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Leases part II: European stocks

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Accounting Lifeguard is a new research product that navigates the murky waters of tax and accounting. Written in plain English, it is the one accounting report a generalist equity investor needs to ensure they understand the impact on stocks.

This report applies our model for estimating the impact of the new lease accounting rules to European stocks. It follows from last month's report which profiled American companies. We believe that when the new rules take force in 2019, the actual cost of borrowing may change for some companies. That is because lenders should be given additional clarity into the true extent of a company's liabilities. Where these are materially different to expectations, borrowing costs may rise or fall.

We also look at how rising European interest rates over the next five years may affect the rate used to discount lease liabilities. Differences arise due to the duration and expiry profile of each company's lease portfolio. We find 26 stocks that may have an obligation that is ten per cent lower than it is today, including: Sainsbury, Vestas, Diageo and Iberdrola.

This analysis of European stocks goes one step further than our last publication and also examines falling and fallen angels - companies that have a credit rating close to the investment grade/high yield barrier. We examine 42 angel stocks and particularly those that have large lease portfolios as a proportion of their market value. These include: Tesco, ArcelorMittal, Telefonica, Heidelberg, Kering, Casino and Saint Gobain.

Our new model estimates the leverage impact of lease accounting rules

The new lease accounting rules which come into force in 18 months will trip up many investors even if they are prepared for the change. That is because companies currently do not disclose the information needed to calculate the increase in their liabilities when operating leases are brought onto the balance sheet. Many investors currently estimate this number using a 'rule of eight' whereby the current year's lease expense is multipled by eight (or another rule-of-thumb number). The new lease accounting rules, however will likely result in very different figures as companies will be required to discount their leases at an appropriate rate.

The exact discount rate to use is difficult to determine. Accounting authorities have indicated they will be happy with an appropriate marginal cost of borrowing, however, this itself allows a wide range of possible outcomes. Our new model makes an estimate based on the variable pre-tax cost of borrowing, admittedly, with a margin for error.

Using this method, we find a substantial gap between the lease obligations calculated using the 'Rule of eight' and the discount method. In fact, this discounted method shows that the median company in the Stoxx 600 (for which data is available) has an operating lease value almost half that of the figure calculated under the 'Rule of eight'. This is a similar result to our previous calculations for stocks in the S&P 500 and also aligns with a 2013 publication by the CFA Institute.

Real world impact

Here are four reasons why the change will have a real impact on companies.

First the good news. Negotiating a lease may become easier as currently, some companies are willing to accept more onerous terms from a lessor in order to sign a lease that can be legally defined as 'operating' and thus kept off-balance sheet. Without this need anymore, those onerous terms will vanish.

The bad news, though, is that the actual cost of borrowing for many firms is likely to rise. This is something even regulators themselves have admitted. The reason is that creditors will have clarity on the full extent of a company's liabilities.

For some, they may be lower than expect. Others, however, may throw up a negative surprise of higher liabilities. As companies renew existing debt facilities with their lenders, the newly-disclosed liabilities will almost certainly factor into the discussion.

Whether or not actual interest expense rises, the reported expense in the P&L will rise for European firms. This is because the inherent interest amount in each lease payment will be split out separately. American firms, however, will have relief from this rule and will disclose their operating lease payments without splitting this out. In addition, the additional interest charges should be front-loaded in keeping with the usual split of principal and interest under a loan repayment schedule. This means European companies with many new leases will report a higher interest expense than otherwise identical companies with identical leases that have a nearer expiry date.

Finally, there is the flow on effects on loan covenants and closely-followed operating metrics. Take, for example, a company with a 20-year lease on a building. Assume an annual lease payment to its landlord equivalent to about one-tenth of revenues, a return on assets of ten per cent and a net debt to ebitda ratio of 3.5. Under the new rules, when it brings the lease onto the balance sheet, its return on assets will fall two-thirds, interest cover will halve and net debt to ebitda will double.

