Event Transcript

Company: G8 Education Limited
Title: G8 Education - AASB 16 Lease Standard
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Start of Transcript

Operator: Ladies and gentlemen, thank you for standing by and welcome to the AASB 16 Lease Standard Conference Call. At this time all participants are in listen-only mode. After the speaker's presentation, there will be a question and answer session. To ask a question during this session, you will need to press star one on your telephone. Please be advised that today's conference call is being recorded. I'd now like to hand the conference over to your first speaker, CFO, Miss Sharyn Williams. Thank you; please go ahead.

Sharyn Williams: Good morning everyone, and thank you for joining us this morning. My name is Sharyn Williams and I'm the CFO of G8 Education. I'm joined today by [John Aspen] from Ernst & Young. By way of background, at our recent AGM in April we indicated that we would provide further details of the impact of the Leasing Standard on the Group prior to the 2019 half-year financial results. Today I will walk through the AASB 16 Leases presentation that was posted on the AFX earlier this morning, and then provide time for questions.

This presentation is intended to provide information on the new standard and its estimated impacts on G8. This presentation is not meant to be an exhaustive coverage of the accounting standard and includes unaudited, non-IFRS management estimates. Financial statements used in this presentation are for calendar year 2018, and our estimates are based on the lease portfolio as it stands today. The presentation and Q&A time following will not relate to the current year. The Company will be releasing its first-half results for calendar year '19 on Monday, 26 August.

Turning now to slide 4. G8 has numerous operating leases that were not reflected on the balance sheet, rather they were simply disclosed as lease expenses in the occupancy and other expenses line of the P&L. The quantum of these future lease commitments were disclosed in the Notes to the Annual Financial Statements. AASB 16 effectively brings the present value of these lease commitments onto the balance sheet.

The co-responding asset relating to these liabilities is a Right-of-Use asset. In G8's case, these assets are the right to occupy the centres we operate from, and the use of motor vehicles and buses. The traditional rental expense will be replaced by a depreciation expense of these Right-to-Use Assets and an interest expense calculated on the outstanding lease liability. The sum of the prior rental expense and the depreciation interests that replace this expense will equal each other over time.

Please turn to slide 5. This slide outlines the key takeaways from the presentation. The change in the Lease Accounting Standard has no impact on the Group's strong cash generation, and as a result, the cash dividend expectations of Shareholders should not change. The debt arrangements and funding of the Group are also unaffected. In addition, the Group's strategy will remain unchanged by the implementation of AASB 16, as will the appetite and ability to grow the network over time.

This accounting standard change will however have a significant impact on how companies report their financial statements. This change is [effective] for G8, and other December year end companies, from 1 January this year. The first G8 financial statements prepared under this new accounting standard will be the 2019 Half-Year Results, being released on 26 August.

This reporting change effectively brings the present value of future lease commitments onto the balance sheet, for the corresponding asset. Consequently, there'll be changes to the income statement as lease expenses are replaced with depreciation and interest, and the timing of these expenses may change.

This results in a higher EBITDA because the rental expense is removed from above the line and becomes depreciation and interest which are below the line. EBIT will also increase, because the rental expense will be removed and only partially replaced by depreciation. The portion relating to interest expense will be below the EBIT line, thereby impacting NPAT. The impact of these changes will vary between entities, due to a number of factors, which we will explore in more detail as we work our way through the presentation.

The first of the factors that impacts the Company's financial statements is discussed on slide 6. This is the transition method taken to adopt the new standard. There are a number of transition approaches for adopting AASB 16. These include fully retrospective; where the standard is applied as though it had always applied to each prior reporting period. Modified retrospective; where the prior periods are not re-stated but the accumulated difference is adjusted against retained earnings. And modified simple; where there is no accumulated difference adjustment.

G8 will be adopting the modified retrospective approach. This approach is used because G8 has grown by acquisition over many years, and taken over a large volume of individual leases part-way through their terms. This makes it extremely difficult to apply the standard as though it always applied. This method takes the lease payments for the remainder of the lease, includes options if reasonably certain of being exercised, and then discounts them back at an incremental borrowing rate to a present-value liability. We then take that liability onto the balance sheet.

The asset is calculated as if the standard had applied since the commencement date of the lease, or in G8's case, on the acquisition date, using the incremental borrowing rate at 1 January 2019. The process undertaken by G8 was a two-year program involving the implementation of a new leasing management system, individual review of each and every lease, an internal as well as external review of the principles applied, testing of data, calculations, and system integrity.

So firstly, on slide 7 we will review the balance sheet impact of AASB 16, which as I've mentioned earlier, involves the lease liability and a corresponding asset to be brought onto the balance sheet. This asset and liability may not equal each other due to the transition method chosen. The graph on the right is an example of a single lease with fixed rent increases, and how the Right-of-Use asset and lease liability operate over time. The Right-of-Use asset depreciates similar to other assets. This occurs on a straight-line basis for G8's Right-of-Use asset, and you can see the systemic even reduction of the asset as the years progress. The lease liability, however, behaves similar to a mortgage, where the lease balance decreases by the cash payments made less the calculated interest expense. At the beginning of the period, the reductions in the liability are smaller - they get progressively larger as the principal balance reduces.

