

A View from the Rating Agency

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S & P Global Ratings

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S&P Global Ratings Leases

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Agenda

Introduction

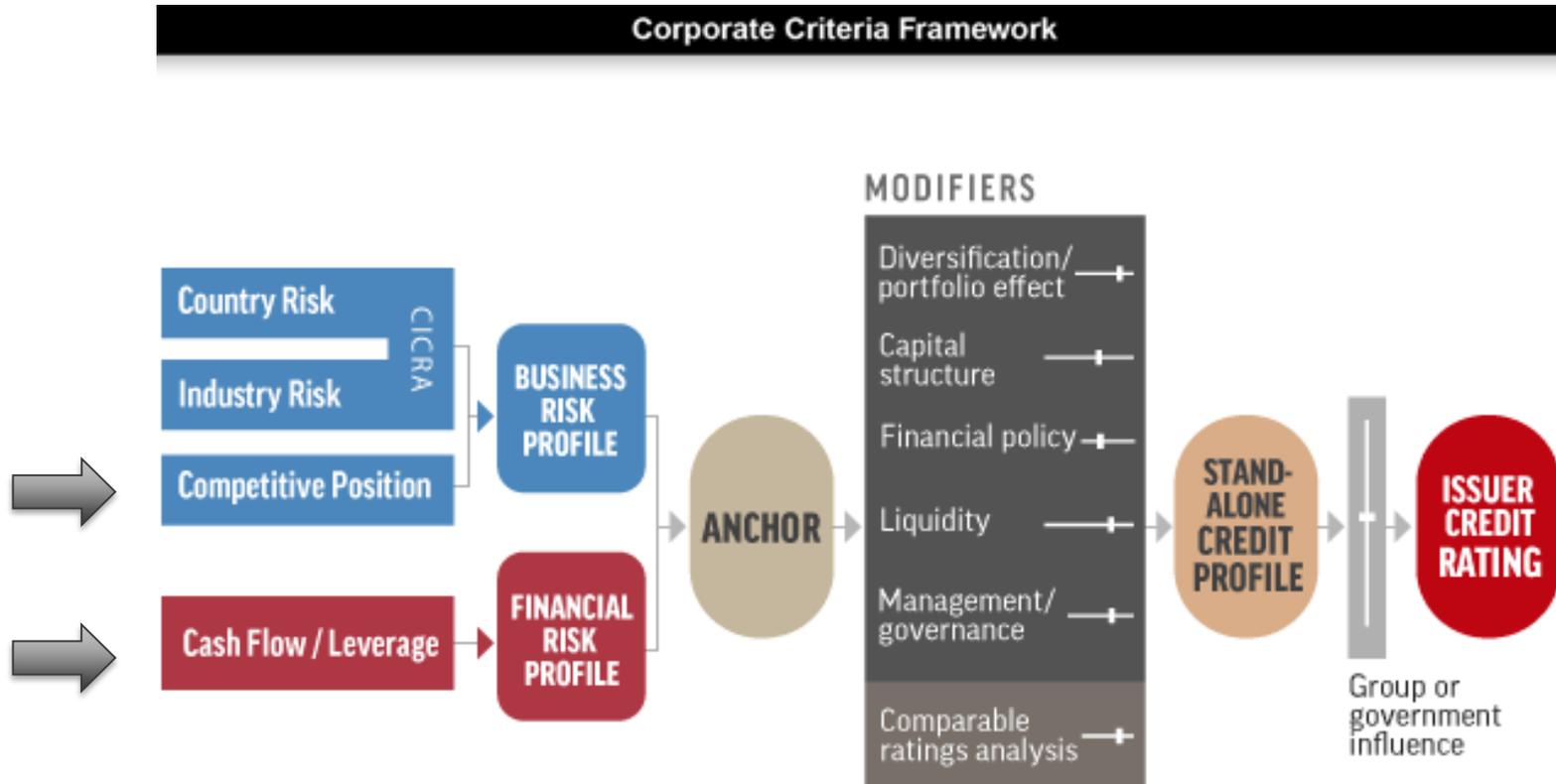
Leases – Current methodology

Leases – Proposed methodology

Rating impact

Introduction

Role of financial reporting in corporate ratings



Source: Criteria | Corporates | General: Corporate Methodology, November 19, 2013

S&P Global
Ratings

Introduction

Analytical adjustments

- Better align financial data with **our view of underlying economics** of specific transactions and continuing operations.
- Improve **global comparability** between companies, industries and geographies.
- Adjust the consolidation approach to better reflect our opinion of an entity's business, economic and financial ties to other members of the group.