Unexpectedly higher liabilities

Investors could be wrong-footed if they assume all companies will have a discounted lease profile that is lower than that calculated using the 'Rule of Eight'. Using our model, we identified 20 stocks in the Stoxx 600 for which their discounted lease liability may be higher than the previously-estimated 'Rule of Eight' amount. It is important to note that this analysis is less meaningful for some companies and industries. For example, real estate firms typically have very long lease periods and some airlines aggregate regional affiliates, however, they are included here for completeness and as a base to examine how leverage changes as interest rates rise.

Figure 1: Some companies may have a higher lease liability than expected

Proportion by which the discounted lease liability using the discount method exceeds the amount using the 'Rule of Eight'

Ocado Group	215%	Admiral Group	40%
Greene King	119%	Whitbread	33%
Vonovia	95%	Tesco	33%
Associated British Foods	95%	Saga	21%
J Sainsbury	89%	Royal Vopak	17%
United Utilities Group	86%	Telefonica	13%
Taylor Wimpey	64%	Kingspan Group	8%
Marks and Spencer Group	45%	Shire	8%
Tate & Lyle	41%	Gamesa Corporacion Tecnologica	6%
Just Eat	40%	GlaxoSmithKline	2%

Source: Bloomberg Finance L.P., Factset, Deutsche Bank

Effect as the discount rate changes

The impact of lease accounting is more complex than merely determining whether a company might have a higher or lower lease liability . That is because a key part of the new accounting rules is that the discount rate is set when the lease is first recognised. So, if the discount rate is based on the marginal cost of borrowing then as interest rates change, the amount of the lease liability will also change as new leases are added. This has the potential to cause confusion between companies that renew otherwise similar leases at different time intervals to their peers.

Take, for example, two retail companies that lease their stores on identical ten-year leases. The only difference is the first renewed its lease in 2007 when base interest rates were five per cent. The second renewed its lease in 2010 when rates were almost zero. The first will report a lease liability one-quarter lower than the second. In turn, this lower liability could cause other creditors to offer more favourable terms for future borrowings to the company. Various other tangible effects are also possible as previously discussed.

The European economics team at Deutsche Bank currently forecasts euro area rates to remain constant until the end of 2018 and after that to rise half a percentage point each year. Given this trajectory, we look at how companies might be affected. To do this, we take their current lease expiry schedule and assume that, on average, this will be maintained in the future as the various leases are renewed on a rolling basis. If we assume that a company's borrowing cost rises or falls directly with the ECB rate, we can estimate each company's future cost of debt by adding the increase in the ECB's rate to the current cost of debt.

Using these expectations, we find that in four year's time, there will be 26 companies with a lease liability over ten per cent lower than the level calculated using the discount method now.

Figure 2: Companies with a materially lower than expected future lease liability

Companies expected to have a lease liability in five year's time that is ten per cent lower than today

United Utilities Group	-65%	Ashtead Group	-16%
DNB	-58%	Pennon Group	-14%
Legal & General Group	-55%	DONG Energy	-14%
Greene King	-25%	Tesco	-13%
Ocado Group	-23%	Tate & Lyle	-13%
J Sainsbury	-20%	InterContinental Hotels Group	-12%
Associated British Foods	-19%	Endesa	-11%
Marks and Spencer Group	-18%	Vestas Wind Systems	-11%
Admiral Group	-18%	Jcdecaux	-11%
Auto Trader Group	-17%	Banco de Sabadell	-10%
Whitbread	-17%	Diageo	-10%
Royal Vopak	-17%	Mediclinic International	-10%
Iberdrola	-16%	Scor	-10%

Source: Bloomberg Finance L.P., Factset, Deutsche Bank

Comparison with current 'Rule of Eight' metrics

Just as important as knowing the companies for which rising interest rates will help, is those it may hurt. Of the companies that have a current discounted lease liability greater than their 'Rule of Eight' liability, many can expected to see that discounted liability fall if interest rates rise as expected. However, as interest rates rise, thereby discounting future lease payments more heavily, it will somewhat offset the increase in liability.

These effects can also be estimated over time. Our model shows that in one year, 20 companies will have a discounted lease liability greater than their current 'Rule of Eight' liability. This number falls over time to 17 companies in five years.

