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Off-Balance Sheet Leases: Capitalization and Ratings Implications

Out of Sight But Not Out of Mind

Product of the Standing Committee on Priority of Claims and Accounting

Should creditors to a company engaged in off-balance sheet leases be concerned about the existence of these transactions? The argument is that leases are secured by their own assets and could effectively be ignored for the purpose of analyzing on-balance sheet debt. However, we beg to differ, and firmly believe that leases represent a use of a company's debt capacity and could meaningfully impact the recovery prospects of a balance sheet creditor in a stress scenario. This special comment discusses these issues, as well as the methods by which operating leases could be capitalized and incorporated in the analysis of rent intensive companies.

DEBT CAPACITY DEFINED

Before we go any further, it would be helpful to explain what we mean by debt capacity. Debt capacity may be loosely defined as a company's capacity to ***incur additional*** debt. This is related, but not identical, to 'cash flow leverage', which measures the ability of a company to ***service the existing*** level of debt. The two are inversely correlated. Both debt capacity and cash flow leverage take into consideration a company's cash generating ability, measured as operating cash flow available for debt service. Simply put, a use of debt capacity, and a corresponding increase in leverage, arises from any transaction that stakes a claim on a company's cash flow.

From this general framework, it is not difficult to see why leases do utilize a company's debt capacity. Lease agreements are a contractual obligation, resulting in a claim on cash flow through fixed rental payments over the life of the lease. Lease terms vary but often require the lessee to provide for ongoing maintenance of the leased equipment. There could be stringent covenants placed on the lessee that may constrain its financial flexibility. Failure to comply with the terms of the lease agreement would constitute a default and likely trigger cross defaults/acceleration of other debt obligations. In default cases, the lessee could become liable for all future payments due under the lease. Termination of lease agreements prior to maturity also entails penalties. Besides, in the absence of a lease financing option, the company would likely borrow the money and buy the asset.

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Compared to other financing methods, leases generally offer greater financial and operating flexibility, though difficult to quantify. Some leases have variable components and can, as a result, offer less debt-like characteristics. An example of this would be short-term leases of trucks in the transportation industry where leases facilitate fleet management through business cycles. The number of trucks in the fleet can be adjusted (through selected lease renewals) as demand fluctuates.

The issue of flexibility is an important one in determining the appropriate debt component. Generally, the more flexibility the financing transaction accords, the less debt amount that should be ascribed. Compare a company owning its productive assets to one that sells its assets and pays down debt with the proceeds, either through sale-leaseback or sale of facilities with outsourcing arrangements. How would we best compare the leverages of these three cases? Leverage for a company that owns its facilities is a straightforward exercise. The task gets trickier for the other two cases. We typically do not ascribe a debt component to an outsourcing contract, even though the company's cash generating capability remains heavily dependent on the sold manufacturing facilities and there may exist an off-balance sheet operational or financial commitment. This is because the outright sale may allow the company to enjoy greater flexibility in terms of lower debt servicing and operating requirements.[1] Assessing leverage for a company that rents is also complicated but more manageable.

METHODS OF CAPITALIZATION

So how should lease obligations be accounted for? The current accounting standards (FAS 13) require the application of finance (or capital) lease accounting for those non-cancelable leases that meet at least one of four criteria (which measure the substantive transfer of risks and benefits associated with the lease contract to the lessee). Finance leases are capitalized on the balance sheet. For all other leases, operating lease (off-balance sheet) accounting is applied.

Our discussion will focus on operating lease transactions. Our objectives in analyzing operating lease intensive companies are two-fold: to accurately depict a firm's effective leverage and to achieve comparability in analyzing firms employing different financing tools (eg. lease vs buy). The company's motivation behind leasing should be scrutinized. Is it for financial flexibility or an effort to mask true leverage? The answer could affect the appropriate capitalization to be applied. Let's face it, there is no one single capitalization method that will be appropriate for all circumstances. The choice of capitalization method is ultimately a judgment call, though we believe that the present value approach (or variations thereof) may be the lessor of the evils. We discuss below the pros and cons of the two principal methodologies (8x and present value), and offer a modified approach to overcome the PV method's primary shortcoming. This is clearly not intended to be an exhaustive list but the issues should apply to other approaches as well.

8X RENT – THE FLAWED, PERENNIAL FAVORITE

The analytical world has traditionally embraced the standard '8x' multiple, which is applied to a company's most current annual rent expense in arriving at a debt equivalent value. This method certainly has its advantages. Foremost, it is simple. It provides a quick thumbnail approach to assessing a company's effective leverage. To some degree, it also incorporates the underlying borrower's creditworthiness (i.e. the rent amount changes with the borrower's credit risk, and applying a constant multiple permits comparability of capitalized rent amounts among different classes of borrowers).

But there are some serious drawbacks. The method is too rigid, and cannot accommodate the several moving parts that would impact the appropriate multiple, such as interest rate environment and type of underlying assets. The multiple method was originally conceived assuming a certain interest rate (6%) on a piece of capital equipment with a long useful life (15 years), and is not designed to be appropriate for all lease types.

