

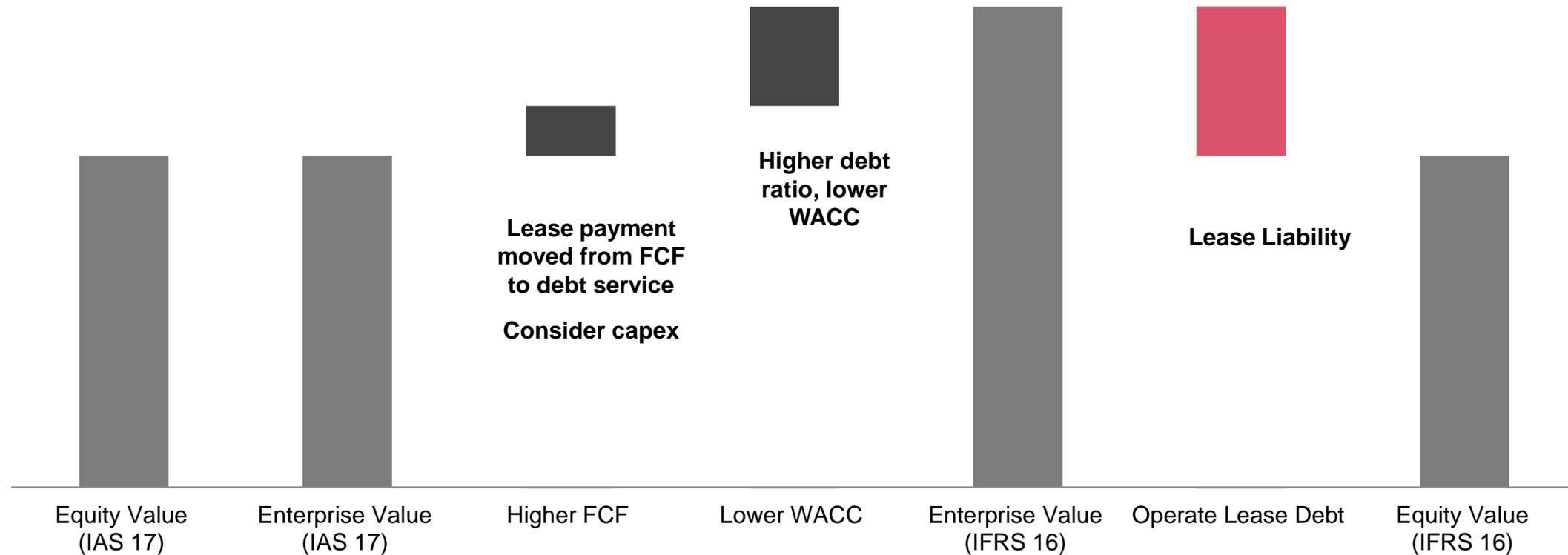
IFRS 16 & impairment tests (IAS 36)

March 2019



Equity value should not change as a result of transition to IFRS 16

Illustrative IAS 17 to IFRS 16 Equity Value Bridge



...but because of IFRS 16, the metrics will change and therefore careful consideration is needed to ensure equity value doesn't change

Valuation analysis

IFRS 16 will impact key valuation inputs:

- Earnings metrics...EBITDA, EBIT
- Forecasts / free cash flows
- Net debt

Multiples

Care should be taken to **ensure consistent treatment** in estimation of valuation multiples during the transition period and beyond

Discount rate

Potential for **numerous impacts to discount rate build up** components:

- Capital structure – spot D/E may not align to historical
- Beta impact
- Cost of debt

Transition

Inconsistent data sets between historical / actuals and forecasts have to be aligned which will be especially challenging in the transition period

Net Debt

S

EV

S

EBITDA

S

EBIT

S

Gearing

S

EV/EBITDA

s/t

EV/EBIT

s/t

Agenda

- 1 Transition to IFRS 16 and impairment test considerations
- 2 Simplified case study
- 3 Impact of IFRS 16 on the discount rate (WACC)
- 4 Summary
- 5 Questions & discussion



