Operating Leases: Implications for Lessees' Credit

Special Report

Overview and Conclusions

Operating leases are widely used by businesses to gain control of assets, such as real estate or equipment, for a fixed duration less than the full economic life of the asset. For a corporate lessee, an operating lease may be an alternative to owning the asset or contracting a capital lease (also called a finance lease).

In order to compare the financial condition of companies that fund assets with different mixes of debt, capital leases and operating leases, India Ratings adjusts the financial ratios of corporate lessees (e.g., nonfinancial corporations, such as retailers, manufacturers, telecommunication companies and utilities) to capitalise operating lease liabilities as debt-like obligations.

India Ratings' analysis of corporate credit with regard to operating leases:

- Reflects India Ratings' treatment of operating leases as debt-like obligations when determining the financial leverage of lessees;
- Is generally not applied to banks, finance companies or lessors; and
- Would include contract or tolling agreements that convey the use of an asset in exchange for fixed periodic payments, although they are not characterised as leases if they are, in India Ratings' judgment, reasonably similar to operating leases.

Valuing Operating Leases for Going Concerns

India Ratings analysts use two methods to value the off-balance-sheet liability equivalent on a going-concern basis. The first method applies a multiple to the most recent year's or the latest-12-months' (LTM) actual rental expense. The second method calculates the present value of reported non-cancellable future rental expense, an approach that requires more detailed information about the terms of operating leases than the first method. The results of these two approaches may vary considerably, and neither is intrinsically superior. When sufficient information is available, the rating committees consider the input from both sources. However, some companies' financial disclosure provides insufficient information to estimate the present value of lease obligations, and in these cases only the first approach is used.

When a company has material operating lease obligations, India Ratings published corporate credit analyses frequently refer to the adjusted financial ratios incorporating operating leases. The most commonly adjusted ratios are those that measure financial leverage or gearing and the coverage of interest expense and fixed charges. Whenever such lease-adjusted ratios are used, the basis of calculating the lease adjustments is explained.

Valuing Operating Leases

Two valuation methods currently used at India Ratings are explained in this report: applying a multiple to the past year's lease rental expense, and calculating the present value of future lease rental commitments.

Method 1: Applying a Multiple to Lease Rental Expense

The first method values the lease obligation and related asset by applying a multiple to the most recent year's or LTM's actual lease rental expense. This approach requires the least amount of information. In addition, this method not only takes into consideration the minimum legal obligation for the formal terms of the leases, but also roughly approximates the assumed renewals or replacements of existing leases by applying a multiple of the most recent period rental expense, including contingent as well as minimum base rent. This method is most useful when comparing companies in the same industry but with different proportions of owned and leased facilities.

The methods used to capitalise lessees' operating lease obligations in going concerns are applying a multiple times the rental expense in the most recent year and calculating the present value of future rental payments.

India Ratings analysts currently apply a multiple of 7 times (x) total rental expense for issuers. While the multiple may be revised to reflect gross changes in market interest rates or average lease terms, such changes are rare. When the leased assets have a short economic life (e.g., a car or small equipment) applying the standard multiple, which is relevant for long-life assets such as property, would overstate the lease-debt equivalent. In such cases, India Ratings may decide to use a lower multiple or, in certain cases, exclude it from the analysis.

For long-life assets, analysts are not obliged to stick to a rigid 7x multiple when the economics dictate a different multiplier. India Ratings may vary the multiplier where there is a strong expectation that a higher or lower multiple is more appropriate for an individual issuer, or market sector. The choice of the multiple used, if it deviates from the conventional multiple, is noted in India Ratings' research on each issuer.

For example, when companies have shorter duration lease portfolios and ongoing business activities that require an extension or replacement of the existing leases, the use of a multiple of 7x rentals incorporates the presumption of lease renewals, because the present value of committed future lease payments only until the expiration of the lease may tend to understate the value of the lease plus expected renewals. On the other hand, when a lessee has leases of short duration and is unlikely to renew them due to changes in business activity level or business plan, a multiple of 7x rent overstates the lease commitments and does not adequately address the flexibility that the company gained from using leases with short expirations. In this case, a lower multiple would be appropriate and the reasons for choosing that multiple would be explained in the company's Credit Report.

Implementing Method 1

Generally, companies' financial statements or notes to financial statements contain sufficient information to apply this method, which requires only the most recent year's total lease rental expense. For some companies, even the amount of actual rental expense is not disclosed, and rental expense cannot be distinguished from aggregate operating expenses. Where such cases exist, India Ratings analysts ask management for additional information about operating lease expenses.

Lease-Adjusted Debt

The analyst values the debt-equivalent component of an operating lease, including possible renewals by applying a multiple (in most cases, 7x) times a single year's lease rental. It should be noted that the rental figure used for the calculation is usually the actual gross lease expense, including any variable or contingent component, not the minimum required rental expense under the lease. However, in rare cases, the contingent or variable rent varies directly with profit, and in those cases, only fixed rental payments should be capitalised. Gross rents are not reduced by sublease income since the original lessee remains liable for the lease when

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(September 2012)

the property is sublet.

