Capitalization of Operating Leases by Credit Rating Agencies

Different agencies use different methods.

Six years ago I co-authored an article for this Financial Watch column on credit rating agencies and operating leases. What's changed in that time to warrant revisiting the topic? Since 2000, operating leases have been put under a microscope due to concerns about corporate off balance sheet obligations. In July 2006, FASB and IASB adopted a joint project on lease accounting, largely due to events stemming from the outcry over Enron. In the past two years, each of the major U.S.-based credit rating agencies—Standard & Poor's Ratings Services (S&P), Moody's Investors Service and Fitch Ratings—have updated their methodology for adjusting financial measurements for operating leases.

Today, as in 2000, the credit rating agencies capitalize operating lease obligations due to a fundamental belief that leasing is simply a form of financing that has a claim on future cash flows of a company. The distinction between capital leases and operating leases is considered an artificial one by the rating agencies based on an arbitrary bright line (the "90 percent" or "7d" test). The agencies' objective is to make companies' financial ratios and measures more representative of their ability to meet their obligations and comparable to one another, regardless of how many assets are leased and how those leases are classified. The refinements in methodology released by the agencies since publication of the previous article, while not groundbreaking, reflect more current thinking about measurement, in some part due to the external environment, as well as a desire in some cases to make adjustments simpler and more transparent to users.

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Rating agencies perform an important role in global capital markets by providing independent ratings on a consistent basis based on in-depth financial analysis. For companies wishing to raise debt, in particular, credit ratings are a critical ingredient that facilitates access to the market, improving pricing and liquidity. Investors and creditors value the independent role of the rating agencies and the analytical perspective they offer on industries and issuers.

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The rating agencies have long practiced adjusting financials. In fact, it is integral to the rating process and part of the value that the agencies provide. Financial statements are not treated as "gospel," that is, as the only depiction of the economic reality of a company's financial position and performance. Financial analysis usually begins with analytical adjustments that enable more meaningful peer group and period-over-period comparison, better reflect underlying economics, better reflect creditors' risks, rights and benefits and facilitate more robust financial forecasts. Although the rating agencies regularly adjust reported information under applicable local accounting principles (GAAP), it does not imply that they challenge the application of GAAP by the reporting entity or the adequacy of its financing reporting or audit, nor the appropriateness of GAAP in fairly depicting the company's financial position. Analysts use financial information to evaluate companies from multiple perspectives, quantitatively and qualitatively, and use adjustments as an analytical technique to consider an entity's financial condition for a different purpose or from another vantage point.

Lease Adjustments

Adjusting for lease obligations is important for rating agencies in considering the overall capitalization of a company and the claim that rent payments have on future cash flows. Lease adjustments seek to enhance comparability of reported results, both operating and financial, and financial obligations. The adjustment model is intended to make companies' financial ratios better reflect underlying economics and more comparable to one another by taking into consideration all financial obligations incurred, whether on or off balance sheet. The model helps improve analysis of how profitably a company employs both its leased and owned assets. The rating agencies also consider the appropriateness of using lease financing while recognizing that leasing has such positive attributes as flexibility, tax advantages and lower effective cost.

Each agency seeks to reconstruct a financial profile of a company that capitalizes off-balance sheet lease commitments. The starting point for all agencies is the disclosure of future minimum lease obligations in notes to financial statements. Five years of minimum lease commitments

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are required under U.S. GAAP and International Financial Reporting Standards (IFRS) along with a sum of obligations for all years thereafter. In addition to revising capitalization, minimum lease payments are reallocated to interest and depreciation expense and the income statement is refashioned accordingly. Similarly, cash flow statements and capital spending are revised. The new profile is then used to calculate key financial indicators such as debt to capitalization, interest coverage, debt to cash flow (or EBITDA), operating margins and return on capital. While the amount of capitalized leases is usually less than the cost of the related property, the adjustments recognize that control of physical property is an economic asset of an enterprise.

Standard & Poor's—Present Value Method

S&P adjusts leverage and capitalization measures to include lease-related obligations using a revised methodology published in March 2005. S&P capitalizes operating leases as addition to property, plant and equipment assets and corresponding debt by calculating the present value of reported minimum lease commitments in notes to financial statements. The objective of the present value method is to capture the discounted value of future payment obligations, not to recognize the whole asset associated with the lease as if the asset were owned by the reporting entity.

