Equity	**18.0%**
After-Tax Cost of Debt	**7.5%**
WACC	**15.5%**

There is a visible difference between the WACC derived as per old and new lease accounting standard. As per the new lease accounting standard, lease liability is treated as debt and forms part of the operating leverage of the subject company leading to higher D/E ratio and lowering the WACC compared to the WACC derived based on old lease accounting where the lease liability did not form part of the balance sheet.

It could be concluded from above that the new lease accounting standard have an impact on the debt / financial liability. In case the valuer chooses to select debt equity ratio of the subject company or industry debt equity ratio while estimating cost of equity, these accounting changes may require extra consideration while estimating cost of equity under discounted cash flow methodology.

Recommendations while carrying out DCF:

Always gain proper insight on the lease obligations and average remaining lease terms of the subject business.

Get the following information from client about the subject company to be valued:

- Rental expenses due to operating lease for the projected period.
- Bifurcation of Interest into interest on loans and notional interest on lease liabilities in the projected period.
- Bifurcation of depreciation into depreciation on tangible assets and depreciation on ROU in the projected period.

Deduct the rental expenses in the EBITDA.

Ignore deducting notional interest on lease liabilities if using FCFE.

Ignore adding depreciation on ROU to the total depreciation.

Consider the debt without considering lease liability.

WACC should exclude lease liability weightage.

This will enable us to overcome the issues related to terminal period adjustments, discount rate, lease liability adjustments and consider tax as per IT Act.

Impact on ratio analysis

It may appear basis plain reading of the financials of the subject company that total debt for the company has increased compared to previous year, which could be interpreted that the subject company is in expansion mode. Secondly, the reader of the financials may presume that the financial position of the subject company is deteriorating and therefore, leverage has increased. However, the leverage for the subject company has increased mainly on account of lease liability recorded on the books.

As per the new lease accounting standard, the subject company is given an option to apply this standard retrospectively/prospectively. This option may pose a great amount of challenge in comparing financials of the companies being analysed. In case, there are certain companies using prospective option then the historical financials of those company may not be comparable to the current year performance. Further this option may also create some difficulty for the valuer in analysing companies as different companies chosen as part of the comparable set may have opted differently and therefore, valuer will have to take extra care while performing ratio analysis. Key ratios that may have an impact would include return on equity, return on capital employed/leverage ratios, margin ratios etc.

Balance Sheet as per old standard	FY20	FY21	FY22	FY23	FY24
Gearing Ratio	0.79	0.46	0.28	0.17	0.12
Return on Capital Employed	24.9%	32.3%	32.7%	34.4%	26.5%
Net Debt/EBITDA	1.51	0.88	0.62	0.40	0.39

Balance Sheet as per new standard	FY20	FY21	FY22	FY23	FY24
Gearing Ratio	1.07	0.59	0.34	0.19	0.12
Return on Capital Employed	23.2%	30.2%	31.9%	34.3%	26.8%
Net Debt/EBITDA	1.70	1.04	0.70	0.43	0.37

The impact on net debt and EBITDA figures is the largest for companies with many operating leases, for example in sectors such as retail, wholesale, aviation and transportation.

The impact depends on the remaining duration of the lease. The incremental net debt/ EBITDA and gearing ratio on the lease liability will generally be high at start of the lease term, gradually decreasing to zero at the end of the lease term.

Impact on M&A and Private Equity Deals

The impact is not evenly spread

Some sectors make extensive use of material operating leases; in other sectors, they are far less significant. Further, companies within a sector use different business models (e.g., while operating leases are widely used in the retail sector, some retailers own stores, similarly for aviation industry).

There is also a lengthy transition period. The new lease accounting standard comes into force for accounting year commencing from FY20 onwards, but early adoption is permitted if the entity has already implemented IFRS 15: Revenue from Contracts with Customers. In theory, entities may have implemented the changes already, whereas other entities may not have. Comparing such companies can give different valuation interpretations for the deal.

Non-compliance with loan covenants: Additional leverage could result in non-compliance with loan covenants, perhaps triggering indemnity clauses or regulatory capital requirements for companies in the financial sector. Certain profitability ratios, such as return on assets and return on capital employed, may also fall as a result of the additional assets taken on balance sheet. Transactions may be viewed as riskier or less attractive. In an M&A context, this may require attention while evaluating M&A proposals considering the accounting changes/accounting policies adopted by the companies.

The impact is not evenly spread across sectors

Affect financial covenants in an already concluded deal agreement

Deal disputes

Deal disputes

Ambiguity can originate from agreements that were concluded before the new lease accounting standard were finalised and the consequential changes in the financial statements post implementation of the new lease accounting standard were not foreseen. For example, many earn-out clauses agreed several years ago make reference to EBITDA but may not have foreseen the increase of EBITDA from converting lease charges to depreciation and interest.

Certain earn-out formulae are linked to net income, and these may also change considering the accounting for interest expenses and amortisation principles suggested in the new lease accounting standard. Further, lease accounting may affect financial covenants in loan agreements. All of this can lead to disagreements between the parties.

