Updating Our Models to Close New Off-Balance Sheet Debt Loopholes

The Financial Accounting Standards Board (FASB) introduced ASU 2016-02 (Topic 842) to require companies to recognize operating lease assets and liabilities on the balance sheet. Details here. However, companies have found other ways to continue to hide lease debt from their balance sheets as detailed in Variable Leases Under ASC 842: First Evidence on Properties and Consequences. As a result, we're updating our models to ensure they capture all liabilities related to operating leases, both on and off-balance sheet.

Background

As part of ASU 2016-02, companies can exclude variable lease payments from the initial recognition of the total operating lease obligation if certain criteria are met. Companies can classify a lease as variable if it is linked to an index or specific rate or based on a performance metric or output.

Lease payments based on a performance metric or output are excluded from the initial calculation of the total lease obligation. As the performance metrics are met, a company incurs variable lease costs in lieu of revaluing the total obligation.

Because companies can exclude these variable lease costs from the total operating lease obligation, they can materially reduce the amount of lease liabilities reported on the balance sheet. As a result, we updated our models to capture variable lease costs in our standardized present value of future operating leases calculation.

Additionally, ASU 2016-02 requires companies to provide information on leases that are signed and create significant rights or obligations for the lessee but have not yet commenced. These "Not-Yet -Commenced" leases are also excluded from the operating lease obligation, and we updated our models to capture them in our standardized present value of future operating leases calculation.

The Update: Including Variable and Not-Yet-Commenced Lease Expenses in Operating Leases

Variable Lease Expense: Starting on February 10, 2023, we will include variable lease expenses in our standardized present value of future operating leases calculation. We use a multiplier (Variable Lease Expense / Operating Lease Expense) to value the variable lease expense; so we can and add it to our present value of operating leases calculation. For example, using the data in Figure 1, we divide the disclosed variable lease expense of $90,852 on page 66 of Lululemon Athletica's (LULU) 2022 10-K by the operating lease expense of $215,549 to calculate a multiplier of 0.42. We then multiply our standardized present value of operating leases by the multiplier (e.g. 0.42) to determine the present value of variable leases. Then, we add the present value of variable leases to the standardized present value of operating leases.

Figure 1: Variable Lease Expense In Lululemon's 2022 10-K

	2021	2020	2019
	(In thousands)		
Net lease expense:			
Operating lease expense	$ 215,549	$ 193,498	$ 176,367
Short-term lease expense	12,366	11,721	9,358
Variable lease expense	90,852	60,991	70,957
	$ 318,767	$ 266,210	$ 256,682

Sources: New Constructs, LLC and company filings.

These model changes will impact Invested Capital and net operating profit after-tax (NOPAT) for companies with material variable lease expenses. More details below.

Not-Yet-Commenced Lease Expense: Starting on February 10, 2023, we will include Not-Yet-Commenced leases in our standardized present value of future operating leases calculation. Similar to our adjustment for variable lease expenses, we use a multiplier (Not -Yet-Commenced / Total Lease Payments) to value the Not-Yet-Commenced leases; so we can and add it to our present value of operating leases calculation.

For example, using the data in Figure 2, we divide the disclosed value of Not-Yet-Commenced leases of $379.7 million on page 67 of Lululemon's 2022 10-K by the disclosed total lease payments of $944.8 million to calculate a multiplier of 0.40. We then multiply our standardized present value of operating leases by the multiplier (e.g. 0.40) to determine the present value of not-yet-commenced leases. Then, we add the present value of Not-Yet-Commenced leases to the standardized present value of operating leases.

Figure 2: Not-Yet-Commenced Leases In Lululemon's 2022 10-K

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As of January 30, 2022, the Company's minimum lease commitment for distribution center operating leases signed but not yet commenced was $379.7 million, which is not reflected in the table above.

Sources: New Constructs, LLC and company filings.

Impacts on our Models

Our updated calculations to capture variable and Not-Yet-Commenced leases will increase both Invested capital and net operating profit after tax (NOPAT) for affected companies. Invested capital will increase since variable and Not-Yet-Commenced leases will be added to total invested capital. NOPAT will increase since the interest expense related to variable leases will be removed to ensure an apples-to-apples, unlevered measure of the company's profits.

Figure 3 highlights companies that will have the largest change to the present value of future operating leases due to the inclusion of variable leases.

Figure 3: Largest Changes in PV of Future Operating Leases Due to Variable Leases

Company	Ticker	% Increase to Op Lease	% Increase to Invested Capital
Newmont Corp	NEM	1871%	4%
Hormel Foods	HRL	1803%	11%
Evergy Inc.	EVRG	1286%	3%
CMS Energy Corp	CMS	1125%	1%
Prestige Consumer Healthcare	PBH	909%	4%

Sources: New Constructs, LLC and company filings.

Figure 4 highlights the companies that will have the largest change to the present value of future operating leases due to the inclusion of Not-Yet-Commenced leases.

Figure 4: Largest Changes in PV of Future Operating Leases Due to Not-Yet-Commenced Leases

Company	Ticker	% Increase to Op Lease	% Increase to Invested Capital
PDC Energy	PDCE	536%	0.4%
CarGurus Inc.	CARG	335%	30%
ZoomInfo Technologies	ZI	316%	12%
Neurocrine Biosciences	NBIX	205%	39%
Elanco Animal Health	ELAN	195%	2%

Sources: New Constructs, LLC and company filings.

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Disclosure: David Trainer, Kyle Guske II, Matt Shuler, and Sam Moorhead receive no compensation to write about any specific stock, style, or theme.

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Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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