1 We do recognize that lowering vertical integration may not necessarily improve debt capacity; in fact it may reduce it. We also note that the outsourcing company's 'debt service' may be incurred in terms of higher cost of sales.

To illustrate, we should first scrutinize the components of a rent payment. Rent captures three basic items: depreciation (to reflect principal portion), interest (to reflect time value of money and credit risk) and the lessor's desired profit margin. Many rents also include executory costs, such as insurance, maintenance and taxes, which should be excluded from capitalization. Changes in each item will impact the rent amount and, thereby, the capitalization rate, given a constant asset cost. For example, the longer the useful life of an asset, the lower the depreciation, the lower the rent amount (all things being equal), and ultimately the higher the capitalization multiple needed to arrive at the same debt equivalent value. A high interest rate (whether due to the high credit risk of the lessee or the interest rate environment) will result in a higher rent amount and thus lower the multiple required. A constant multiple will not capture these nuances.

We have studied companies across different rent intensive sectors, such as in retail and transportation, and have discovered that the 8x rent methodology is often punitive when compared to the results of leverage calculated on a PV method, for reasons discussed in the following sections.

PV METHOD – BETTER, BUT STILL NO CIGAR

Moody's believes that a more flexible method of capitalization may be the present value calculation. Here, we would calculate the net present value of the future minimum lease payments using an appropriate discount rate. The most accurate discount rate to use would be the rate implicit in the lease agreement. However, this may not be readily available. Other rates that could be used as a proxy would be the finance lease rate, or the firm's weighted average cost of debt. The PV method is flexible since it incorporates the changing rate environment, the underlying creditworthiness of the lessee, and the types of assets (whether it be short or longer term). It also provides consistency with companies engaged in finance leases (which uses the PV method with the result being on-balance sheet). Furthermore, the PV method captures the actual payments required under the leases. Since companies are not obligated to renew the leases beyond the contractual period, it is argued that we should not be capitalizing rent in excess of its required lease payment amounts either (which the 8x rent effectively does), and herein lies the PV method's biggest flaw.

Contractual obligations alone may not accurately capture a company's leverage and its resulting debt capacity. As we already know, on-balance sheet debt may not offer a complete debt picture of a company. But simply adding on contractual off-balance sheet obligations may not either. What we need to do is to assess a company's cash generating resources and determine its effective leverage, considering the company's operating and financing plans, as well as its risk appetite. *This "effective leverage" may exceed all on and off-balance sheet obligations*. Let's return to the PV method for a case in point.

The PV method basically fails in cases where a company enters into a short-term lease for a long-lived essential asset or where a lease of a long-lived asset is nearing the end of its term. In these cases, the PV method would understate the debt equivalent since presumably the lease will either be renewed or a new replacement asset will be acquired (debt financed of course). Our analysis needs to incorporate the likelihood of lease renewal given our understanding of the company's business needs.[2]

To a lesser degree, the PV method may also understate the debt equivalent since the future minimum lease payments tend to be lower than actual (because certain lease terms contain payment escalators in line with inflation or with revenue generated from the leased property).

MODIFIED PV METHODOLOGY – BEST, BUT CUMBERSOME

One way to rectify the PV method's shortcoming of debt understatement is to identify all the essential assets (i.e. all the core cash generating assets) of the company. In the case of cyclical businesses, like transportation discussed earlier, the core asset could be the minimum level of, say, fleet required. For going concern entities, it would be prudent to assume that these assets would be required in perpetuity. Consequently, we should present value the rent payment of the core assets (net of depreciation) in perpetuity. In other words, take only the interest component of the rent and divide it by the discount rate, the

2 Similarly, a company that owns essential assets or employs finance leases may also be understating its amortizing debt/capitalized leases, if the assets are almost fully depreciated or leases are nearing maturity. An adjustment to account for the likely increase in debt should be made.

result of which would yield the gross debt amount. Rents of non-core assets would continue to employ the traditional PV method.

Unfortunately, this is likely to be a cumbersome exercise since it will involve segregating the numerous asset types within a pool of leased assets not readily discernible in a company's financial statements. The analyst will have to make a determination as to which of the leased assets are essential. The table below provides a simplified example of the three methodologies and the differences in capitalization value that would emerge. Notice the wide divergence in capitalization between the 8x and the PV methodologies. In this example the modified PV's capitalization fell in between the other two methodologies. Had all leased assets been essential, the modified method would have resulted in the highest capitalization value.