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

Introduction

Debt principle

In general, items that we add to reported debt include:

- Incurred liabilities that provide no future offsetting operating benefit (such as unfunded postretirement employee benefits and asset retirement obligations);
- **On- and off-balance-sheet commitments for the purchase or use of long-life assets** (such as lease obligations) or businesses (such as deferred purchase consideration) where the benefits of ownership are accruing to the company; and
- Amounts relating to certain instances when a company accelerates the monetization of assets in lieu of borrowing (such as through securitization, sale, or factoring of accounts receivable).

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

Leases

Current methodology

- We view the **accounting distinction** of finance and operating lease as **substantially artificial**. Therefore we capitalize operating leases to achieve comparability.
- Our starting point is the minimum lease payment disclosure as provided in the reported financial statements. We use a fixed 7% discount rate to calculate a net present value.

CY, million	Y1	Y2-Y5	Y5<	NPV @ 7%
Reported	110	118	60	195

Source: Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments November 19, 2013

Leases

Current methodology

However, if we view the term of the lease as ‘artificially short’ relative to the length of expected use of the leased assets, we may make further adjustments to reflect a more economically appropriate depiction of the lease obligation.

‘We view Company A’s operating leases as artificially short, relative to the length of expected use of the leased assets and, hence, make an analytical adjustment to reflect a more economically appropriate depiction of the lease obligation on a going concern basis. Still, we view Company A’s operating flexibility as a result of its long-term operating leases with short notice exit options as a positive to the overall financial risk profile.’ [Retail]

CY, million	Y1	Y2-Y5	Y5<	NPV @ 7%
Reported	110	118	60	195
S&P incremental		236		
S&P adjusted	110	354	60	443



Leases

Proposed methodology

- The accounting treatment under IFRS 16 is largely in line with our current view, with a more accurate calculation using precise discount rates and exact lease payment profiles.
- Therefore, **we generally accept** the reported balance sheet, income statement and cash flow (*note, that we always view interest paid as operating cash flow*) reporting.
- However, we will have **to retain analytical adjustments** to
 - US GAAP reporters,
 - those who do not capitalize all leases,
 - and where we believe the lease leverage is not appropriately reflected in the reported metrics.

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

Leases

Proposed methodology

IFRS 16

- Accept Balance Sheet, Income Statement and Cash Flow treatment

US GAAP ASC 842

- Accept Balance Sheet treatment
- Adjust Income Statement and Cash Flow measures to eliminate distinction between finance and operating leases

No lease capitalization

- Continue with current methodology
- Adjust all relevant measures

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

Leases

Proposed methodology

Credit metrics, cash flow leverage impact:

- **Known**
 - Discount rate (7% vs. company specific)
 - Future cash flows
- **Unknown**
 - Definition of lease (scope)
 - Optional exemptions (small value assets and short leases)
 - Structuring opportunities (lease vs. service)

Leases

Proposed methodology

- In certain circumstances we may adjust the reported lease liability to better reflect the **lease leverage**. Our expectation is that, in most cases, the liability should be at least 3 times the next 12 month's lease commitments. The 3 times multiple is not a hard measure, the rating committee applies **analytical judgment**.
- In rare cases, we also adjust lease liabilities (such as when companies characterize lease contracts as service contracts) because we believe the reported amounts do not adequately capture the transaction's **underlying economics**.

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

Leases

Proposed methodology

Practical issues

- Staggered implementation
- Comparative information

Rating impact

- Our opinion of a company's **underlying creditworthiness** will generally **not change** because
 - accounting does not affect the fundamental strengths and weaknesses of a company's business.
 - underlying cash flows will not change.
- Most **ratios will be impacted** by lease accounting changes and some components of the rating may change.
- However, to the extent that we identify **new information** that we consider to be relevant to our opinion of a company's underlying creditworthiness, it will be incorporated in our analysis.

Source: Criteria | Corporates | Request for Comment: Ratios And Adjustments January 3, 2019

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