



BY JOHN KINGHAM

## DIVIDEND HUNTER

# SHINING A LIGHT ON HIDDEN DEBT

## CAPITALISING LEASE OBLIGATIONS

**John Kingham looks at lease obligations and why fixed lease obligations should be capitalised on the balance sheet.**

Unless you're an accountant or an experienced and well-read investor, the chances are you either haven't heard of capitalising lease obligations or, if you have, it's something you don't do because it can be a lot of work.

Until recently I fell into the second group. I knew what lease capitalisation was (don't worry if you don't; I shall explain all shortly) but I didn't do it because a) none of my investments so far have had problems with crippling lease obligations and b) it was a lot of work.

However, the argument (or excuse) that it's all too much work is about to become null and void, thanks to a new accounting standard known as IFRS 16: Leases.

This new standard is about to shine a light on what was previously a dark and largely hidden debt, so now seems like a good time to review the basics of lease obligations.

### Why renting often makes sense

Like most debts, lease obligations are not intrinsically bad. For example, let's say you wanted to start your own retail business. You go to a bank, take out a 20-year interest-only loan for £1 million and use it to buy a large store on your local high street. After five years of hard work the business isn't doing well, and you blame the location. You want to move to a nearby high street, so you decide to sell. Unfortunately the economic environment is weak and the best offer you get for the store is £700,000.

You now have a dilemma. You either stay where you are in a suboptimal location, or you take a £300,000 capital loss on the chin. Either way, your business is being affected to an enormous degree by commercial-property price movements, and that's unfortunate, because your core skill is retail and not property speculation.

However, in contrast to buying, leasing can give retailers (and other companies which depend on expensive capital assets, such as those operating in the travel and leisure or industrial transportation sectors) the right to use a property or other asset for a fixed period of time for a more or less fixed fee. This removes most of the risk associated with asset ownership, but there are downsides as well.

### Why fixed lease obligations are a form of hidden debt

The main downside is that a fixed lease obligation is almost exactly the same as a debt obligation. You have regular fixed payments to make, and if you miss payments, the lessor (eg the landlord) can take you to court. I wouldn't say that lessors can't be bargained with, can't be reasoned with or that they absolutely will not stop, ever, until they get their payments, but you get the idea.

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## “IT’S TRUE THAT LONG LEASES ARE TYPICALLY CHEAPER THAN SHORT LEASES, BUT THE ADDITIONAL RETURNS ARE OFTEN NOT WORTH THE RISK OF TAKING ON SUCH A LONG AND INFLEXIBLE OBLIGATION.”

In fact, you can take the debt analogy even further. Let's say you leased a shop for a fixed monthly rent for five years. However, instead of paying the rent monthly, you decide to borrow enough money from the bank so you can pay all the rent upfront. Now you have the same right to use that property for five years, but you're making monthly payments to the bank rather than the landlord. In terms of cash flows, these two scenarios would be virtually identical, so thinking of lease obligations as a form of hidden debt really does make a lot of sense.

One caveat is that debt-like lease obligations have fixed payments. If lease payments are variable, perhaps being paid as a percentage of revenues or some other variable factor, then the lease isn't a debt obligation; it's just an ongoing expense. For example, a revenue-based lease might see lease payments fall by 10% if your revenues fell by 10%. That's great for the lessee as it's much more flexible, but it isn't how debt works, so for now we'll ignore variable or contingent lease liabilities.

### Why fixed lease obligations should be on the balance sheet

The balance sheet is where we record the assets of the company (eg cash, stock, equipment, property) and its liabilities, ie those who have a claim on the assets (eg shareholders, debtholders, suppliers and governments).

With an operational lease, the company doesn't own the thing it's leasing, so no asset is recorded on the balance sheet. And if there's no asset, there can be no related liability. But if a fixed lease obligation is effectively the same as having borrowed money today to pay for a multi-year lease up front, then the obligation should be on the balance sheet.

This might sound like a load of accounting minutiae, but it isn't. And here's why: fixed lease obligations can



have a major impact on a company's risk profile and profitability.

### How fixed lease obligations increase risk

Excessive debt is a common cause of dividend cuts and corporate decline. It's why I have strict rules about how much debt a company can carry, and it's why Warren Buffett generally prefers companies with "little or no debt".

As a relatively fixed expense, large debt interest payments amplify small changes in revenue into large changes in profit. So companies with lots of debt often do well when revenues are going up, but when revenues go down those debt interest payments can quickly become unaffordable.