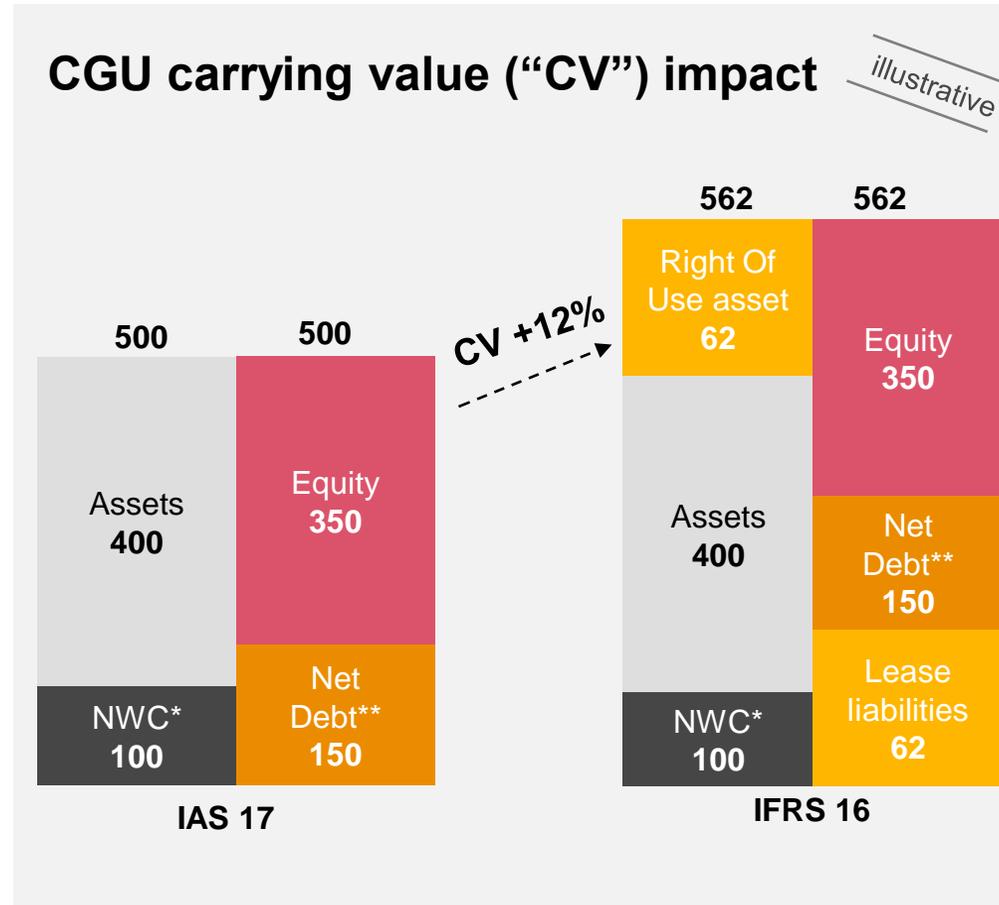
Transition to IFRS 16 and impairment tests considerations

Setting the scene for transition to IFRS 16

First-time application is by itself not a “triggering event”

Impairment testing only required in case of a “triggering event”

Testing the right-of-use asset at the individual asset level?



There are multiple questions that arise on performing an impairment test after transition to IFRS 16

What is the carrying amount? What should be included, what not?

What are the forecasts and cash flow projections when IFRS 16 is applied?

Are future investments (capex) to be considered for leases/ROU assets?

$$\text{Carrying Amount (CGU)} \begin{matrix} < \\ > \end{matrix} \sum_{i=1}^n \frac{\text{Free Cash Flows}}{(1 + WACC)^n} + TV$$

On what level or what is to test (test object)?