S&P's objective in the revision to its methodology is to more accurately calculate the present value of future lease obligations. Prior to the March 2005 revision, S&P used a 10 percent rate to discount lease obligations across the board. S&P believes the 10 percent rate likely resulted in lower capitalization of leases in the current lower interest rate environment. Commencing in March 2005, the discount rate is based on an estimate of an issuer's actual borrowing costs and will naturally respond to changes in borrowing cost with each year of analysis. Currently, S&P calculates the average interest rate from a company's most recent annual statements as a proxy for its cost of funds. Payments to be discounted are the total reported lease

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The agencies acknowledge limits of their models. The adjustments are not designed to exactly replicate a company's acquisition of an asset and corresponding debt financing.

commitments for five years plus the "thereafter" value, which is divided by the fifth-year minimum payment value to determine the number of years remaining under the leases to discount. Occasionally, better information on interest factors inherent in actual leases may be available, or the average cost of funds is judged unrepresentative and an alternative discount rate is chosen. The resulting present-value figure is added to reported debt to calculate certain debt-based financial ratios (e.g., total debt-to-capital ratio). The figure is also added to assets to account for the right to use leased property over the lease term. Although U.S. GAAP and IFRS require disclosure of future lease commitments, the data may not be available under other GAAP. In these cases, S&P uses a multiple of the last annual rental expense to approximate the obligation.

In order to calculate additional financial performance measures, further adjustments are required. A company's operating expense is reduced by the average of minimum lease payments in the current and previous years. Interest expense is calculated by applying the discount rate to the average net present value of current and previous years minimum lease commitments and added to reported interest expense. Effective depreciation expense is calculated by subtracting implicit interest expense from the operating expense adjustment and added to reported depreciation expense. With these calculations, there is no change in reported net income, simply adjustments to operating income and interest expense. In addition, capital spending measures are adjusted to reflect the approximation of the "capital expenditure" value inherent in the capitalization model by adding the sum of the calculated effective depreciation and the year-to-year change on the imputed debt to capital spending.

Moody's—Factor Method

Moody's released new methodology in February 2006 that represents a change in philosophy as well as a desire to make lease adjustments simpler and more transparent to its users and easier to achieve its stated goal of comparability. Prior to February 2006, Moody's employed a "modified" present value method to develop a proxy for the contractual value of future lease obligations. Under the new methodology, Moody's uses a multiple of current rent expense to capitalize operating lease obligations. The change in approach is intended to simulate the purchase of the whole asset not just capture the present value of contractual obligations. In theory, the multiple is designed to recognize the full economic life of the asset (not just the lease term). Moody's position is that the asset or some replacement thereof is needed by the enterprise to sustain cash flow on a continuing basis. The application of a multiple helps to look through situations where a company leases long-lived assets for very short terms (with either replacement leases or renewal options).

The rent expense multiple utilized is based on the industry sector in which a company participates and reflects the characteristics of the specific sector and the type and mix

of assets typically leased in the industry. However, to keep calculations simple and transparent for users of Moody's analysis, multiples are limited to 5X, 6X and 8X rent expense and assigned to individual sectors. Industries such as airlines, shipping and public utilities have the highest multiple reflecting the long economic life of assets employed. In no event will operating leases be capitalized at less than the present value of future lease payments discounted by the issuer's long-term borrowing rate.

Further adjustments to a company's balance sheet, income statement and cash flow statement are made to reflect the capitalized lease obligations. Rent expense is reallocated on the income statement in a simple fashion—one-third to interest expense and two-thirds to depreciation expense. Cash flow is adjusted by reclassifying the principal portion of lease payments from operating cash flow to financing cash flow and capital expenditures is increased in investing cash flows and concomitant borrowing in financing cash flows.

Fitch—Hybrid Model

Fitch released updated lease capitalization methodology in December 2006 allowing for either the factor method or present value. Previously, Fitch applied a simple 8X multiple of current rent. The new adjustments are based on either an 8X multiple or, if sufficient information is available about the terms of operating leases, then the present value method using the lessee's cost of capital. Neither method need be rigidly applied. Fitch's approach allows for discretion amongst analysts to select the approach, the multiple and discount rate and other components based on individual fact patterns. The flexibility allowed by Fitch seeks to extract the best advantages of the present value and multiple approaches but may create issues in drawing comparisons between industry peers.