Turning now to the income statement on slide 8, there are two aspects to note; a change in how the cost of the leases are expensed, and also a change in timing. Under AASB 16, the lease expense is replaced by depreciation and interest expense. Over the total life of the lease, the depreciation and interest expense is the same as the cash rental paid. Secondly, AASB 16 has an impact on the timing of the expenses over the life of the lease. Because the interest expense is higher in the earlier years and reduces over time, these expenses are brought forward in the lease and then reverse over time. This impact on NPAT will vary entity by entity.

This is demonstrated in the graph on the right. This shows the prior expense as a straight black line, where the lease expense is straight-lined. The green bars are equal depreciation amounts over the life of the lease. The black bold area at the bottom that reduces over time is the diminishing interest expense over the life of the lease. The sum of these two expenses equate to the red curved line at the top of the graph. You can see at the beginning of the lease, these expenses are dilutive to NPAT; towards the latter period of the lease, the impact is accretive to NPAT. The area under and over the red line, the same size, effectively cancelling each other out, so the expense recognised pre- and post-AASB 16 is the same. Now in an aggregated lease portfolio, the stage at each lease is at will differ, and as leases are renewed the effect will be less pronounced.

Turning now to G8 specifically. Slide 9 outlines the Centre Lease Portfolio. The weighted average lease expiry, without options, is circa six years; including all options, circa 20 years.

Slide 10 outlines the G8 Lease Liability and how this links to the operating lease commitments previously disclosed in the 2018 Annual Report. The AASB 16 lease liability is lower than the $754 million lease commitment disclosed, due to the addition of reasonably certain options offset by the application of lease-specific discount rates. This results in a lease liability of circa $700 million. So the more options that are recognised, the larger the lease liability will be. I do note that short-term leases and low value leases are not taken onto the balance sheet.

Turning to slide 11, the corresponding Right-of-Use Asset is $611 million, with a Deferred Tax Asset of $29 million. You'll note this asset does not match the lease liability; this is due to the transition method adopted where the asset is treated as though the standard always applied. The resulting reduction in net assets is $69 million, which is reflected as a reduction in retained earnings.

The resulting impact on the G8 income statement is outlined on slide 12. To portray the estimated impact of AASB 16 on the G8 income statement, the disclosed calendar year '18 numbers have been used. We've then overlayed the estimated 2019 Lease Portfolio to demonstrate the impact. These numbers are unaudited, non-IFRS numbers.

The extent of the impact of AASB 16 on NPAT will differ for each Company, depending on a number of factors, including; the lease composition of the Company, the number of options considered as certain to be renewed, rental as a proportion of NPAT, the transition method chosen, the Company's borrowing rate, the stage of the leasing profile a Company is at, and for G8 the result of these factors is a lower post-AASB 16 NPAT in calendar year '19.

Firstly let's look at the changes to the way the cost of the lease is expensed. Under AASB 16, the rental expensed is replaced by depreciation expense and an interest expense. The sum of the prior rental expenses and depreciation interest equal each other over the life of the lease. This results in EBITDA increasing, because the $107 million rental expense is removed from above the line, and both depreciation and interest expense are below EBITDA. EBIT also increases, because the $107 million rental expense is removed and only partially replaced by $77 million in depreciation, therefore increasing by $30 million.

The $44 million portion, relating to interest expense, will be below the EBIT line. The [tax-effected] impact of this is $10 million reduction in NPAT. The driver of this reduction is predominantly interest expense which is higher because G8 is in the first half of its leasing profile. A further nuance for G8 is the seasonality of earnings where the first half generates lower earnings than the second half. Therefore AASB 16 will have a higher relative impact on the first half as the expenses are broadly incurred evenly during the year.

Given the lease portfolio is not static, the impact on NPAT in future years will also change, reflecting the changes in the portfolio and the respective underlying leases. The $10 million estimate captures reasonably certain renewals on leases, fixed rental increases, as well as leases where there are minimum rent increases. Variable lease escalations, such as CPI rent increases, are not captured in this estimate and under AASB 16.

The implications for the cash flow statement are outlined on slide 13. The cash generation of the Company does not change due to the new accounting standard. There is a reclassification in the cash flow statement between operating and financing activities, but there is no change to net cash flows.

Turning now to slide 14; to demonstrate the flow-on effect that these changes have on gearing ratios, we have taken the earlier estimates of lease liability, EBITDA and interest. Whilst the ratios are affected, the absolute gearing level of G8 has not changed and the terms of our debt facilities are also unchanged. Importantly AASB 16 has no impact on G8's lending arrangements as we have agreed with our lenders that the application of the standard will not impact our existing covenant arrangements or the headroom we have available.

To recap on slide 15, AASB 16 is a change in financial statement reporting. There's no change to cash earnings or cash generation, no impact on debt covenants, facility headroom or strategic plans. And shareholders can have the same expectations to dividends pre- and post-AASB 16. To assist investors and analysts, the Company will provide transparency on a pre- and post-AASB 16 basis going forward in its disclosures, as the transitions to the new standard is absorbed.

Kevin, we'll now take questions.

Operator: Ladies and gentlemen, we'll now begin the question and answer session. If you wish to ask a question, please press star one on your telephone and wait for your name to be announced. If you wish to cancel your request, please press the pound or hash key. Once again ladies and gentlemen, it is star one. Thank you.

Once again ladies and gentlemen, to ask your telephone question, it's star one. At the moment there's no further questions.

Sharyn Williams: Okay, thank you Kevin. We'll wrap up the call now; thank you for joining us.

Operator: Ladies and gentlemen, that does conclude the call for today. Thank you for participating; you may all disconnect. Goodbye.

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