Pay attention to “like-for-like” requirement!

Should the cost of capital (WACC) be adjusted? What is the influence of the debt-equity ratio?

How to model the terminal value (perpetuity)?

Simplified case study

Impairment test according to IAS 36: Illustrative Example

Facts and assumptions

General assumptions

Last impairment test performed	31 December 2018
Transition method IFRS 16	Modified retrospective method and simplified calculation of the ROU assets
Determination of CGU's Carrying Amount	Lease liabilities are not included within the carrying amount of the CGU
Transition date	1 January 2019
Test date	1 January 2019

Further assumptions

Note: Calculation example may include rounding differences

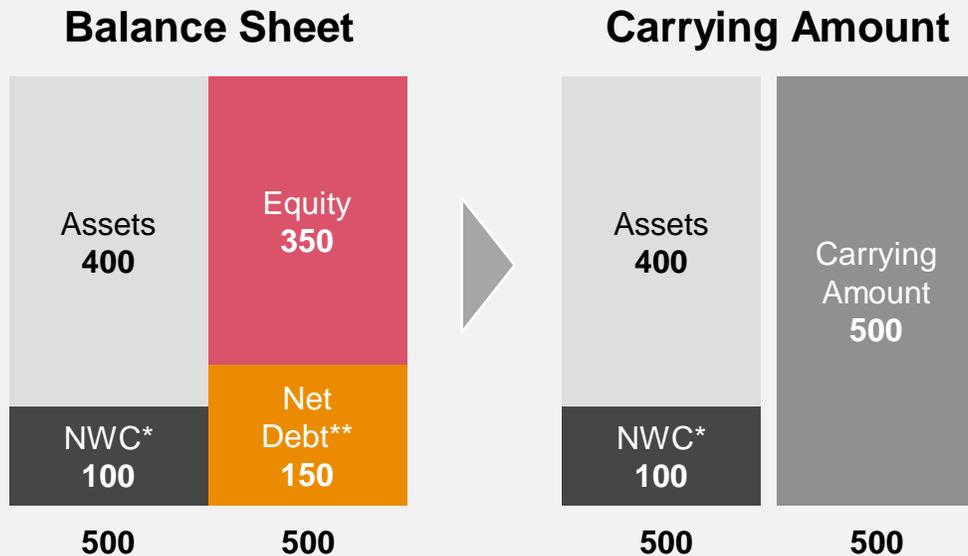
- Discounted Cash Flow-based impairment test (WACC-Method)
- Recoverable Amount: Value in use (Assumption: no differences to FVLCD)
- Tax rate: 17%
- No growth during detailed planning period
- Long-term growth rate (Terminal Value): 1.0% p.a.
- No consideration of further special topics (e.g. initial direct costs, restoration costs, etc.)
- Five lease assets (see above right)

