X5 Retail Group N.V.
IFRS 16 Conference call held on 25 March 2019
Edited transcript

Speakers:

- Natalia Zagvozdina, Head of Corporate Finance and IR
- Natalia Gaynullina, Head of Financial Reporting and Accounting
- Andrey Vasin, Head of Investor Relations
- Andrey Dyadechko, Head of IFRS Reporting

Participants asking questions:

- Maria Kolbina, VTB Capital
- Nikolay Kovalev, VTB Capital
- Elena Jouronova, J.P. Morgan

Operator:

Good afternoon, ladies and gentlemen, thank you for standing by. Welcome to the X5 IFRS 16 conference call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a Q&A session, at which time, if you wish to ask a question, you can press "*1" on your telephone and wait for your name to be announced. I also must advise you that this conference is being recorded today, 25 March 2019. I would now like to hand the conference over to your first speaker, Natalia Zagvozdina, Head of Corporate Finance and IR.

Natalia Zagvozdina:

Good morning and good afternoon, ladies and gentlemen. This is Natalia Zagvozdina, Head of Corporate Finance and IR at X5 Retail Group. I would like to welcome you to our special briefing dedicated to the introduction of IFRS 16 new accounting standard.

The aim of this call is to provide you with a framework of the new standard and our view as to how it might impact our business and our financials. We will explain main principals, highlight some important factors and give qualitative explanation regarding IFRS 16. We will be happy to answer your questions after a presentation.

Now, let me introduce our speakers today. Details of IFRS 16 methodology and impact on our financials will be presented by Natalia Gaynullina, Head of financial reporting and accounting. Also here with me, available for your questions, are Andrey Dyadechko, Head of IFRS reporting and Andrey Vasin, head of Investor Relations.

Before we begin, please let me remind you that starting from Q1 2019, X5 will be reporting its financial results under two standards: the new IFRS 16 as well with the old IAS 17 standard, which will be comparable with the previous year. The first such dual reporting will be on April 25, when we release our Q1 financials.

Let me start with our view on what IFRS 16 standard is designed for and its essence. IFRS 16 seeks to align the presentation of leased assets more closely to owned assets. Leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. A right-of-use asset and lease liability are brought on to the balance sheet, with the lease liability recognised at the present value of future lease payments. Whilst the right-of-use asset is matched in value to the lease liability at inception, it differs in value through the life of the lease.

A general statement from us regarding the alignment of the new standard with realities of the Russian retail market is that even though our lease agreements for stores are long-term, we, as well as real estate owners, both have cancellation options in our lease contracts. In that sense, our long-term agreements are not really binding, but rather an indication of both parties' long-term intention to lease. Having said that, let me confirm that we prefer long-term contracts to ensure predictability of our business and reduce risk of business disruption.

Our main message to you today is that the new IFRS 16 standard has no economic impact on our business. The new accounting method for assets in long-term lease, which for X5 include more than 12.5 thousand stores and 32 distribution centers, does not change our cash flows or our approach to leases, or related business practices or cost of these leases. It also does not impact our ability to pay dividends, which is limited only by our financial leverage target of staying below 1.8x Net Debt-to-EBITDA.

At the same time, impact of the IFRS 16 standard on financial accounts of the company is significant. We will rely on the market to determine new benchmark levels for retailers' financial ratios under the new accounting standards. 2019 will likely be a transitional period for companies, investors and analyst to agree on the approach to value retailers and compare them.

Let me pass the floor to Natalia Gaynullina to walk you through the main differences in our financial results presentation under the new accounting standard. After that we will be ready to take your questions.

Natalia Gaynullina:

Thank you, Natalia. Hello, ladies and gentlemen.

As was already mentioned, the new standard will affect the way our leases are represented in our financial statements. Value of assets and liabilities on the balances sheet, as well as some lines in the income statement will be significantly changed. I will explain main principals of these changes in a few minutes.

Please also note, that IFRS 16 applies only to fixed lease payments. If lease is linked to revenue, it does not fall under IFRS 16 except for the minimum floor amount. X5, however, has a fairly small percentage of lease payments with rent linked to revenue.

Let us look at main input data to calculate the impact of IFRS 16 on X5 financial results and ratios.

Let us start from the balance sheet.

In our 2018 IFRS accounts, we already provided an estimate of our balance sheet value of lease liabilities and right-of-use assets at the range of 410-460 billion roubles as of year-end 2018. Let me explain how this figure was derived.