The same is true of fixed lease obligations. If rental payments are large relative to profits, small declines in revenue can become large declines in profit.

The length of the lease is another risk factor. Long leases (typically more than five years) lock the lessee into fixed payments far into an uncertain future. If a retail store starts to struggle and it has 15 years until the lease expires, getting out of the lease early can be extremely difficult and expensive.

Contrast that 15-year lease with a store that has a couple of years until the lease is up for renewal. With such a short lease the retailer only has to suffer weak profits for at most two years before it can either exit the lease at little or no cost or renegotiate the rent downwards.

It's true that long leases are typically cheaper than short leases, but the additional returns are often not worth the risk of taking on such a long and inflexible obligation.

### How fixed lease obligations flatter profitability

Return on shareholder equity (ROE) is arguably the best measure of a company's performance over the long term. However, the problem with ROE is that it's easy to boost with borrowed funds.

For example, a company could borrow millions to buy factories, machinery, computers, software and who knows what else. Somewhat simplistically, the value of the assets and the outstanding loan liability will negate each other on the balance sheet, so there is no change to shareholder equity. But any profits those assets generate above and beyond the cost of the loan and the

depreciation of the assets will flow straight into the return side of the ROE ratio.

It's a bit like buying a house. If you pay for the house out of your own money and its price doubles then your gain is 100%. But if you buy a house and borrow 90% of the value (leaving you with 10% equity) and the price doubles, then you have a 1000% return on your investment (ignoring costs).

So, if we look at ROE and ignore debt then we're at risk of buying companies with exceptional ROE but only because they have mountains of very risky debt.

We can get around this problem by looking at return on capital employed (ROCE), where capital employed is the sum of shareholder equity and interest-bearing debt (usually called borrowings). Since companies that increase their debts will also increase their capital employed, ROCE is much less affected by debt than ROE.

You can also think of ROCE as the risk-adjusted version of ROE. It's basically asking what the ROE for this company would be if it raised new capital from shareholders to pay off all of its borrowings and become debt free. It effectively levels the playing field as far as borrowings are concerned.

However, ROCE doesn't take the hidden debt of fixed lease obligations into account, and I think it should. Why? Because there's effectively no difference between taking out a 10-year lease and paying for it upfront with borrowed money or paying monthly rent where the rent payments are the same as they would be for the loan. And if that's true, then the present value of those future lease obligations should be added to the ROCE figure along with shareholder capital and debt capital.

This would give us a return on lease-adjusted capital employed figure (ROLACE), or as I like to think of it, a debt-adjusted lease-adjusted return on equity figure. It tells us the returns a company would produce if it raised enough cash from shareholders to pay off its debts and also pay for all its leases upfront.

### Why almost nobody lease-adjusts capital employed

If turning a company's fixed lease expenses into a debt obligation on the

balance sheet is so sensible, why do so few investors do it?

The answer is that it's a lot of work to calculate an estimated present value for future lease obligations (otherwise known as capitalising lease obligations). It's a lot of work because most companies don't provide very usable data on their leases. What you'll find is current rental payments, which is a bit like having monthly repayment numbers for a loan but little or no information on the repayment term of the loan.

What most investors do is take historic rental figures (usually called minimum lease payments in annual reports) and multiply that by an industry standard multiplier. 'Rent times eight' used to be a widely used rule of thumb, but recently that seems to have shifted to six-times. Either way, it's an estimate and a ballpark estimate at that. But it's better than nothing, so I'm going to start using a multiplier of six-times minimum lease payments to calculate ROLACE for lease-heavy stocks on my stock screen.

This isn't perfect, because a fixed multiplier overstates lease obligations for companies with very short leases (eg less than five years) and understates them for companies with very long and potentially much

riskier leases (eg 10 years or more). But a stock screen is by its nature a blunt tool, and capitalising leases in this way will still provide much more accurate profitability numbers than not capitalising them at all.

Once you start analysing a company in detail it will be a good idea to have more accurate figures. Fortunately, it is possible to do better than using a simple six-times rent multiplier, but it's even more work and it's still just an estimate.

You start off by getting the total minimum future lease payment figures from the company's annual reports, which are usually buried somewhere in the notes at the back. This sounds like exactly what we need, but the amounts are lumped together based on the remaining lease length, ie "£500 million due in less than one year", "£750 million due in one to five years" and "£900 million due in more than five years". So, the data is coarse rather than fine, and on top of that you have to estimate a reasonable discount rate (say 5%) to calculate the present value of future obligations.