Assumptions regarding lease assets

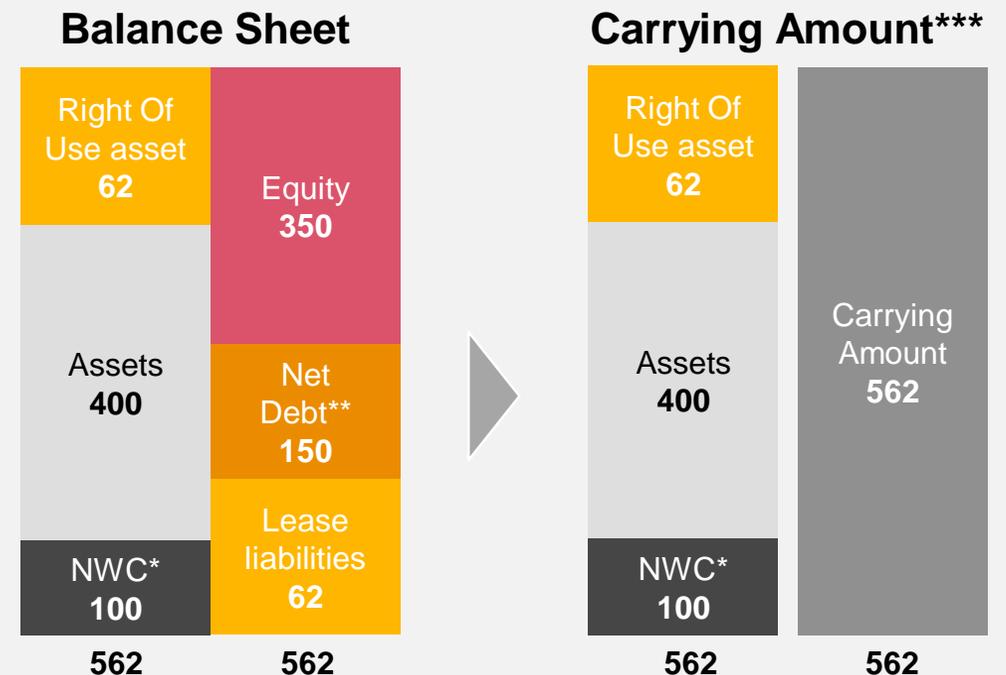
Lease Assets	Lease term (years)	Remain-ing live (years)	Cost	Incr. borrowing rate	Carrying amount 1.1.2019	Lease expense p.a.
LA 1	5	1	20.0	4.0%	4.3	4.5
LA 2	5	2	20.0	4.0%	8.5	4.5
LA 3	5	3	20.0	4.0%	12.5	4.5
LA 4	5	4	20.0	4.0%	16.3	4.5
LA 5	5	5	20.0	4.0%	20.0	4.5
Total:					61.6	22.5

The carrying amount increases as a result of recognising the Right of Use asset

31 Dec. 2018: Operating Lease (IAS 17)



1 Jan. 2019: Lease (IFRS 16)



* Net Working Capital

** Long-term liabilities less cash and cash equivalents

*** Carrying amount of a CGU does normally not include the carrying amount of any recognised liability (IAS 36.76 [b])

■ New balance sheet items that results from application of IFRS 16

Lease expenses (previously within EBITDA) are replaced with depreciation and interest (below EBITDA)

31 Dec. 2018: Operating Lease (IAS 17)

	2019	2020	2021	2022	2023
Revenue	1.000	1.000	1.000	1.000	1.000
Cost of materials	(700)	(700)	(700)	(700)	(700)
SG&A	(200)	(200)	(200)	(200)	(200)
Lease expenses (OL)	(22)	(22)	(22)	(22)	(22)
EBITDA	78	78	78	78	78
Depreciations – PPE	(10)	(10)	(10)	(10)	(10)
Depreciation – ROU assets	-	-	-	-	-
EBIT	68	68	68	68	68
Interest expenses – Financial liabilities	(10)	(10)	(10)	(10)	(10)
Interest expenses – Lease liabilities	-	-	-	-	-
EBT	58	58	58	58	58
Income tax expense	(17)	(17)	(17)	(17)	(17)
Profit / (Loss) for the year	40	40	40	40	40

- Lease expenses reduce free cash flows as a recurring, cash-effective expense (incl. financing component)
- No impact on forecast depreciation and financing cash flows

1 Jan. 2019: Lease (IFRS 16)

	2019	2020	2021	2022	2023
Revenue	1.000	1.000	1.000	1.000	1.000
Cost of materials	(700)	(700)	(700)	(700)	(700)
SG&A	(200)	(200)	(200)	(200)	(200)
Lease expenses (OL)	-	-	-	-	-
EBITDA	100	100	100	100	100
Depreciation – PPE	(10)	(10)	(10)	(10)	(10)
Depreciation – ROU assets	(21)	(20)	(20)	(20)	(20)
EBIT	69	70	70	70	70
Interest expenses – Financial liabilities	(10)	(10)	(10)	(10)	(10)
Interest expenses – Lease liabilities	(2)	(2)	(2)	(2)	(2)
EBT	57	57	57	57	58
Income tax expense	(17)	(17)	(17)	(17)	(17)
Profit / (Loss) for the year	40	40	40	40	40