Figure 3: The 'Rule of Eight' method does not always produce a greater lease liability

Companies for which the discounted lease aggregate is greater than the 'Rule of Eight' for each future year

Name	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
GlaxoSmithKline	2%				
Gamesa Corporacion Tecnologica	6%	5%	4%	3%	2%
Shire	8%	6%	4%	2%	0%
Kingspan Group	8%	6%	4%	2%	0%
Telefonica	13%	11%	9%	7%	5%
Royal Vopak	17%	11%	6%	2%	
Saga	21%	19%	17%	14%	12%
Tesco	33%	28%	24%	20%	16%
Whitbread	33%	27%	21%	16%	11%
Admiral Group	40%	33%	26%	20%	15%
Just Eat	40%	37%	35%	32%	29%
Tate & Lyle	41%	37%	32%	28%	24%
Marks and Spencer Group	45%	38%	31%	25%	19%
Taylor Wimpey	64%	62%	60%	58%	56%
United Utilities Group	86%	37%	3%		
J Sainsbury	89%	78%	68%	59%	50%
Associated British Foods	95%	84%	74%	65%	57%
Vonovia	95%	95%	94%	94%	94%
Greene King	119%	103%	89%	76%	65%
Ocado Group	215%	194%	175%	157%	141%

Source: Bloomberg Finance L.P., Factset, Deutsche Bank

Unexpected changes in leverage

We can now estimate how companies' leverage could change over time under two scenarios. First, we take a firm's existing non-current liabilities, add the discounted lease payments (excluding the portion due in the next 12 months) and compare with the company's equity. Then, we do the same thing but substitute the expected liability estimated using the 'Rule of Eight'.

We find that a majority of companies should have a better debt/equity ratio in four years' time under the discounted method compared with 'Rule of Eight' method. For some companies, the change is material. In fact, 41 firms will have a debt/ equity ratio more than 20 per cent better in five years' time than investors may currently estimate under the 'Rule of Eight'. Meanwhile, 13 firms will see their ratio deteriorate by over ten per cent.

When we examine this effect using our discounted calculations projected five years out compared with the discounted estimations today, we find that most companies see their future debt/equity ratio improve or remain unchanged. However, 18 stocks will experience a positive change of five per cent or more. None will have a worse ratio given the anchoring effect of the discount rate in the model.

Figure 4: Movements in debt/equity ratios over five years

Proportional decrease in debt/equity ratio (D/E in five years time on a discounted basis compared with current D/E grossed up for Rule of Eight' lease liabilities)	
Distribuidora Internacional de Alimentacion	70%
SSP Group	55%
Christian Dior	51%
ISS	45%
Viscofan	43%
Teleperformance	43%
Daily Mail and General Trust	42%
DSV	40%
Akzo Nobel	39%
Casino, Guichard-Perrachon	39%
Intertek Group	36%
William Demant Holding	35%
Spectris	35%
Sodexo	34%
Jcdecaux	33%
Valeo	33%
Compagnie de Saint-Gobain	32%
Metro	31%
London Stock Exchange Group	31%
Dixons Carphone	30%
Cellnex Telecom	30%
Deutsche Lufthansa	30%
DCC	29%
Novozymes	28%
Kering	28%
CRH	24%
Bunzl	24%
Aggreko	23%
Compass Group	23%
Babcock International Group	21%
RSA Insurance Group	21%
ArcelorMittal	21%
UCB	20%
QinetiQ Group	-10%
Tesco	-10%
Marks and Spencer Group	-12%
Greene King	-15%
Coloplast	-15%
Indivior	-36%
J Sainsbury	-39%
Vivendi	-54%
Novo Nordisk	-56%
ASML Holding	-58%
Associated British Foods	-59%
Ocado Group	-59%

Proportional decrease in debt/equity ratio (D/E in five years time on a discounted basis compared with current D/E grossed up for lease liabilities calculated on a discounted basis)	
Associated British Foods	19%
J Sainsbury	17%
Ocado Group	16%
London Stock Exchange Group	14%
Marks and Spencer Group	13%
Whitbread	13%
Hays	13%
Greene King	10%
Tesco	9%
International Consolidated Airlines Group	7%
Dixons Carphone	7%
Metro	6%
SSP Group	5%
Tate & Lyle	5%
DONG Energy	5%
Royal Vopak	5%

Source: Bloomberg Finance L.P., Factset, Deutsche Bank

Falling and fallen angels

Credit investors may find the most tangible impact on companies from changes to the new lease accounting rules concerns falling or fallen angels. These are stocks whose credit rating is close to the border between investment grade and high-yield. As the market is structured to take a binary view of stocks on either side of this line, investment opportunities if a stock's credit rating moves. For a stock with a large lease portfolio, this is possible if the new rules give a clarity to its obligations that was previously unavailable. In turn, investment grade or high-yield funds will be forced to buy or sell the stocks. We have operating lease data for 46 companies with a market value greater than €5bn and a credit rating in the region of BBB to BB.