It's a very time-consuming way to get what is essentially an estimate, and that's why almost nobody does it even though the end result is worthwhile.

|  | Consolidated     |                  | Segment          |                  |
|--|------------------|------------------|------------------|------------------|
|  | 2015             | 2014             | 2015             | 2014             |
| <b>ASSETS</b>                                |                  |                  |                  |                  |
| <b>CURRENT ASSETS :</b>                      |                  |                  |                  |                  |
| Cash   | 45,104           | 54,681           | 35,150           | 24,810           |
| Temporary investment                         | 359,200          | 258,462          | 354,300          | 254,100          |
| Accounts Receivable                          | 31,958           | 15,985           | 28,590           | 14,100           |
| Note received                                | 50,859           | 45,987           | 48,521           | 3,100            |
| Inventory                                    | 585,090          | 326,900          | 535,084          | 3,100            |
| <b>TOTAL CURRENT ASSETS</b>                  | <b>1,072,211</b> | <b>702,015</b>   | <b>1,002,155</b> | <b>308,210</b>   |
| <b>NON-CURRENT ASSETS :</b>                  |                  |                  |                  |                  |
| Long - Term Investment                       | 200,100          | 180,650          | 195,025          | 1,452,600        |
| Property Plant Equipment - net               | 1,452,600        | 1,590,500        | 1,452,600        | 20,658           |
| Intangible Assets                            | 25,305           | 0                | 0                | 18,067           |
| Other assets                                 | 20,620           | 1,686,35         | 1,686,35         | 2,688,5          |
| <b>TOTAL NON-CURRENT ASSETS</b>              | <b>1,698,625</b> | <b>1,771,150</b> | <b>1,647,625</b> | <b>1,697,320</b> |
| <b>TOTAL ASSETS</b>                          | <b>2,770,836</b> | <b>1,973,165</b> | <b>2,649,780</b> | <b>1,995,530</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                  |                  |                  |                  |
| <b>CURRENT LIABILITIES :</b>                 |                  |                  |                  |                  |
| Short - Term Loan from Financial Institution |                  | 32,062           | 30,653           |                  |
| Trade Accounts                               |                  | 112,000          | 92,756           |                  |
| Notes Payable                                |                  | 255,000          | 175,416          |                  |
| Accrued Expense                              |                  | 35,260           | 28,445           |                  |
| <b>TOTAL CURRENT LIABILITIES</b>             |                  | <b>434,322</b>   | <b>327,270</b>   |                  |
| <b>NON-CURRENT LIABILITIES :</b>             |                  |                  |                  |                  |
| Term Loan from Financial Institution         |                  | 500,000          | 400,000          |                  |



## A few examples

To make all this a little more concrete, let's take a look at a few real examples to see just how much impact lease-adjusting returns on capital employed can have. These are mostly examples of retailers and other lease-dependent companies I own at the time of writing, and the lease capitalisation is done using the simple six-times minimum lease payments rule:

**Burberry (LON:BRBY):** I've owned Burberry for a few years. It's generally regarded as a quality retailer and it's been a very successful investment so far. Over the past decade it produced average returns on equity of 24%, which is very good. If we add in the company's relatively small debt pile then we get average ROCE of 21%, which is also very good. If we take the next step and add in estimated capitalised lease obligations then we end up with a 10-year average lease-adjusted ROCE of 12%.

A 12% return on capital, including lease obligations, is very good, but it's a long way short of the company's 24% return on unadjusted equity. Just to clarify, what I'm saying here is that if Burberry had carried out a rights issue to pay off all its debts and pay all of its fixed leases upfront, then it would have produced ROE of about 12%.

As a general rule, I'm aiming for at least a 10% annual return, so if a company can produce annual returns of more than 10% on its debt-adjusted, lease-adjusted equity (ROLACE) then I'm reasonably confident that earnings retained within the company are likely to benefit shareholders.

**The Restaurant Group (LON:RTN)** (which I'll refer to as TRG): I've owned TRG for a few years; many investors now wouldn't touch it with a bargepole and it's been a pretty bad investment so far. Pre-2016 (before the company recorded a loss and before its shares fell off a cliff), it produced average ROE of 27%. That's very impressive and even beats Burberry's ROE figure.

