ACT LEADING TREASURY PROFESSIONALS

Welcome to this ACT webinar

IFRS 16 - what treasurers need to know about leasing

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Introduction

Michelle Price

Associate Policy & Technical Director

ACT

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Agenda

Introduction

Michelle Price

Associate Policy & Technical Director, **ACT**

Presentations followed by panel discussion

Henry Wilson

Structured Finance Manager EMEA & Leases, **BP**

Matthew Stone

Head of Long Income, **M&G Real Estate**

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Presentation

Henry Wilson
Structured Finance Manager
EMEA & Leases
BP

IFRS 16 Impact

Henry Wilson 24 May 2017

IFRS 16 Overview

Summary

- Leases will all be treated like Finance (Capital) Leases
  - Lease Asset and Lease Liability reported on balance sheet
  - Lease rentals split into debt repayment and interest expense

Timing

- Effective for annual reporting periods beginning on or after 1 January 2019

Scope

- New and existing leases which run into 2019
- Lessees may elect to exclude leases which are
  - immaterial (< $5k) *or*
  - whose term is 12 months or less
- Lessor accounting substantially unchanged

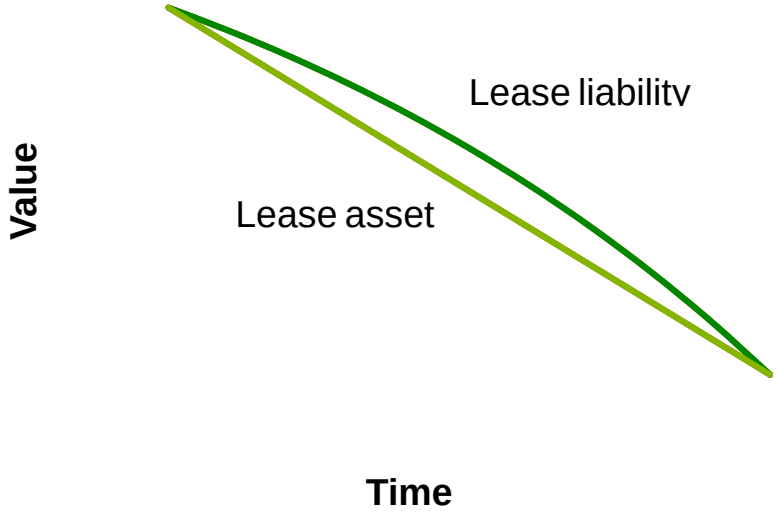
Balance Sheet

Lease Asset

- Lease asset evaluated as
  - PV of lease payments, discounted at
    - Interest rate implicit in the lease *or if that is not available*
    - Lessee's incremental borrowing rate
- Typically depreciated on a straight-line basis

Lease liability

- = Lease asset at start of lease
- Reduces on a declining balance basis: higher interest charge at start of lease



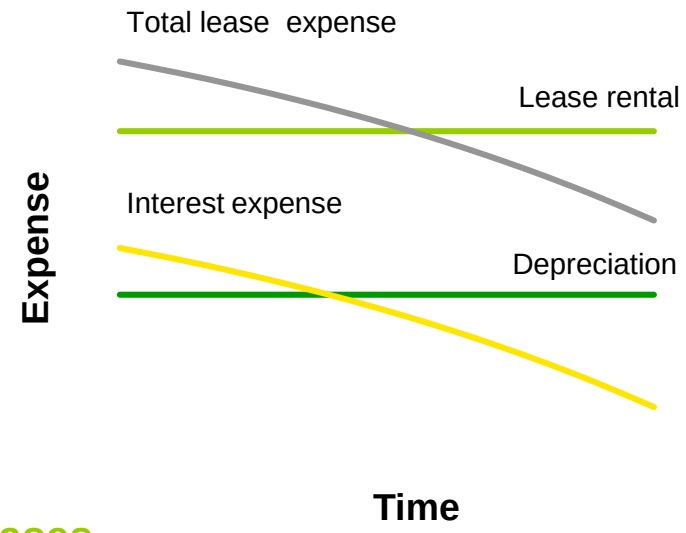
Net impact

- Reduction in equity

Profit & Loss

Components of lease expense

- Interest expense (higher at start of lease)
- Depreciation (typically straight line)
  - Lease expense will be higher at start of lease