- In the forecasts lease expenses (operating cash outflows) are replaced by depreciation of the ROU assets (non-cash) and interest expenses (as part of finance costs)

As leases expire, the capex assumption needs to include the impact of renewing / entering into new leases

Depreciation and (re-)investments of/in lease assets

	2019	2020	2021	2022	2023
<i>Depreciation – ROU asset (existing) 1</i>	(4.3)	-	-	-	-
<i>Depreciation – ROU asset (existing) 2</i>	(4.2)	(4.2)	-	-	-
<i>Depreciation – ROU asset (existing) 3</i>	(4.2)	(4.2)	(4.2)	-	-
<i>Depreciation – ROU asset (existing) 4</i>	(4.1)	(4.1)	(4.1)	(4.1)	-
<i>Depreciation – ROU asset (existing) 5</i>	(4.0)	(4.0)	(4.0)	(4.0)	(4.0)
<i>Depreciation – ROU asset (new) 1</i>	-	(4.0)	(4.0)	(4.0)	(4.0)
<i>Depreciation – ROU asset (new) 2</i>	-	-	(4.0)	(4.0)	(4.0)
<i>Depreciation – ROU asset (new) 3</i>	-	-	-	(4.0)	(4.0)
<i>Depreciation – ROU asset (new) 4</i>	-	-	-	-	(4.0)
<i>Depreciation – ROU asset (new) 5</i>	-	-	-	-	-
Depreciation – ROU assets	(20.8)	(20.5)	(20.2)	(20.1)	(20.0)

	2019	2020	2021	2022	2023
<i>Capex – ROU asset (new) 1</i>	(20)	-	-	-	-
<i>Capex – ROU asset (new) 2</i>	-	(20)	-	-	-
<i>Capex – ROU asset (new) 3</i>	-	-	(20)	-	-
<i>Capex – ROU asset (new) 4</i>	-	-	-	(20)	-
<i>ICapex – ROU asset (new) 5</i>	-	-	-	-	(20)
Investment – ROU assets	(20)	(20)	(20)	(20)	(20)

- Assuming a largely consistent business activity portfolio of lease assets with remaining useful lives of 1 to 5 years or a constant average remaining useful life of approx. 3 years
- Leases are replaced with equivalent assets at the end of their respective useful lives in order to preserve the economic benefit of the CGU (as required by IAS 36.49)
- Thus, payments for anticipated new leases are to be considered as replacement capex (cash outflow)
- It has to be ensured that the reinvestments in lease assets are adequately planned, which might need detailed forecasting

→ In this illustrative example reinvestments in the lease assets amounting to €20m p.a. considered in the detailed planning period.

IFRS 16 will change how we derive free cash flows, and EBITDA may no longer represent a close proxy for cash

31 Dec. 2018: Operating Lease (IAS 17)

	2019	2020	2021	2022	2023	TV
EBIT	68	68	68	68	68	68
Adjusted tax expense	(20)	(20)	(20)	(20)	(20)	(20)
NOPLAT	47	47	47	47	47	48
+ Depreciation – PPE	10	10	10	10	10	10
+ Depreciation – ROU assets	-	-	-	-	-	-
- Capex – PPE	(10)	(10)	(10)	(10)	(10)	(11)
- Capex – ROU assets	-	-	-	-	-	-
+/- Changes in NWC	-	-	-	-	-	(1)
Free Cash Flow	47	47	47	47	47	46

- Determination of capex in the terminal value (TV) takes into account the expected terminal growth of the business