Future lease payments, rent indexation and the remaining life of the leases are the main inputs for the calculation. Our total lease expenses amounted to 80.8 billion roubles in 2018, including 5.4 billion roubles of lease that we paid for our distribution centers. Lease expenses linked to revenue totaled 3.8 billion roubles. Weighted average remaining life of our store lease portfolio was between 6 and 7 years at the end of 2018. The methodology to calculate the value of the lease liability is to discount back to present all future minimum fixed cash lease payments to be made over the lease term. While doing so, we should account for minimum guaranteed and actual lease indexations each year, and we also need to assume that no modifications are made to any of our lease agreements. If such modification occurs, the lease liability is recalculated with the corresponding adjustment to the right-of-use asset. On top of that, new openings planned for 2019 and future periods will have to be accounted for differently – using their actual life of lease, which can be longer than those used for the existing portfolio of stores.

The initial measurement of the right-of-use asset is its cost, which consists of the initial measurement of the lease liability, lease payments made at or before the commencement of lease (such as advances, guarantee payments and etc.) and initial direct costs.

Let me comment on the discount rate that should be used for present value calculation of the lease liabilities. It is not a usual weighted average cost of capital. IFRS 16 suggests that a purchase of an asset should be a benchmark for any company's decision to lease vs purchase and thus it prescribes to use the interest rate implicit in the lease or the incremental borrowing rate if the first one is not available, which, as you all understand, is our case due to the size of our lease portfolio. Therefore, incremental borrowing rate at the date of initial application should be used as a discount factor. We, therefore, should take an OFZ rate of an appropriate duration to match the remaining life of the lease portfolio, and apply a fair corporate spread on top of it, to derive the discount rate.

Now, let me draw your attention to one important detail. In each reporting period going forward, and we report quarterly, the value of existing portfolio of lease liabilities and assets that appear on the balance sheet will be reducing in line with the amount of time left until the lease contracts expire or come for prolongation. At the point of prolongation, the same liability and asset are again brought to the balance sheet, but with a new term of the lease, and hence with a new value.

When the assets and liability appear on the balance sheet, the asset starts depreciating with the interest on the lease liability being charged in the P&L.

X5 will use a modified retrospective approach for the new standard application. We applied cost vs benefits analysis of available methods to introduce the new standard, and it was decided that for X5, which has nearly 5 million m2 of selling space in lease (this is 76% of all selling space that we operate), and more than 12.5 thousand lease agreements in total, the modified retrospective was the most efficient method. Under this approach the prior year figures will not be restated and both lease liabilities and right-of-use assets will be recognised at the date of transition. The lease liability will be measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the right-of-use asset on a lease-by-lease basis, at either:

- Its carrying amount as if IFRS 16 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application (Alternative 1)
- An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments (Alternative 2).

The choice of alternatives is made on a lease-by-lease basis. We have chosen the most significant leases to be calculated under alternative 1, the remaining being calculated under alternative 2.

A final comment on the balance sheet with regards to IFRS 16. After the initial recognition, the right-of–use assets (without the effect from including advances into such assets) is generally lower than the corresponding liability (being the present value of future minimum lease payments). Thus for the leases calculated using the modified retrospective method the asset recorded at the transition date (which is 1 of January 2018) will be lower than liability. This difference is accounted for in retained earnings. Besides that, on initial application, initial direct costs will be excluded from the measurement of the right-of-use asset with the adjustment recorded in retained earnings.

Finally, let me walk you through the lines of INCOME STATEMENT that will change under IFRS 16. First, I would like to draw your attention that for lessees, the income statement presentation and expense recognition pattern will be similar to today's financial lease. i.e. separate interest and depreciation expenses with generally higher periodic expense in the earlier periods of lease in comparison to the amount of lease expenses under the previous standard. The lease expense is replaced by a combination of two items: First) depreciation of the right-of-use assets AND, Second) the interest calculated for the lease liabilities. The interest rate is the same as was used to calculate present value for the balance sheet. Depreciation of the right-of-use assets is calculated on a straight-line basis. It is important to remember, that over time, the interest calculated for lease liabilities, will be coming down because the carrying amount of the lease liabilities on the balance sheet will also be reduced by the lease payments made during the life of the lease. After a few years the impact from IFRS 16 on net income will turn positive assuming no modifications resulting in an increase of a lease liability. In general, the amount of expenses recognised for the whole life of the lease will be the same under old and new accounting standards, being more front-loaded under IFRS 16.