Portfolio of leases

- For a portfolio of evenly-distributed leases
  - No IFRS 16 impact: lease expense = lease rental

Cash Flow

IAS 17

- Leases rentals reported under Operating Activities

IFRS 16

- Rentals split into
  - Interest paid (Operating Activities)
  - Debt repayment (Financing Activities)

Key Metrics

Metric	IAS17 (current)	IFRS 16 (from 2019)	Impact
Replacement Cost Operating Profit	Lease rentals	Depreciation	Increase
Operating Cash Flow	Lease rentals	Interest paid	Increase
EBITDA	Lease rentals	Nil	Increase
Funds From Operations (S&P)	Interest expense	Interest expense	Minimal
Fixed Assets	Nil	Lease asset	Increase
Financial Liabilities	Nil	Lease liability	Increase
Adjusted Debt (S&P)	PV commitments	Lease liability	Minimal
Equity			Decrease (slight)
Financial Liabilities			Increase
Gearing			Increase

Transition Rules

Date of initial application (DIA)

- DIA is the beginning of the first reporting period starting on or after 1 January 2019

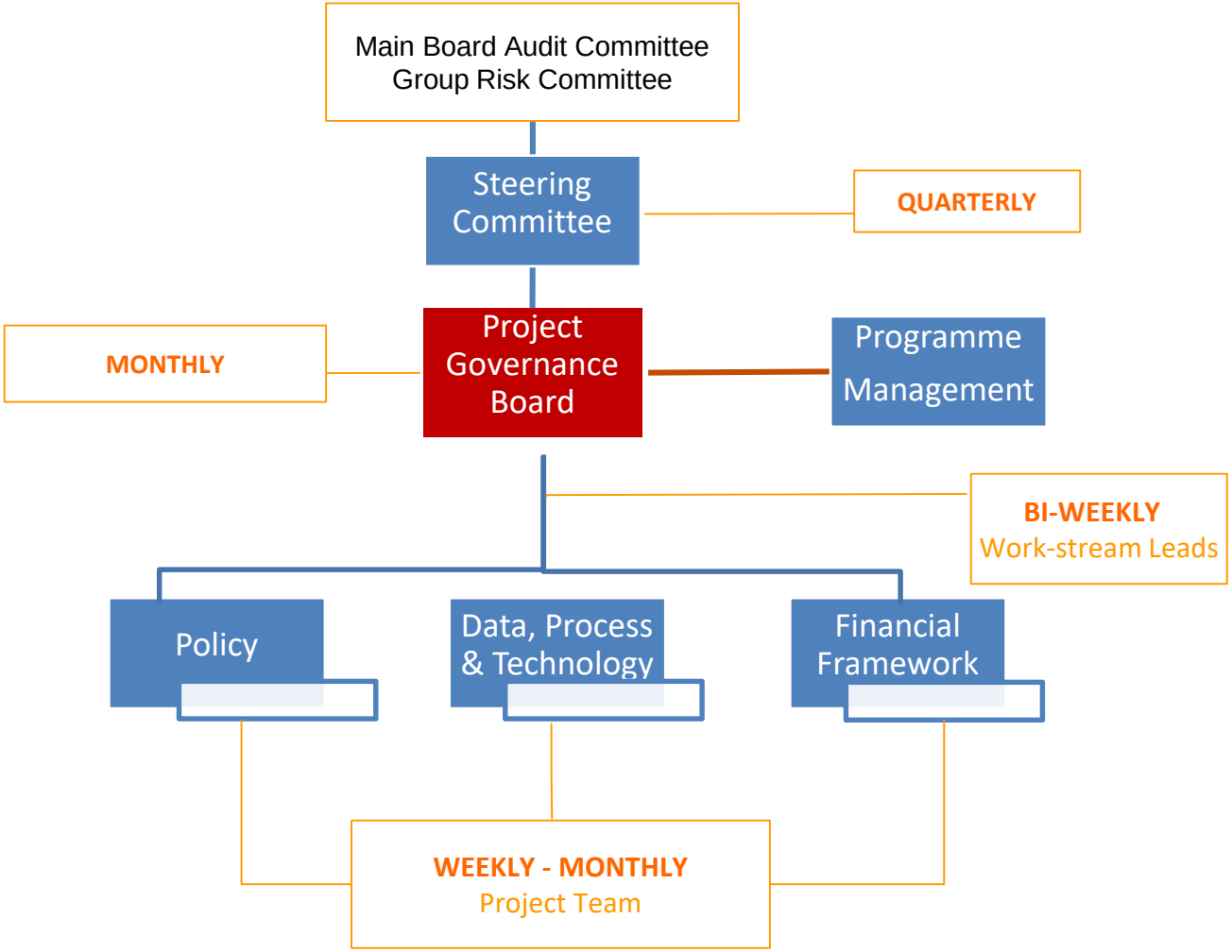
Full retrospective approach

- As if IFRS 16 had been in place in prior reporting periods

Modified retrospective approach

- Comparatives not re-stated
- Leases which end < 12 months of DIA may be excluded
- Lease liabilities = future payments (from DIA), discounted at the lessee's IBR
- Lease assets
  - at lessee's choice and on a lease-by-lease basis, either
    - lease liability or
    - as if IFRS 16 had been in effect from start of lease
      - discounted using lessee IBR

Implementation: Governance



Implementation: Timeline

1Q16	IFRS16 issued
3Q16	Project initiated
1Q17	Lease commitments reported quarterly
1H17	IT system selected
	Data collection: leases > $xm
	Accounting policy substantially complete
3Q17	Policy training plan (for delivery in 2018)
2Q18	System go-live
?Q18	Revise Financial Framework and Delegations of Authority
?Q18	Investor update
1Q19	IFRS 16 takes effect

Implementation: Treasury Support

- Discount Rate Models
  - Interest Rate Implicit in the lease
    - When Residual Value can be reliably estimated
    - Lease by lease basis
