

WHAT'S THE DIFFERENCE?

CONNOR COLEMAN AND JOHANN KRUGER LOOK AT THE BALANCE SHEET AND HEDGING IMPLICATIONS OF OPERATING LEASES IN LIGHT OF PROPOSED CHANGES TO IFRS

Companies that have operating leases are obliged to make fixed payments for the use of an asset. As a result, operating leases can be considered as similar to fixed-rate debt.

The cash flow schedules for operating leases and fixed-rate finance leases are very similar, especially in relation to their interest rate assumptions. For example, ignoring any service or maintenance element, a £20m per annum cash payment on an operating lease will contain an interest and capital element paying down an amortising loan profile. The key difference from the perspective of the lessor, is that operating lease cash flow schedules typically assume larger residual values and replacement lease

contracts beyond the maturity of the original contract.

Recent proposed changes to IFRS accounting rules recognise this and may see operating leases reported similarly to finance leases on balance sheets from 2015. It will therefore become much more visible if a company's actual fixed vs floating mix (including operating leases) is inconsistent with its treasury policy. Companies with significant operating lease exposures, such as those with large retail units, are most at risk.

These companies may wish to swap some of their fixed operating lease payments to variable payments (linked to Libor) using an interest rate swap (IRS), where the company receives a fixed rate and

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pays three-month Libor + spread. This would allow them to increase the floating proportion of their liabilities. It will also produce immediate cash flow savings due to the yield curve currently being upward sloping. This can result in a cost of carry when floating rate borrowers swap to fixed. However, doing the opposite results in a carry benefit.

Illustration

Consider a hypothetical company (Company A) with a single long-term lease:

- ◆ £50m of senior debt at three-month Libor + 2.50%;
- ◆ £20m of senior debt has been converted into a fixed rate by entering into a swap at 2.35% + margin 2.50% (4.85% fixed coupon); and
- ◆ £20m annual operating lease obligation on a large retail unit for 10 years (£200m total).

Using Company A's cost of funds on their existing fixed debt, this lease could be interpreted as a 4.85% £156m amortising 10-year loan with fixed payments of £20m. (See Chart 1.)

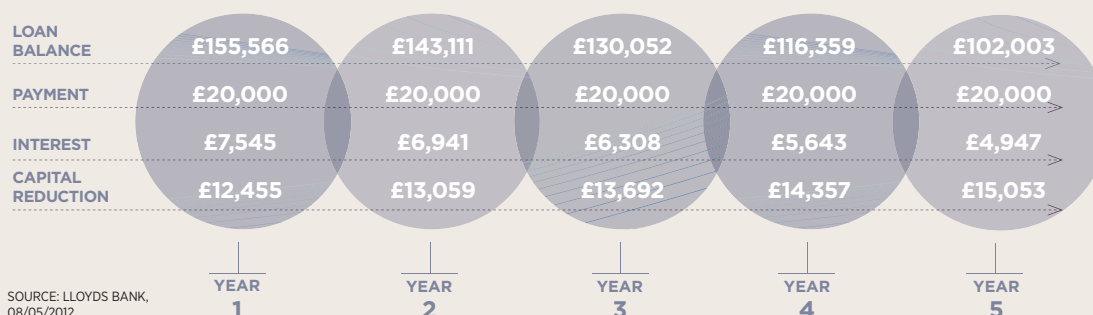
If Company A has a treasury policy targeting 40% fixed debt, they will be operating outside their policy by some distance. To restore their original 40% fixed proportion, 60% of their operating leases could be swapped to floating rate by converting £93.6m of the implied £156m loan from fixed to floating – potentially with an amortising profile.

The variable rate available on this IRS would be three-month Libor + 3.22%. Assuming three-month Libor at 1.01% this results in an initial interest coupon of £1.74m per quarter. Compared with the current interest cost of £1.89m, this produces a £150k quarterly saving (£600k per annum) on their lease payments for as long as three-month Libor remains at this level.

This allows Company A to benefit from short-term rates staying low, or falling even further. Should Libor increase in future periods, this benefit may reverse into a cost when compared to the underlying lease payments. If three-month Libor increases beyond 1.62% (4.85% – spread), the company will be paying more on their operating lease than the original cost (note that three-month Libor has not been at this level since April 2009 – refer to Chart 3). However, the target fixed-floating mix would take into account the degree of

CHART 1: CASH FLOW SCHEDULE (£000s)

This chart, from Company A's perspective, shows how this cash flow schedule looks very similar to that of a finance lease



SOURCE: LLOYDS BANK, 08/05/2012

*IFRS 9 IS THE REPLACEMENT STANDARD FOR IAS 39, FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

cyclicality of the company. An increase in interest rates would likely be accompanied by an economic recovery, which may well see simultaneous increases in company revenue, offsetting the additional interest cost.

As time passes, this swap notional will amortise. The two implications are: (1) the target fixed/float balance is maintained; and (2) since a progressively smaller proportion of the annual payments are related to interest, the later payments will increasingly be less variable.

This example is based on Company A operating with a single simple lease. In practice, most will likely have a portfolio of leases with a variety of maturities. They may want to convert these leases to floating rates with swaps on a one-for-one basis or construct a single portfolio swap, depending on the accounting treatment available.

