Does IFRS 16 Add Value?

The valuation of businesses which include Property assets, whether they are owned or leased, is complicated at the best of times.

IFRS 16 “Leases” was introduced a few years ago to improve comparability between businesses that either Lease or Own its Properties. In doing so, however, IFRS 16 has added a further layer of complexity when it comes to valuations, and there are widely contrasting views on how to approach this topic.

To help us explore this matter, let us look at the following puzzle in which we have been asked to value the shares (Equity Value) of Fiery Ice, a sizeable manufacturing business. Fiery Ice uses large industrial premises to operate effectively. Below are the market multiples of three similar businesses:

	Lannister	Stark	Targaryen
EV-EBITDA	5,91	3,30	1,98
Price-to-Earnings	10,48	12,93	35,08
Price-to-Book	1,04	1,07	1,12

As a starting point, we could possibly calculate the average of the three multiples and apply these averages to Fiery Ice’s financial statements. Whereas the EV-EBITDA and Price-to-Earnings multiples seem erratic, the spread of the Price-to-Book multiples is more reasonable so perhaps another option would be to ignore the first two multiples and focus only on this.

A far better approach, however, is for us to study Lannister, Stark and Targaryen in more detail. Market multiples are powerful tools but lead to disastrous valuation decisions if handled carelessly.

Below are the summarised income statements of each business:

	Lannister	Stark	Targaryen
	R'm	R'm	R'm
EBITDAR	100	100	100
Lease Expense	0	-40	0
EBITDA	**100**	**60**	**100**
Depreciation: Plant & Machinery	-20	-20	-20
Depreciation: Right of Use Assets	0	0	-33
EBIT	**80**	**40**	**47**
Interest: Mortgage Bond	-31	0	0
Interest: Lease Liability	0	0	-33
Profit before Tax	**50**	**40**	**15**
Tax	-13	-11	-4
Profit for the Period	**36**	**29**	**11**

The operations of Lannister, Stark and Targaryen are identical as can be seen by their EBITDAR (being EBITDA before Rent Expense). EBITDAR is expected to grow steadily into the future.

Each of the three businesses requires a one-hectare manufacturing facility ("the Property") to operate, but have chosen different ways in which to either finance or account for this Property. We can better see this in the summarised balance sheets below:

	Lannister	Stark	Targaryen
	R'm	R'm	R'm
Property	400	0	0
Plant & Equipment	100	100	100
Right of Use Asset	0	0	294
Deferred Tax	0	0	7
Net Working Capital	75	75	75
Mortgage Bond	-296	0	0
Lease Liability	0	0	-319
Cash	83	180	180
Net Asset Value	**362**	**355**	**337**
Share Capital	275	275	275
Retained Earnings	87	80	62
Equity	**362**	**355**	**337**

Lannister recently purchased its Property (for R400 million) and therefore owns it. 80% of the purchase price was financed by a mortgage bond that Lannister is gradually paying down. Lannister has decided to fair value its Property from time to time and therefore does not depreciate it.

In contrast, Stark chose to rather lease its Property for a period of 5 years. The lease payments are market-related and Stark will, in all likelihood, extend the lease for a further 5 years (therefore 10 years in total). The lease may also be cancelled at any time without Stark having to pay any penalties payments. Stark does not believe in IFRS 16, on the basis that it "distorts things".

Targaryen is identical to Stark except that it sees the benefits of IFRS 16. In calculating its Lease Liability (and hence the Right of Use Asset), Targaryen used a lease horizon of 10 years. The Deferred Tax asset is purely an accounting measure, arising from the fact that local tax authorities (currently) ignore the requirements of IFRS 16.

The fundamental aspects of the three businesses are otherwise identical. Plant & Equipment is machinery used in the Property and is replaced (Capital Expenditure) as it is depreciated. Net working capital is also the sum of Trade Receivables and Inventory less Trade Payables.

Let us now see what this means for Enterprise (Business) Value and Equity Value of each business.

To speed things along, we have prepared 5-year discounted cash flow ("DCF") valuations for each of the businesses. After Year 5, Lannister, Stark and Targaryen are each assumed to grow annually at a rate of 5% – the so-called "terminal growth rate".

Stark Valuation

As Stark is the most straightforward business, with its income statement reflecting actual cash flows, let us start with this DCF valuation:

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
	R'm	R'm	R'm	R'm	R'm	R'm	R'm
EBITDAR		100	110	120	130	140	147
Lease Payments		-40	-43	-47	-50	-54	-59
Net Working Capital		-8	-8	-8	-8	-8	-5
Capital Expenditure		-20	-20	-20	-20	-20	-20
Tax Paid		-11	-13	-14	-16	-18	-18
Free Cash Flow to Firm (FCFF)		**22**	**27**	**32**	**36**	**40**	**45**
Terminal Value (TV)							**285**
Discount Factor		0,829	0,686	0,569	0,471	0,390	0,390
PV of TV							111
PV of FCFF		18	18	18	17	16	
Enterprise Value	198						
Net Cash / (Net Debt)	180						
Equity Value	**379**						
Multiples							
EV-EBITDA	3,30						
Price-to-Earnings	12,93						
Price-to-Book	1,07						

A weighted average cost of capital ("WACC") of 20.7% has been used to discount the future cash flows.

We already know that there are no onerous clauses in Stark's lease agreement but, had these existed, we would have further reduced the Equity Value by such clauses.

This valuation is not completely without nuances, however. We have assumed that, after Year 5, Lease Payments will increase annually by 5% (i.e., the terminal growth rate). This is unlikely to be the case, however, considering that annual Lease Payment escalations are currently 8%. As such, there is possibly a slight element of over-valuation above.