Figure 1
Comparing Valuation Methods 1 and 2
Each method has advantages and drawbacks, which are weighted by Fitch Ratings' analysts as part of the financial ratio adjustment process. There is rarely a "right" answer, but the adjustment process serves to help clarify areas of greater and lesser concern.

	Advantages	Drawbacks
Method 1 (Multiple)	Easy to apply and highly comparable across issuers with varying levels of disclosure.	Inclusion of contingent rental payments in reported financials may inflate debt equivalence when using reported historical rent expense to capitalise operating leases.
	Approximates the effect of reasonably expected renewals of leases upon their expiry.	Ignores flexibility provided to lessee by ability to terminate leases at expiry.
Method 2 (Present Value)	More accurately identifies the debt equivalence of existing fixed, noncancelable obligations.	Raw data is unavailable in most cases.
	More comparable with capitalised finance leases.	Requires some subjective assumptions on lease maturity profile after five years, even for those companies with the best current disclosure.
		Understates operating lease liability for companies effectively obliged to renew leases to maintain stable operations.

Source: Fitch

Lease-Adjusted Leverage Ratios

Rental payments are added back to EBITDA to form EBITDAR. The total lease-adjusted debt is then divided by EBITDAR to calculate lease-adjusted debt to EBITDAR. Similarly, total lease-adjusted debt plus preferred stock is divided by funds from operations (FFO) plus rental expense and preferred dividends to calculate FFO lease-adjusted leverage

Lease-Adjusted Coverage Ratios

The total lease rental expense is added to interest expense and the related coverage ratio is calculated as EBITDAR/(interest plus rent). Similarly, rental expense and preferred dividends are added to interest expense and the FFO fixed-charge coverage ratio is calculated as (FFO plus interest, rents and preferred dividends)/(interest, rents and preferred dividends).

Method 2: Calculating the Present Value of Future Lease Rentals

Method 2 looks to the legal obligation under existing leases and capitalises the present value of required rental payments over the remaining duration of the current lease agreements. This approach is used when the credit issue is the amount of the legally committed lease obligations and there is adequate information about future rental payment requirements under existing leases. There is not currently adequate information for analysts to carry out Method 2 for all companies.

In many cases, the lessee has a large and varied lease portfolio, and the information about projected annual lease rentals is only provided in the aggregate. Consequently, the discount rate applied represents the lessee’s cost of capital for the year in question. If more detailed information is available, it may be possible to calculate present value using as a discount rate the lessee’s cost of capital in the year the lease was initiated, which is a more precise approach. The present value declines annually as the lease term continues, but the discount factor used is always that at the initiation of the lease. This is consistent with maintaining the stated principal value of fixed-rate debt despite changes over time in the market interest rate or the issuer’s credit spread.

Implementing Method 2

Companies that India Ratings rates will sometimes provide more detailed projections of committed lease rental payments for all years.

If India Ratings has no information beyond the next five years' payments and the aggregate payments for all subsequent years, analysts generally are able to calculate a present value by assuming that all subsequent years' payments occur in year six or, alternately, by dividing the aggregate remaining payments by the rental expense in year five to determine the approximate duration.

Information provided may report total rents, including contingent rentals (payments dependent on revenue, etc.), rather than the minimum required lease payments that should be capitalised. In the absence of explicit disclosure, analysts can gauge the relative importance of contingent rents by comparing total rental expense for a single year relative to prior year's disclosure of the disclosed minimum required payments for that year.

Comparable information to calculate Method 2 is not available for all companies, and India Ratings's analysts apply judgment to determine whether sufficient information is available to apply this method appropriately.

Lease-Adjusted Debt

The imputed lease principal is the present value of committed minimum lease payments, ideally at the lessee's estimated marginal cost of debt at the initiation of the lease. However, with current disclosure, it is not feasible to capture the discount rate at the time the lease was entered for each lease in a large and diversified lease portfolio. In general, analysts within a sector establish for each year a single discount rate characteristic of companies in their sector or a current discount rate applicable to companies of the same rating category and apply that discount rate to calculate the present value of lease rentals.

Lease-Adjusted Leverage and Coverage Ratios

These ratios will differ between Methods 1 and 2 because the present value calculation of Method 2 produces a different lease-adjusted debt number than the rent multiple of Method 1. The calculations of these ratios are identical for Methods 1 and 2 except for the differences in the lease-adjusted debt value. We can make no systematic statements about which method produces higher or lower leverage, given the variability of discount rates among companies and analysts' flexibility to apply a multiple other than 7x if appropriate. In addition, given these differences, analysts would not normally compare companies where lease-adjusted ratios are calculated using different methods.

When there is sufficient information to utilise Method 2, the analyst also has the option to calculate additional coverage ratios that more purely reflect lease-adjusted interest coverage. These lease-adjusted interest coverage ratios are computed as follows.

EBITDAR[a]/(Interest + Imputed Lease Interest)
(FFO + Interest + Rent[a])/(Interest + Imputed Lease Interest)
[a]Rent includes both principal and interest portions of rent.

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