  - Incremental Borrowing Rate
    - For majority of leases
    - Cost of Debt for specific lessees
    - Assumptions updated regularly
- Lease Resource
  - Set planning limits
- Company Metrics
  - Investors and Rating Agencies

Governance: Current

Project Proposals

- Leases which run through 2019 create fixed assets (capital investment)

Calculation of IFRS 16 Lease Asset and Liability (modified retrospective approach)							
$m		**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Lease start / end			1-Apr-17				30-Jun-21
Lease rentals		0.0	8.2	11.0	11.0	11.0	5.4
Discount factor (IBR)	5%				0.976	0.929	0.896
PV Rentals = Lease Asset and Liability at 1.1.19				**25.8**	10.7	10.2	4.9

- *From 1.1.19, under new accounting standard IFRS 16, the lease will be reported on balance sheet. The value of the lease asset and liability, which will depend on the accounting methodology adopted and on borrowing rates, is currently estimated at $xm*

Governance: Post 1.1.19

- Recalibrate financial framework / revise board delegations
  - Gross Debt, Net Debt, Gearing Ratio
- Adjusted Debt
  - More precise measurement of liabilities
- Planning
  - Lease resource
    - Period-end Right of Use Assets?
    - Treasury input

Business Drivers

- Pre-IFRS 16
  - Off balance sheet: operating lease (*not* finance leases)
    - Limited term leases with evidence of residual value transfer
- Post-IFRS 16
  - 'Finance' leases now acceptable (not cash capex)?
    - Financing at company's cost of debt

But leases impact Fixed Assets and Debt:

- Post-IFRS 16: lease commitments managed through Planning process

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Presentation

Matthew Stone

Head of Long Income

M&G Real Estate

Part of the M&G Group

The Changes to Lease Accounting

Webinar with ACT

24 May 2017

M&G REAL ESTATE

Agenda

- What are the key changes to property leases?
- What will be the impact to occupiers?
- What is M&G viewpoint?
- Questions

Property Leases - changes to lease accounting

What are the changes – a material impact on occupier accounts?