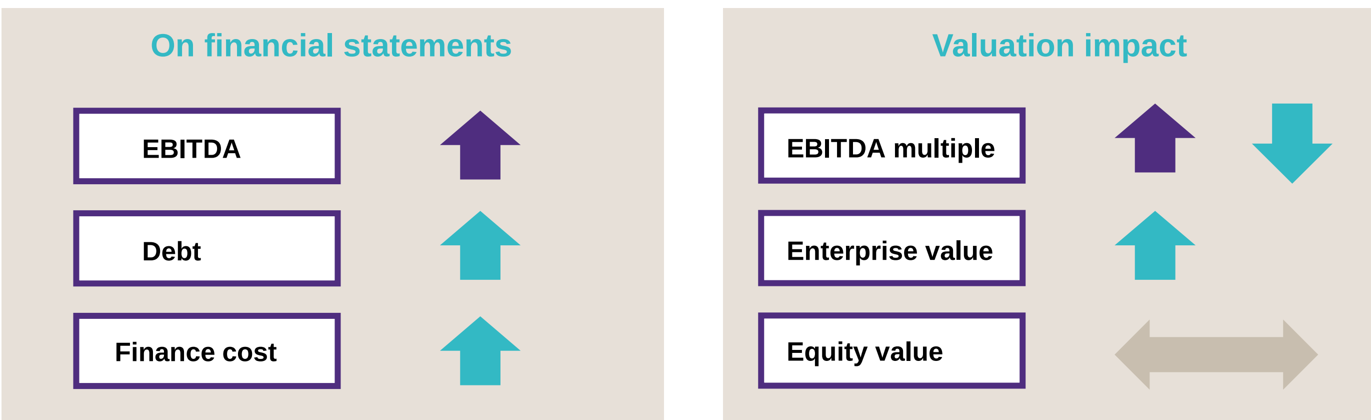
Under the new lease accounting standard, right-of-use assets and accompanying liabilities are valued using a set of assumptions for interest rates, inflation, future reinstatement costs, residual value guarantee payments, etc., which can have a significant impact on the value of asset and liability recognised in the financials of the subject company.

In a corporate transaction, estimation of incremental cost of borrowing may have an impact on recognition of net debt and consequently, may have an impact on the value of the subject company.

Practitioners need to ensure they are aware of how the changes may affect the subject company's accounts, its valuation and the specifics of the completion mechanism in the sale and purchase agreement.

Impact of lease accounting on market multiple approach

Market multiple method is most used method in the valuation exercise, either as a primary method for the valuation of subject company or for the purpose of benchmarking in case other methods of valuation are used as primary method. A valuer using this method may have to be diligent in considering the inputs used in this method.



Price to Earnings (P/E) multiples

Equity value multiples should theoretically remain same after introduction of the new lease accounting standard. Although it may get impacted due to front loading effect if any, of interest on net income.

EBITDA multiples

As discussed earlier, it could be observed that the companies who have adopted new lease accounting standard will report higher EBITDA mainly due to the fact that lease expense is not considered for EBITDA calculation whereas companies who are not following new lease accounting standard will show lower EBITDA on account of lease expense being considered as an outflow.

Accordingly, enterprise values will increase due to capitalisation of the present value of future lease payments which are treated as borrowings in new lease accounting standard.

Historical market multiples based on old lease accounting standard will not be comparable to the market multiples derived by applying new lease accounting standard. The comparability of market multiples across companies post implementation of new lease accounting standard will be affected by the level of lease liabilities each company would have, which depends on a range of factors, one of which is the remaining lease term.

Enterprise value to EBITDA multiple

=

Enterprise Value

EBITDA

Enterprise Value to EBITDA multiple is uncertain

Enterprise values increase due to capitalisation of the present value of future lease payments.

EBITDA increases, due to the removal of operational lease expenses from P&L as per new standards.

EBTDA multiples (old vs new lease accounting standard): Historical EBITDA multiples based on old lease accounting standard will not be comparable to the EBITDA multiples derived by applying new lease accounting standard.

EBITDA multiples (across companies post implementation of new lease accounting standard): The comparability of EBITDA multiples across companies post implementation of new lease accounting standard will be affected by the level of lease liabilities each company would have, which depends on a range of factors, one of which is the remaining lease term.

Both numerator and the denominator increase, post implementation of the new lease accounting standard, EV/EBITDA trading multiples may be either lower or higher when compared to the old lease accounting standard, but in any case, will not remain unaffected in case a company has operating leases.

The impact of the new lease accounting standard on EV / EBITDA multiples will never be the same between comparable companies and the subject company, the results of market-based valuations may get affected in absence of appropriate adjustments being made while deriving the multiples. Although value assessments based on market multiples post implementation of the new lease accounting standard should theoretically result in the same equity value, the outcomes of valuations may change and raise new attention areas in business valuation.

Relation of impact on EV/EBITDA with the lease multiple

When the ratio NPV lease obligation i.e. lease liabilities/lease rental expenses (also referred to as 'lease multiple') is lower than the current EV/EBITDA trading multiple, the EV/EBITDA trading multiple decreases following the introduction of new lease accounting standards.