1 Jan. 2019: Lease (IFRS 16)

	2019	2020	2021	2022	2023	TV
EBIT	69	70	70	70	70	71
Adjusted tax expense	(21)	(21)	(21)	(21)	(21)	(21)
NOPLAT	48	49	49	49	49	49
+ Depreciation – PPE	10	10	10	10	10	10
+ Depreciation – ROU assets	21	20	20	20	20	20
- Capex – PPE	(10)	(10)	(10)	(10)	(10)	(11)
- Capex – ROU assets	(20)	(20)	(20)	(20)	(20)	(21)
+/- Changes in NWC	-	-	-	-	-	(1)
Free Cash Flow	49	49	49	49	49	47

- In this case, depreciation closely follows replacement capex as the lease portfolio in the company is constant.
- For companies in which the lease portfolio is more lumpy, detailed forecasting of depreciation and capex will be required
- The terminal value should represent a 'steady state' – this may mean extending out the period to calculate an appropriate annuity value for depreciation and capex

With updated cash flows and carrying value of the CGU, leaving the WACC unchanged could result in a reduction of headroom

Risk free rate	1.3%
Asset beta	1.15
EMRP	6.5%
Cost of equity	8.7%
Cost of debt (pre tax)	4.0%
Tax rate	17.0%
Tax Shield	0.7%
Cost of debt (after tax)	3.3%
Equity ratio	80%
Debt ratio	20%
WACC	7.6%

→ Equity and debt ratios are determined on the basis of the average historical capital structure of the peer group entities (established approach in practice)

31 Dec. 2018: Operating Lease (IAS 17)

<u>DCF</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>TV</u>
Free Cash Flow		47	47	47	47	47	46
Present value factor	7.6%	0.93	0.87	0.80	0.75	0.70	10.70
Present value Free Cash Flow	44	41	38	35	33	489	
Recoverable Amount	681						

Impairment test as of 31 Dec. 2018

Recoverable Amount	681
Carrying Amount	500
Headroom	181

1 Jan. 2019: Lease (IFRS 16)

<u>DCF</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>TV</u>
Free Cash Flow	49	49	49	49	49	47
Present value factor	7.6%	0.93	0.87	0.80	0.75	10.70
Present value Free Cash Flow	46	43	39	37	34	502
Recoverable Amount	700					