$3.3tn
Lease commitments (future payments) in listed companies

1 in 2
Almost half of listed companies using IFRS or US GAAP will be affected by the changes

Most property leases will come on-balance sheet for lessees, prompting recognition of a right-of-use asset and a liability for the lease component.

Straight line operating lease expenses will be replaced with depreciation and front-loaded interest.

85%
of those commitments are currently “off balance sheet”

66x Debt
Analysis of some retailers that have gone into liquidation: value of off B/S leases is almost 66 x value of on B/S debt.

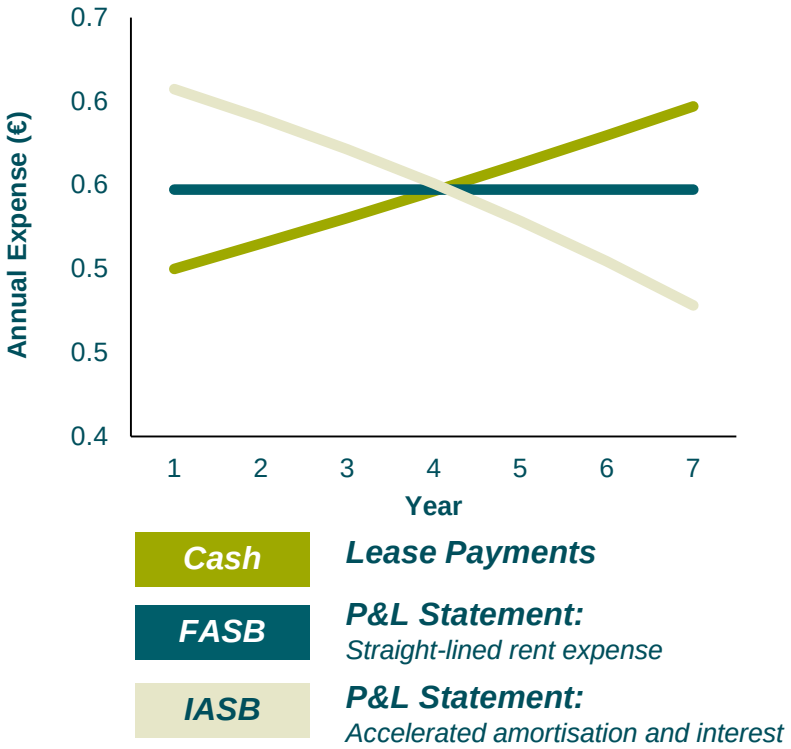
M&G REAL ESTATE

Impact to Occupiers

The focus is likely to be on the P&L

- Under IASB
  - Depending on the method of adoption an additional charge could be created in the P&L
  - The longer the lease the higher the day one P&L charge assuming no change to rent
  - The graph opposite illustrates the increased charge in the P&L between cash and the new P&L payment (IASB line)
  - Occupiers are likely to be sensitive to this increased cost as it will have a direct impact on overall profitability
- Under US GAAP
  - P&L accounting will not change and will largely follow cash flow

P&L Impact – Day 1



** The above graph represents a 7 year office space lease. The annual base rent is €500,000 annually with fixed uplifts at 3% per annum.*

Impact to Occupiers

What is the market predicting?