Conversely, when the lease multiple is higher than the current valuation multiple, the EV/EBITDA multiple will increase (this applies to companies with long average remaining lease terms).

Advantage of new standard – while comparing and valuing companies, of which some own assets and while other lease similar assets, EBITDA as per new standards, removes this operating difference for comparability.

Disadvantage of new standard – nature of the net debt related to the remaining lease obligation might not be comparable between companies.

Case study for market multiple method – retail companies in India

A sample of few listed retail companies in India was considered. Avenue Supermarts Limited (D-Mart) has very insignificant amount of lease hold asset and owns majority of the stores rather than leasing the premises. Whereas other retail companies such as Trent Limited (Trent), Shoppers Stop Limited (Shoppers Stop) and Aditya Birla Fashion and Retail Limited (Aditya Birla) have opted for more lease hold properties rather than own properties. Hence, post implementation of the New Lease Accounting Standard, there is hardly any change in the margins of D-Mart between historical verses FY20 margins compared to the other three retail companies which have more operating lease

Listed companies in Retail	EBITDA Margins		EBIT Margins		PAT margins	
	FY19	FY20	FY19	FY20	FY19	FY20
D-Mart	8.2%	8.6%	7.1%	7.1%	4.5%	5.2%
Trent	9.1%	15.7%	7.1%	8.6%	3.6%	3.0%
Shoppers stop	6.9%	15.9%	2.9%	2.9%	1.8%	-4.1%
Aditya Birla	6.8%	13.8%	3.4%	3.7%	4.0%	-1.9%

Information related to lease rentals and lease liabilities was analysed for identified companies from the audited accounts of the identified companies. Further EV/EBITDA multiples were analyzed by applying the accounting principles set out in the old lease accounting standard and new lease accounting standard. The summary of analysis is reproduced in the table:

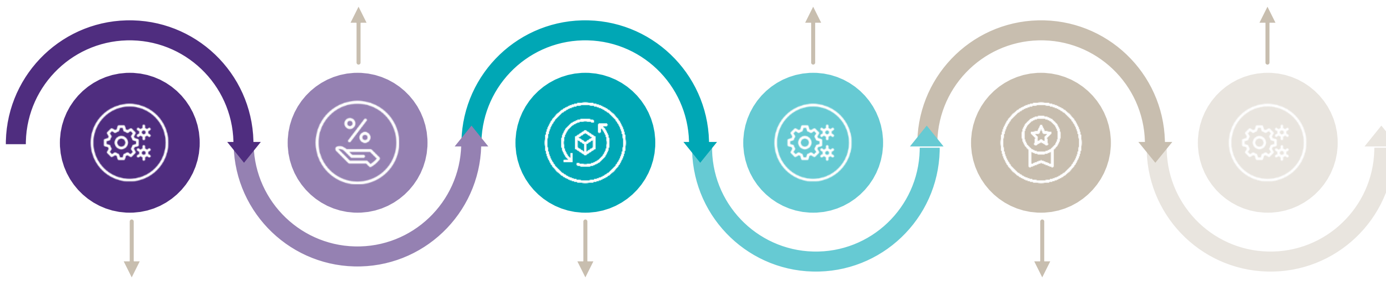
Listed companies in retail	EV/EBITDA		
	FY19	As per New StandardFY20	As per Old StandardFY20
D-Mart	56.4	65.2	68.2
Trent	48.3	33.6	61.5
Shoppers stop	16.1	6.8	9.0
Aditya Birla	34.2	14.0	13.0

For estimating the EV/EBITDA as per the old lease accounting standard, lease liability has been reduced from the EV as provided in the financial statements post adoption of the new lease accounting standard and rental expense is adjusted from the EBITDA as per the new lease accounting standard.

The outcome of above analysis as reproduced in the table above reflects the impact accounting changes may have in derived EBITDA multiples pre and post implementation of IFRS 16.

The analysis substantiates the fact that the valuation multiples considered under the market multiple approach may change significantly on account of the new lease accounting standard and therefore the valuer should be diligent in analyzing the multiples of comparable companies. Preferably, if the information on lease rentals is available in notes to accounts of the listed comparable companies, then one should consider adjusting the same in EBITDA and arrive at EV/EBITDA based on the Old Lease Accounting Standard only. The valuer should make appropriate adjustments to arrive at the concluded multiple. Valuer should exercise prudence while making adjustments to arrive at EV/EBITDA of the comparable companies considered in case there is variation in the operating business model (owned verses leased properties) of the subject company being valued.

Things to consider



- Consistency in applying lease adjustments to cash-flows and discount rate
- Similar approach to be followed while determining carrying value and recoverable value while carrying out Impairment Assessments
- Application of replacement capital expenditure while estimating terminal / perpetuity value
- Interpretation of Gearing ratios and EV market multiples due to change in lease accounting
- Effect of lease liabilities on the EV market multiples across companies depending on certain factors
- Care to be taken while comparing peer sets which do not follow IFRS or IndAS accounting policies with those following the same.

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