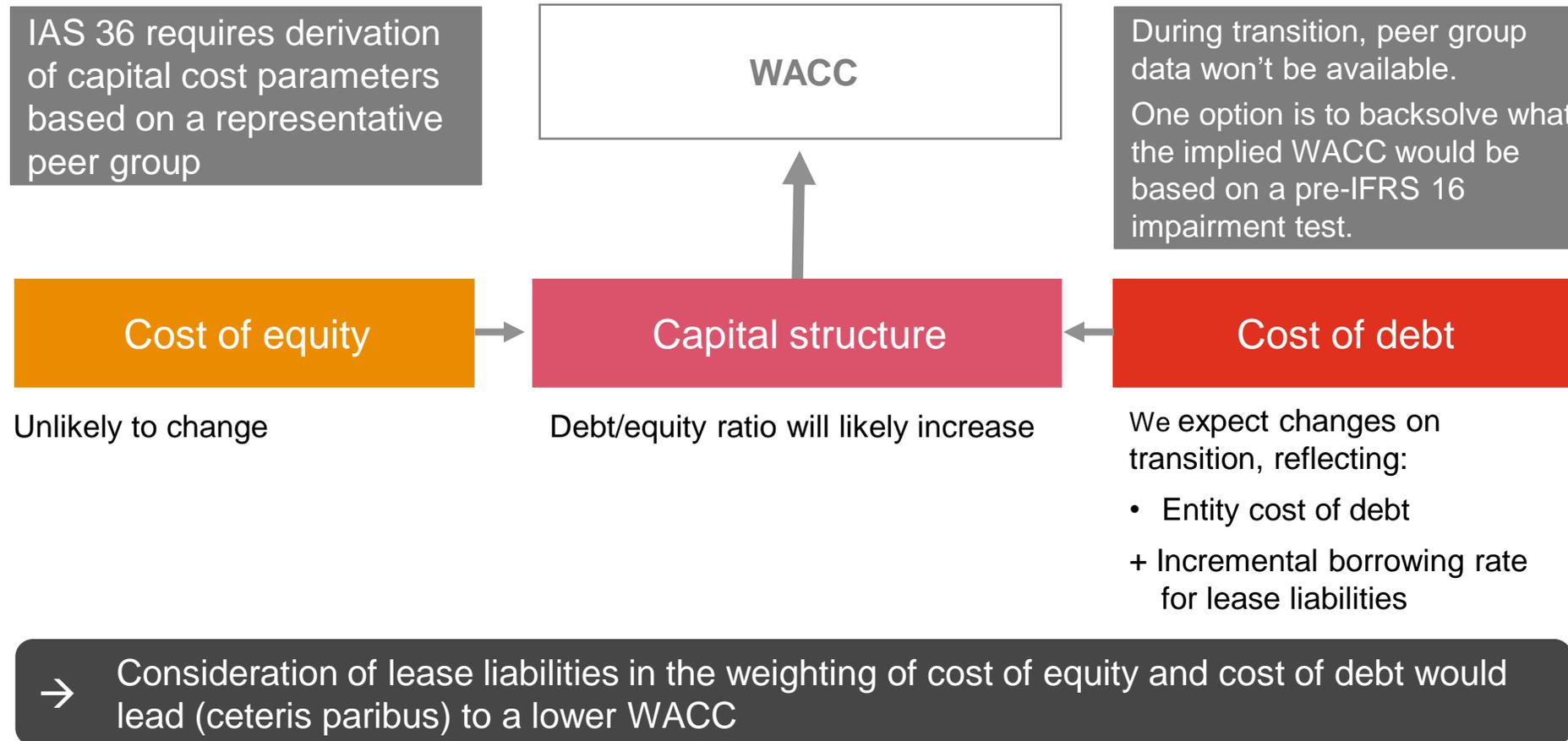
Impairment test as of 1 Jan. 2019

Recoverable Amount	700
Carrying Amount	562
Headroom	139

Using the identical WACC (7.6%) results in lower headroom!

Impact of IFRS 16 on the discount rate (WACC)

We would expect the WACC to decline as a result of greater weighting towards cost of debt



As your debt ratio increases, your WACC should decrease, assuming cost of equity remains unchanged

Cost of capital

Cost of equity	8.7%
Cost of debt (after tax)	3.3% (simplifying assumption)

Scenario analysis

Debt ratio (incl. IFRS 16)	20%	25%	30%	35%	40%
WACC	7.6%	7.2%	6.9%	6.6%	6.3%

- Cost of equity remain unchanged
 - The debt ratios of the peer group companies have to be determined taking into account application of IFRS 16 (difficulty in practice due to lack of available data points)
 - At transition date this information may not be available or is not available in sufficient quality (at this time averaging over historical data is not possible)
- **WACC decreases – this may need to be backsolved during transition**

Summary

Key take aways

1

Ultimately, an accounting change should not change the underlying equity value of the business and should not result in changes to the level of headroom

2

Key valuation metrics will change (enterprise value, EBITDA, EBIT, gearing and multiples) requiring careful consideration during the transitional period and beyond

3

Key assumptions in impairment testing will need to be updated, including carrying values, forecast cash flows and the discount rate.

4

Where there is limited headroom or a potential impairment, a closer look at the WACC is warranted and the WACC should adequately reflect impact of IFRS 16 (given available data)

5

There is limited data at this stage and our approach to the impairment testing may need to evolve as market practice develops

Thank you and any questions?



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