- Increased focused from **finance** and **treasury** over leasing decisions as buy vs lease policies are re-calibrated.
- The market generally expects occupiers to resist the need to enter in to long term leasing controls and predicts a **shorter lease terms**.
- A reduction in **sale and leaseback** activity given the removal of the accounting arbitrage*
- Increased transparency is likely to place increased pressure on affordability and may accelerate **rightsizing** and exit from **surplus space**.
- Some have gone on to predict **falls in real estate values** as occupiers push for greater flexibility in leasing creating uncertainty on cash flows and pressure on values.

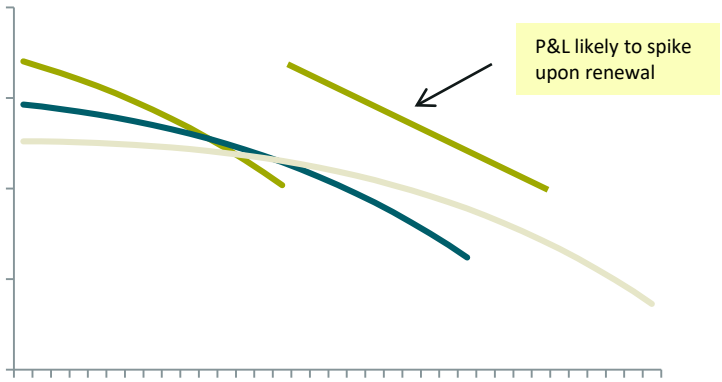
Mitigating the Impact to Occupiers

A long lease does not necessarily mean the P&L is worse off…

15 year with renewal
25 year
35 year

- Despite the changes to lease accounting a longer lease may not mean an adverse impact in the P&L
- A flexible approach to pricing means an occupier can optimise the rent in order to mitigate or even neutralise the day 1 P&L impact under the new lease accounting regulations.
- The graph opposite illustrates the P&L impact post adoption of IFRS16 between a 15, 25 and 35 year lease. In the 25 and 35 term scenarios, the rent has been reduced to deliver the same day 1 capital sum.
- The reduced rent has the impact of neutralising the P&L impact which would otherwise be felt if the rent remained unchanged, providing both an **economic and accounting benefit** to the occupier.

Income Statement Impact



Example IFRS: *Accelerated amortisation and interest*

Assumptions	15 year	25 year	35 year
NIY	6.50%	5.00%	4.00%
Day 1 Rent	6.5	5.0	4.0
Proceeds	100	100	100
Annual Inflation	2.25%	2.25%	2.25%
Term	15	25	35
Day 1 Saving	0%	23%	38%
IBR	3.5%	3.5%	3.5%

Full P&L profiles available in appendices.