Lannister Valuation

The DCF of Lannister is similar to Stark in many respects, with a few notable differences.

With its mortgage bond, Lannister has a large debt component in its capital structure. Costs of debt typically decrease the discount rate, and so, for Lannister, we have used a lower WACC of 15.9%.

	Year 0 R'm	Year 1 R'm	Year 2 R'm	Year 3 R'm	Year 4 R'm	Year 5 R'm	Terminal R'm
EBITDAR		100	110	120	130	140	147
Lease Payments		0	0	0	0	0	0
Net Working Capital		-8	-8	-8	-8	-8	-5
Capital Expenditure		-20	-20	-20	-20	-20	-20
Tax Paid		-22	-24	-27	-30	-32	-34
Free Cash Flow to Firm (FCFF)		**51**	**58**	**66**	**73**	**80**	**88**
Terminal Value (TV)							**802**
Discount Factor		0,863	0,744	0,642	0,554	0,478	0,478
PV of TV							383
PV of FCFF		44	43	42	40	38	
Enterprise Value	591						
Net Cash / (Net Debt)	-213						
Equity Value	**379**						
Multiples							
EV-EBITDA	5,91						
Price-to-Earnings	10,48						
Price-to-Book	1,04						

One key difference to the Stark valuation is the treatment of Lease Payments. As Lannister owns its Property, there is no need for it to make any Lease Payments. This leads to a much higher Enterprise Value (R591 million) which, of course, includes the Property Value of R400 million.

Another important difference is that, as a result of the Mortgage Bond, Lannister is in a Net Debt position (compared to Stark's Net Cash position).

We could have performed this DCF Valuation in a different way, had we hypothetically assumed that Lannister leases the property from itself. With Lease Payments now treated as a cash outflow in this instance, we would be in a remarkably similar position to the Stark valuation with a resulting Enterprise Value of around R200 million.

To get to the full value of Lannister, however, we would then need to add the Property Value (R400 million) to this lower Enterprise Value (R200 million), as a so-called Excess Asset. The resulting Equity Value would therefore be similar under either approach.

It is interesting to see that Lannister and Stark have an identical Equity Value of R379 million, despite each business having an entirely different method of financing its Property.

Targaryen Valuation

The DCF valuation for Targaryen is identical to that of Stark in all respects:

	Year 0 R'm	Year 1 R'm	Year 2 R'm	Year 3 R'm	Year 4 R'm	Year 5 R'm	Terminal R'm
EBITDAR		100	110	120	130	140	147
Lease Payments		-40	-43	-47	-50	-54	-59
Net Working Capital		-8	-8	-8	-8	-8	-5
Capital Expenditure		-20	-20	-20	-20	-20	-20
Tax Paid		-11	-13	-14	-16	-18	-18
Free Cash Flow to Firm (FCFF)		**22**	**27**	**32**	**36**	**40**	**45**
Terminal Value							**285**
Discount Factor		0,829	0,686	0,569	0,471	0,390	0,390
PV of TV							111
PV of FCFF		18	18	18	17	16	
Enterprise Value	198						
Net Cash / (Net Debt)	180						
Equity Value	**379**						
Multiples							
EV-EBITDA	1,98						
Price-to-Earnings	35,08						
Price-to-Book	1,12						

It would seem that the impact of IFRS 16, on the valuation, has been completely uneventful. This should not come as a surprise, however, if we consider the specific requirements of IFRS 16:

- Depreciation (of the Right of Use Asset) and Interest Expense (on the Lease Liability) are both non-cash items and have no impact on a DCF valuation;
- Local tax authorities do not recognise the requirements of IFRS 16 and so tax-related cash flows are not affected;
- The Lease Liability has no (adverse) value because Targaryen can cancel this lease at any time without any penalties; and

- The Right of Use Asset has no value in that the lease agreement does not grant Targaryen any unusual rights over and beyond what it is paying for; i.e. occupation of the Property for a certain period of time.

IFRS 16 ultimately seeks to improve the presentation and disclosure of financial statements in order to enhance comparability but does not, in any way, impact the cash flows (and hence valuation) of a business.

Even though the valuation is not affected by IFRS 16, the valuation multiples of Targaryen differ significantly to those of Stark. This is because IFRS 16 still has an impact on certain income statement and balance sheet measures (specifically the Net Asset Value, EBITDA and Profit for the Period).

Bringing it all together

Instead of looking at just the valuation multiples of Lannister, Stark and Targaryen, let us now expand the picture:

	Lannister	Stark	Targaryen
	R'm	R'm	R'm
Enterprise Value	591	198	198
Equity Value	379	379	379
EBITDA	100	60	100
Net Asset Value	362	355	337
Profit for the Period	36	29	11
EV-EBITDA	5,91	3,30	1,98
Price-to-Earnings	10,48	12,93	35,08
Price-to-Book	1,04	1,07	1,12

With each of Lannister, Stark and Targaryen having identical Equity Values of R379 million, we can now see the danger of relying solely on valuation multiples without fully understanding the underlying businesses.

In our example, investors appear to be indifferent between whether a business owns its property or leases it. Of course, depending on market timing and location, this may not always be the case.

Regardless, for businesses that leases their properties, IFRS 16 should not result in valuation differences. The additional presentation and disclosure details required by IFRS 16 should actually lead to improved valuations as more granular information on assumptions is made available.

So, then, how would we go about determining the Equity Value of Fiery Ice? Well, we would first need to understand how Fiery Ice finances its property assets – are these owned by Fiery Ice, or has Fiery Ice entered into a number of lease agreements? If the latter, our second question will be whether or not has Fiery Ice applied IFRS 16?

Armed with this vital information, and treading very carefully, we may then put on our valuation hats…