Figure 5: Potential falling or fallen angels

Stocks with a credit rating close to the investment grade/high-yield barrier

Name	Credit rating	Mkt cap (local m)	Leases as % of mkt cap	Change in D/E compared with 'Rule of Eight'
Distribuidora Internacional de Alimentacion	BBB-	3,410	7%	70%
ISS	BBB	52,358	7%	45%
Teleperformance	BBB-	6,078	10%	43%
Daily Mail and General Trust	BBB-	2,404	6%	42%
Casino, Guichard-Perrachon	BB+	6,184	41%	39%
Jcdecaux	BBB	6,985	7%	33%
Valeo	BBB	15,592	2%	33%
Compagnie de Saint-Gobain	BBB	27,523	11%	32%
Metro	BBB-	9,821	81%	31%
Cellnex Telecom	BB+	3,700	8%	30%
Deutsche Lufthansa	BBB-	7,801	29%	30%
Kering	BBB	32,725	11%	28%
Babcock International Group	BBB	4,616	11%	21%
ArcelorMittal	BB	22,653	5%	21%
Weir Group	BBB-	4,532	4%	18%
William Hill	BB+	2,592	16%	18%
Veolia Environnement	BBB	9,856	17%	18%
Fiat Chrysler Automobiles	BB	14,814	9%	17%
Ashtead Group	BB	8,222	3%	17%
SKF	BBB-	78,112	5%	15%
DS Smith	BBB-	4,166	2%	15%
Leonardo	BB+	8,429	2%	13%
HeidelbergCement	BBB-	17,342	7%	12%
Royal KPN	BBB-	11,957	7%	8%
ITV	BBB-	8,840	4%	7%
Grifols	BB	10,404	3%	7%
Amadeus IT Group	BBB	21,125	1%	6%
Anglo American	BB+	15,774	1%	5%
UBM	BBB-	2,878	3%	3%
Barclays	BBB	37,935	8%	3%
Imperial Brands	BBB	36,594	1%	2%
Endesa	BBB	23,250	1%	1%
Intermediate Capital Group	BBB-	2,258	1%	1%
Severn Trent	BBB-	5,487	0%	0%
Eutelsat Communications	BBB	4,983	1%	0%
Banco de Sabadell	BB+	9,963	4%	0%
Shire	BBB-	41,964	2%	0%
Saga	BB+	2,339	0%	-1%
Telefonica	BBB	52,973	20%	-1%
Tate & Lyle	BBB	3,569	8%	-8%
Tesco	BB+	14,527	90%	-10%

Source: Bloomberg Finance L.P., Factset, Deutsche Bank

Appendix 1

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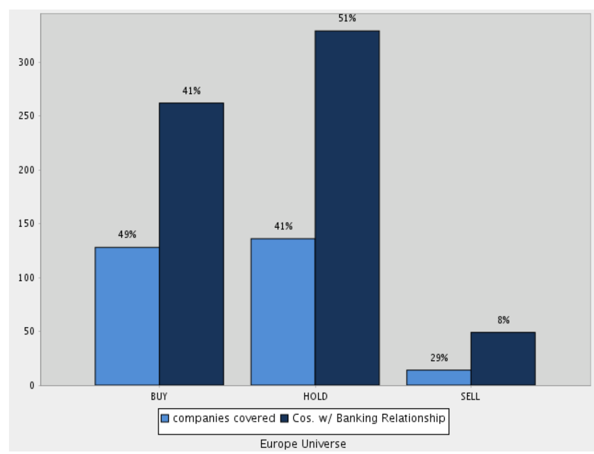

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