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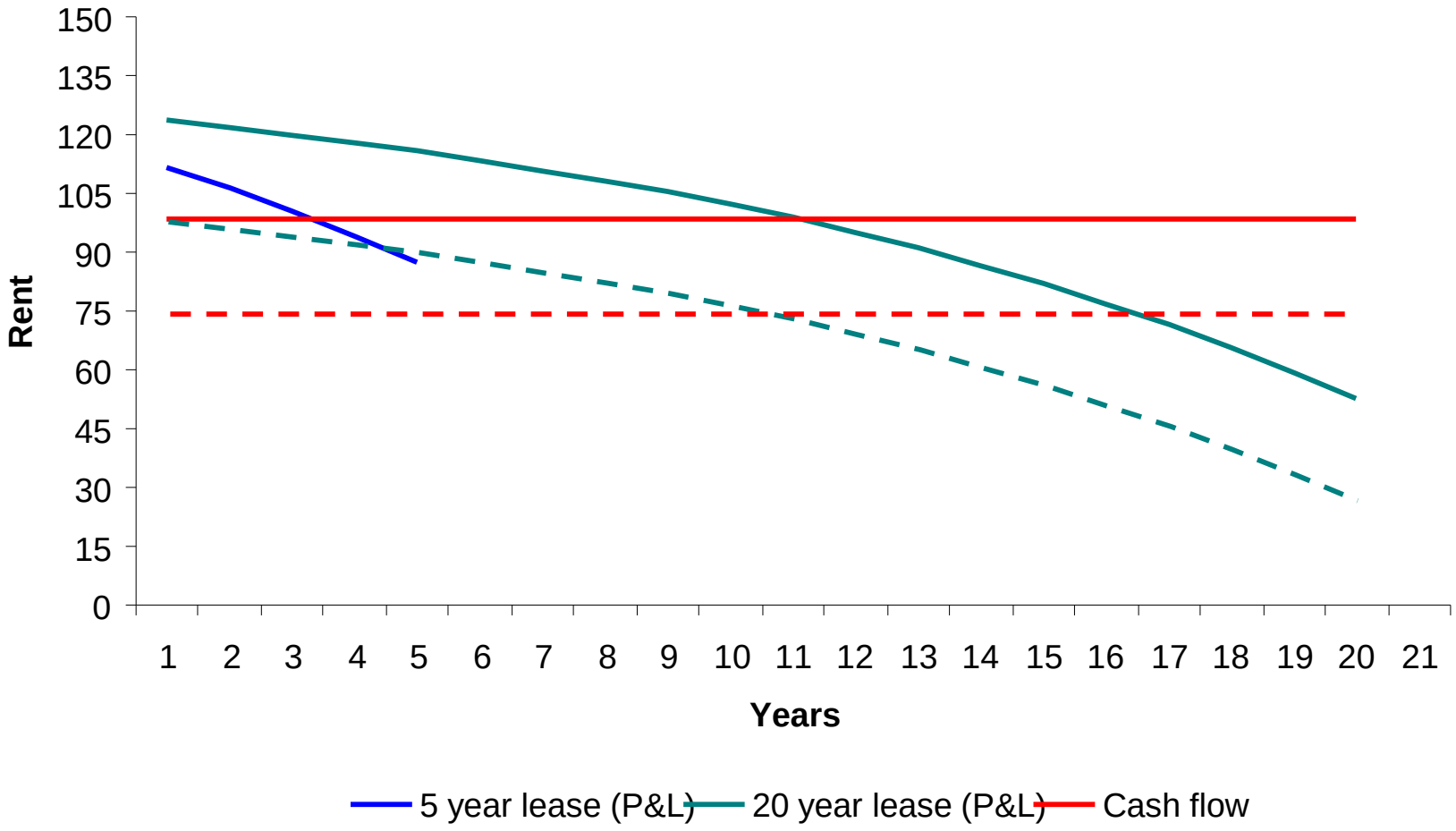
IFRS 16 – Cashflow and P&L – rent as a function of lease length?



M&G Viewpoint

How do we think the market might change?

- As everything is now on balance sheet the own vs lease decision should now be predominantly about the economics rather than accounting
- If leasing is the better economic funding option then all the tests that would have previously caused finance lease treatment are now academic. For example property leases of the future can now have buy back options for £1 etc
- Property leasing should now become much more sophisticated with rental level as a function of lease length and credit rating. Premium rents for short flexible leases and heavily discounted rents (up to 50%) for long leases to investment grade occupiers

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Panel discussion

Chair

Michelle Price

Associate Policy & Technical Director, **ACT**

The panel

Henry Wilson

Structured Finance Manager EMEA & Leases, **BP**

Matthew Stone

Head of Long Income, **M&G Real Estate**

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Chair’s closing remarks

Michelle Price

Associate Policy & Technical Director

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CONNECTING MINDS

FORTHCOMING EVENTS

In Codes we trust:
the new financial markets codes of practice
13 June 2017 | London, UK

Asia Treasury Leaders' Forum
27 September 2017 | Hong Kong

ACT Treasury Forum
8 November 2017 | London

ACT Annual Dinner
8 November 2017 | London

ACT Middle East Annual Summit
21-22 November 2017 | Dubai

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Thank you for listening

If you have any questions, please contact us at:

events@treasurers.org