Assumptions:
8 essential equipments each costing $10 with a 10 year life but leased for 4 years.3 leased in 1996, 3 in 1997 and 2 1998.
2 non-essential equipments each costing $5 with a 5 year life leased for 2 years. Both leased in 1998
Discount rate = 5%

For Each Equipment	8 Essential	2 Non-essential	Total
Depreciation	1	1	2
Interest Component	0.5	0.25	0.75
Annual Rent Expense	1.5	1.25	2.75
Aggregate Annual Rent	12	2.5	14.5

	# of Equipment		Rent			PV		Total
	Essential	Non-essential	Essential	Non-essential	Total	Essential	Non-essential	PV to 1998
1996	3	0	4.5	0	4.5	n/a	n/a	n/a
1997	6	0	9	0	9	n/a	n/a	n/a
Current Year 1998	8	2	12	2.5	14.5	n/a	n/a	n/a
1999	8	2	12	2.5	14.5	11.43	2.38	13.81
2000	5	0	7.5	0	7.5	6.80	6.80	–
2001	2	0	3	0	3	2.59	2.59	–
2002	0	0	0	0	0	–	–	–
						20.82	2.38	23.20

Method:	8x Rent	PV Method	Modified PV
Capitalized Rent (a/o Y/E 1998)	**116***	**23.20**	**82.4****

* 14.5 x 8
** (Essential Rent – Depreciation)/5% + PV Non-Essential

Moody's believes that it would be helpful to compare and contrast the multiples obtained from different methodologies amongst themselves and to similarly rated or peer group companies. The exercise is likely to yield more questions than answers, but should provide deeper insights into the company's business, and point to areas that need further investigation, as we endeavor to ascertain the "true" leverage of a company.

RATING CONSIDERATIONS

Once an "appropriate" capitalization amount is determined we could incorporate it in the analysis and rating of various debt issues. It is more meaningful to incorporate capitalized rent if the amount is significant and the leased assets are essential. We believe that there could be ratings implications (for the assignment of ratings to balance sheet debt), depending on whether, and how, the rent is capitalized on the balance sheet since credit statistics could be meaningfully different.

In evaluating a company with significant operating leases, the analysis should weigh heavily on cash flow generation. A useful measure of cash flow would be EBITDA**R** (**R** being the rent amount). Meanwhile fixed charge coverages should incorporate the rent component (or at the minimum the interest portion of the rent by applying the discount rate to the capitalized rent amount) in both the cash flow and fixed charges. One should also note the margin differences that would arise between two companies, where one rents and the other buys. Gross margin would be lower (because of depreciation) while operating margin higher (interest expense is below the line item) for companies that buy versus those that rent.

Looking at EBITDAR/Revenues would eliminate this distortion. Return measurements will also be distorted. EBITDAR to Adjusted Assets (which include capitalized leases) should provide a more accurate picture of the efficiency of a company's asset utilization.

RECOVERY PROSPECTS FOR BALANCE SHEET CREDITORS

The recovery prospect for a balance sheet noteholder in a distress situation is contingent upon the adjusted capital structure (incorporating capitalized leases) of the company and the anticipated future evolution of that structure. *We believe that a preponderance of leases effectively subordinates the unsecured balance sheet creditors to these secured debt, thereby impacting the ultimate recovery value of the unsecured creditors.*

There are several qualitative factors we should consider in determining the potential impact of operating leases on the recovery of bondholders. Foremost, we need to ascertain the importance of the lease transaction to the viability and franchise value of the lessee. If the leased assets are essential, the lessee may be inclined to continue to make current the rent payments in a distressed situation. We should also consider the ability of the lessee to reject the lease in a bankruptcy, and the substitutability of the leased assets – can they be quickly and cost effectively replaced?

The strength of the lessor group is also an important consideration. A limited number of lessors at a debtor may have greater negotiating leverage, and thereby be able to extract more concessions in a workout situation at the expense of other creditors.

Lessors are protected by the various remedies available in the event of a lessee default. In these cases, the lessor would typically compare the aggregate PV of the remaining rent payments to the current fair market value (FMV) of the asset. If the FMV has declined significantly the lessor may be inclined to keep the asset with the lessee. Otherwise, there may be an incentive to repossess the asset[3] and accelerate the PV of the remaining rent payments. Note that proceeds from remarketing the equipment would be used to mitigate damage to the lessee – i.e. lessors do not receive both the equipment and the PV of the remaining rents.

In general, the more critical the leased assets are to the lessee and the greater the negotiating power the lessors possess, the higher the likelihood that these leases would negatively impact the position of the balance sheet debtholders.

CONCLUSION

The global popularity of leasing is reflective of its diverse benefits. Leases offer operating and financial flexibility for companies to manage such risks as business cycles and technological obsolescence. It also represents an alternative form of financing. And because it is a financing vehicle, our credit analysis must incorporate these leases, else we risk missing the true credit picture of a company.

3 In a Chapter 11 bankruptcy however, lessors initially lose the right to repossess due to the 60-day stay period after a petition for bankruptcy has been filed. Lessees would then have the choice of either assuming or rejecting the lease. In the event of lease rejection, the lessor would repossess the asset and its pre-petition claims (i.e. back rents) would be treated as unsecured claims. Meanwhile, rents accruing during the stay period would be treated at higher priority (as an administrative claim) while the aggregate PV of post petition rents, subsequent to the stay, would be classified as rejection damage and again be treated unsecured.

Special Comment

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