Accounting implications

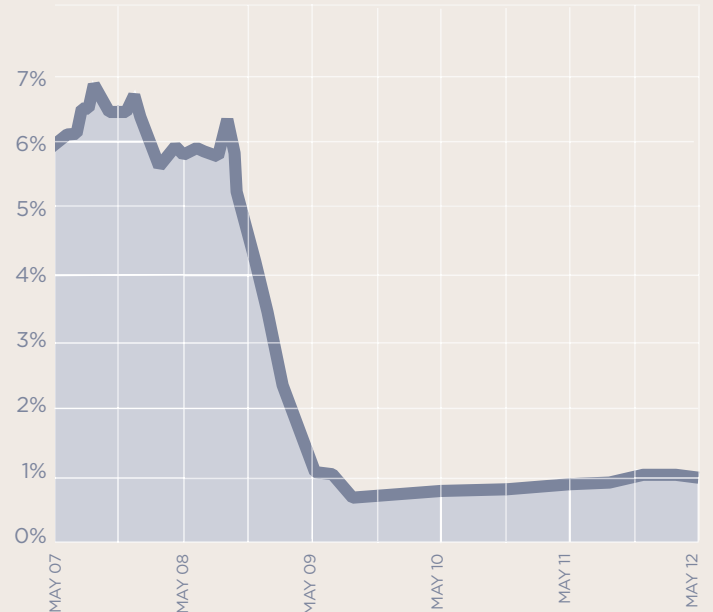
Operating lease liabilities are currently off-balance sheet and are considered 'non-financial items' under IAS 39, *Financial Instruments: Recognition and Measurement*. While hedging operating leases makes sense from an economic perspective, achieving hedge accounting for a non-financial item in practice can be challenging.

IAS 39 only allows designation of the full fair value of such items. Therefore, proving hedge effectiveness for a fixed to floating interest rate swap will require a regression analysis because of the asymmetry of risks – interest rate risk in derivative vs interest rate risk plus credit and non-performance risk in the underlying.

The tighter the definition of risks in the underlying, the more likely the hedge relationship will achieve hedge accounting. For example, if the auditors are happy to consider only interest rate risk and credit

CHART 3: GBP THREE-MONTH LIBOR

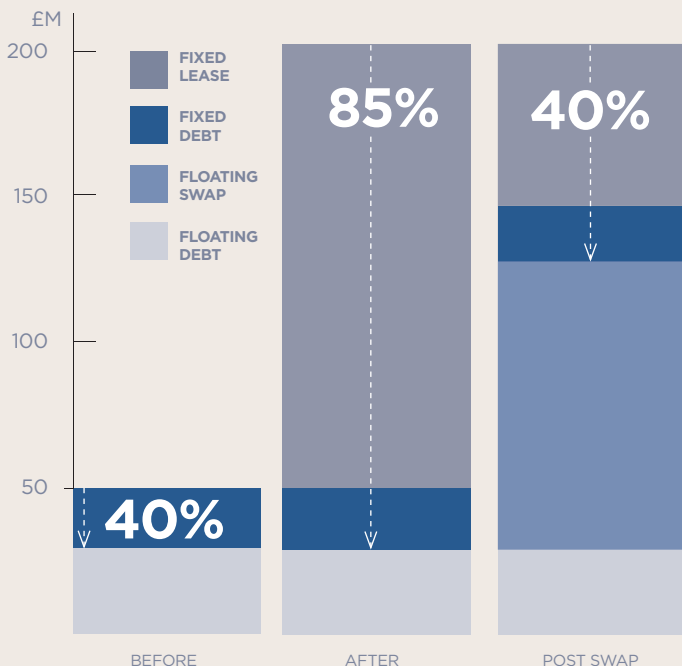
This chart shows the trend in the three-month Libor rate over the past five years



SOURCE: BLOOMBERG 28/05/2012

CHART 2: IMPACT OF CONSIDERING OPERATING LEASES AS DEBT

This chart shows that the fixed cost exposure more than doubles from 40% to 85% (amortising) if the operating lease is added to the debt



SOURCE: LLOYDS BANK 08/05/2012

risk, then a regression test may well support effectiveness even if their credit risk changes significantly during one or two periods (out of 30 data points).

Under current proposals for the new lease accounting standard and IFRS 9, *Financial Instruments** (both likely to be effective from 2015) operating leases will be on-balance sheet, and interest rate risk can specifically qualify for hedge accounting, thereby aligning the accounting with the economic hedge.

Conclusion

The interest rate risk profile of operating leases is very similar to fixed-rate amortising debt. However, current accounting rules do not recognise them as such. Therefore, many treasurers overlook them when considering their treasury policies in relation to fixed vs floating rate debt mix.

Proposed new accounting rules, likely coming into effect in 2015, will bring leases on-balance sheet and should solve the hedge accounting vs risk management mismatch.

It may be prudent to acknowledge the economic characteristics of operating leases in advance of the accounting changes and to start including them in calculations of fixed-rate debt, in which case treasurers should consider swapping these exposures to floating.

For more information on proposed changes to IFRS, visit www.lloydsbankwholesale.com/financialstrategies



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