Example of Capitalization

The box provides an illustration of capitalization of operating leases using the methods prescribed by S&P and Moody's for AMR Corp., parent company of American Airlines. This example neatly displays the conceptual differences between the S&P and Moody's methodologies. AMR leases aircraft and airport facilities. The capitalized lease obligations in 2005 equated to roughly 58 percent and 76 percent of on-balance-sheet debt of the overall enterprise as calculated by S&P and Moody's, respectively. This difference in overall debt is driven by S&P's goal to capture only the contractual obligation as opposed to Moody's attempt to capture the whole asset.

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AMR Corp.
Calculation of Capitalized Lease Obligation *(in millions)*

	2005	2004	2003
Total Reported Debt	$13,607	$13,095	$12,504
Total Interest (inc. capitalized interest)	$892	$791	
Implied Interest Rate	6.7 percent	6.2 percent	
Actual Rent Expense	$1,300	$1,300	$1,400
Future Minimum Lease Commitments			
2005	–	$1,092	
2006	$1,065	$1,022	
2007	$1,039	$996	
2008	$973	$938	
2009	$872	$840	
2010	$815	–	
Thereafter	$7,453	$7,534	
Total Lease Obligations	**$12,217**	**$12,422**	
S&P - Present Value of Lease Commitments	$ 7,871	$ 8,328	
Moody's - Rent Expense Multiple @ 8X	$ 10,400	$ 10,400	
Total Reported Debt and Capitalized Leases			
Standard & Poor's	$ 21,478	$ 21,423	
Moody's	$ 24,007	$ 23,495	

Note: Calculations were performed by the author and do not represent actual values used by S&P and Moody's.

Limitations

Moody's and S&P readily acknowledge limits of their models. The adjustments are not designed to exactly replicate a company's acquisition of an asset and corresponding debt financing. The models simply attempt to capture a debt equivalent of existing lease contracts in place (S&P) or the economic value of assets (Moody's). In general, it is believed that calculated lease-equivalent debt is still understated. One factor is that adjustments only recognize rent associated with the primary lease term of an asset and not its full productive life. Moody's use of a multiple applied to current rent expense is more likely to overcome the lack of information regarding lease term. S&P's methodology is more apt to result in a wider range of outcomes in adjustments for similar assets based on individual companies' strategies on length of lease commitments. Both rating agency approaches overlook differences in provisions between short-term and long-term leases, the corresponding impact on rental costs and the qualitative and economic impact on operating flexibility in the business resulting from varying corporate strategies about the use of leases.

Leases differ significantly in structure and in features such as purchase options, renewal options, contingent rent and responsibility for executory costs, all frequently undisclosed, which make like comparisons virtually impossible. Contingent rent plays no role in adjustment even though it may be probable and common in certain sectors such as retail. Leases of real estate are frequently on a full rental basis and operating expenses are not necessarily broken out separately. Finally, there are many lease-like off-balance-sheet arrangements that are not factored into the lease adjustments, although some may be subject to different types of adjustments by the agencies (e.g., power purchase contracts). Many service and supply arrangements avoid capitalization even though accounting rules have changed to recognize certain types of contractual arrangements.

New Accounting Standard and Credit Ratings

A new standard for lease accounting is generally supported by the rating agencies but it is not anticipated to eliminate the need for adjustments regardless of the outcome. The rating agencies generally believe that lease accounting is not congruent with other standards. Since rating agencies have traditionally considered the impact of operating leases in their analysis, a new approach to lease accounting is not expected to result in material changes in issuers' credit ratings barring external influences such as increased pressure on covenant compliance or an actual violation of covenants. In addition, banks and other lenders typically capitalize lease obligations in a manner similar to rating agencies. Depending on the protocol of a new lease accounting standard, rating agencies may continue to make certain types of adjustments for lease obligations. In general, the agencies support international convergence of accounting standards so that financial analysis can be managed more consistently between reporting regimes.

FASB and the IASB work on lease accounting is expected to eliminate the distinction between operating and capital leases and capitalize most leases. While financial reporting and financial analysis are distinct disciplines, the rating agency view of the importance of lease obligations is valuable food for thought for the standard setters.

ELT thanks Mindy Berman, Managing Director, Corporate Finance, Jones Lang LaSalle, for this month's column.