Add in TRG's then relatively low debts and that pre-2016 ROE figure turns into a very high 20% ROCE figure. So far so good, and at this point TRG is looking like a very profitable business, which makes sense because pre-2016 it was growing rapidly.

However, TRG is a heavy user of leased restaurants; so heavy in fact that its capitalised lease liability typically exceeds debt capital and equity capital. Once we factor in these lease obligations, lease-adjusted ROCE falls to just 9%.

There's a big difference between a 20% ROCE and a 9% ROLACE, and at this point TRG begins to look a lot less attractive. With hindsight, I think it's likely that I wouldn't have invested in this company had I realised just how dependent its returns were upon large fixed lease obligations.

**Next (LON:NXT):** here's another retailer which I've owned for a while. Like Burberry, it generally has a good reputation, although like most retailers its reputation has taken a hit in recent years. Next generated average returns on equity over the last 10 years of 161%, which is, quite frankly, ridiculous. A more sensible (but still very high) value for profitability appears when we add in debts, giving Next an average ROCE of 51%. That is still extraordinarily high, largely because it ignores the hidden debt of lease obligations.



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**“ALL WE HAVE TO DO IS LOOK AT THE LEASE OBLIGATION ON THE BALANCE SHEET AND ADD THAT TO SHAREHOLDER EQUITY AND BORROWINGS TO GET A LEASE-ADJUSTED CAPITAL EMPLOYED FIGURE.”**

It's only once we factor in leases that Next's profitability starts to look more reasonable, with the company's average ROLACE coming in at 22%. That is still exceptionally high, but it's far more representative of Next's true risk-adjusted returns than either 161% or 51%.

**Marks & Spencer (LON:MKS):** I used to like M&S as a customer, but I've never owned it as an investor. The company has been struggling for many years and from 2017 onwards its earnings have basically collapsed. If we look at pre-2017 earnings (when things were going relatively better) we see a company with ROE declining from around 24% in 2010 to 12% in 2016. That isn't a confidence-inspiring trend, but at least it was producing double-digit returns on shareholder equity.

However, take debt into account and M&S's pre-2017 profitability falls to an average 10% ROCE. That's about average for UK companies and just about passes my minimum threshold. But we're still ignoring lease obligations at this point. Once fixed lease obligations are capitalised and added to capital employed, we get an average pre-2017 figure for ROLACE of just 7.4%.

A 7.4% ROLACE isn't horrendous, but it isn't great either. It's below average and it shows that M&S just

wasn't earning sufficient returns once debt and lease obligations were accounted for.

In addition to these four companies, I've looked at other lease-dependent companies and there's a clear pattern: robust companies tend to have higher returns once debts and leases are factored in, while more fragile companies tend to have weaker returns. I'm not sure this would stand up in court or in a PhD thesis, but it's more than enough to convince me that I should be looking at ROLACE rather than ROE or ROCE.

**Why calculating ROLACE is about to get a whole lot easier**

Fortunately, the good people at the International Accounting Standards Board agree that the current situation is not ideal, and that fixed lease obligations should indeed be on the balance sheet.

Their solution is International Financial Reporting Standard (IFRS) 16: Leases. This new standard makes it obligatory for companies to calculate a single figure for the present value of all future fixed lease obligations, with a few exceptions such as very short or small leases.

This rule comes into effect this year, and companies will have to start

**Return On Capital Employed (ROCE)**

The technically correct way to calculate ROCE is to remove interest expenses from the returns side since we're effectively measuring debt-free profitability. For ROLACE, fixed lease expenses should also be removed because we're measuring profitability as if all fixed leases had been paid upfront. However, I calculate both ROCE and now ROLACE using profits net of interest and lease payments because a) it's easier and b) it makes heavily indebted, heavily lease-dependent companies look even less profitable, and that's fine by me.

doing the hard work of capitalising fixed lease obligations themselves. As a result, we should start seeing a 'right of use' asset on the balance sheet along with a more or less equal lease liability in upcoming annual results.

This is excellent news and it will make calculating ROLACE a doddle, more or less. All we have to do is look at the lease obligation on the balance sheet and add that to shareholder equity and borrowings to get a lease-adjusted capital employed figure. Hopefully some data providers (Morningstar, ShareScope, SharePad etc.) will make this even easier by extracting the relevant figures for us and perhaps also calculating the ratio for us.

It isn't quite one giant leap for mankind, but it is a significant step forward for investors and balance-sheet transparency.

**About John**

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

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