Let me summarize key impacts you are going to see on our P&L from IFRS 16:

- Revenue will not be affected
- Gross profit and gross margin will be slightly higher because lease for distribution centers, which was previously a part of our cost of goods sold, will be removed from gross profit calculation
- Operating store lease expenses will be removed from operating costs
- Additional new depreciation on our leased assets will appear under operating costs (but the amount will be lower than lease expenses we used to have there before).
- Absence of lease expenses and additional depreciation will push our EBIT and EBITDA substantially higher. Please also note, that purely from P&L reclassification, our rent expenses will not be visible in the income statement. You would need to check our operating cash flow to see what we will actually pay for lease of our premises
- Under financial costs, an additional line for the interest expenses on lease liabilities will appear. The amount under this line will NOT be equal to lease expenses either. BUT, for the entire period of any lease, there will be a full match of actual lease payments with calculated interest on lease liability and depreciation of right-of-use asset, but not in each of reporting periods. We know it could be confusing, but this is how the standard works.
- While the standard does not affect tax calculation or actual tax payments, IFRS 16 will result in additional deferred tax asset/income in the P&L.
- And finally, net income will be impacted significantly by IFRS 16 standard, through additional depreciation and interest. Let me repeat, in the first few years the impact on net income will be negative, and after several years the impact on earnings should turn positive in terms of each separate lease.

To conclude our presentation and anticipate some of your questions: we estimate the impact from IFRS 16 on our EBITDA margin in 2019 will be positive and will be between 4 and 5 percentage points. At the same time, the impact on net margin will be negative and significant. We cannot provide you any figures now, however, I think we are going to explain this effect after the Q1 financial statements are published.

Natalia Zagvozdina:

Thank you very much, Natalia. This is the end of our brief presentation and a walk through IFRS 16. Operator, will you please open the call for questions? Thank you.

Operator:

Thank you, ladies and gentlemen. We will now begin the Q&A session. As a reminder, if you wish to ask a question, you can press "*1" on your telephone and wait for your name to be announced. Please stand by while we compile the Q&A queue, this will only take a few moments.

If you wish to cancel your request, you can press "#". Once again, for any questions, please press "*1". We have the first question. It is coming from the line of Maria Kolbina. Please, go ahead, your line is now open.

Maria Kolbina:

Good afternoon. Can you provide any numerical data on the impact on 2018 EBITDA and net income and leverage ratio? The only figures that we have now are from Magnit, which estimates 60%, 20%, 25% and even 3.2x Net Debt / EBITDA for 2018. Can you give some indication how these ratios will look in your case?

Natalia Zagvozdina:

Masha, thank you for your question. The only figure we can provide at this moment is the value of the lease liabilities, which will be brought onto our balance sheet. The estimate for the end of 2018 is RUB 410–460 bn. The rest will give you the impact on EBITDA margin. We have the EBITDA target for the end of this year. For 2018, we will not be restating any figures under IFRS 16, so I am talking only about 2019. We just said that the positive impact on EBITDA margin will be between 4–5 p.p. Regarding net income, we are not ready to give you any indication at this point. We will discuss it on 25 April, and then you will receive exact figures under both accounting standards. As far as financial ratios such as Net Debt / EBITDA, including leases are concerned, let us discuss internally if we will be willing to give you this guidance. If so, you will get it on 25 April.

Maria Kolbina:

Thank you. Do I understand it correctly that most of your logistic centres are leased vs Magnit ones, which are owned, for the impact on EBITDA for you should be even more dramatical than for Magnit, potentially above 60%? Just to get an idea of the magnitude. Do I get it right with regard to the logistic centres and the impact on your numbers?

Natalia Zagvozdina:

Yes, that is an important point that you have made, we lease 32 out of 42 distribution centres that we operate. It impacts the value of the leases on the balance sheet quite significantly – as well as depreciation – which you will see in the P&L report. Indeed, the impact that you have mentioned for Magnit is 60% higher EBITDA under the new standard vs the old one. Following your logic, we should have a more pronounced positive impact on EBITDA.

Maria Kolbina:

Thank you very much.

Operator:

We have another question. It comes from the line of Nikolay Kovalev. Please go ahead, your line is now open.

Nikolay Kovalev:

I wanted to clarify one thing: in the dividend policy, you have a 2x threshold for Net Debt / EBITDA. If, for example, leverage goes up, will you revise your dividend policy or make certain disclaimers? You also commented before that in the second stage of your LTI programme, you have a link to the implied EV/EBITDA in comparison to peers. How will this be adjusted?

Natalia Zagvozdina:

Thank you for your question, Nikolay. Actually, our Net Debt / EBITDA threshold for paying dividends is not even 2x, but 1.8x. 2019 is a transitional year for us as a reporting company in the sector and we believe this is an equally transitional year for the investor and analyst community. Therefore, for this year, we will have two audited figures for both EBITDA and net debt, and our next dividend payment will be based on the previous reporting methodology. By the end of this year, the management team of X5 should present to the Supervisory Board its view whether we should change the metrics for the new LTI programme, as well as for financial budgeting and monitoring. When we agree on that and the management presents it to the Board, we will make it available to the market. It will be done by the end of this year.

Nikolay Kovalev:

OK. Thank you very much.

Operator: We have no further questions coming from the phone lines, but just to remind everyone: if you wish to ask a question, you can press "*1" on your telephone and wait for your name to be announced. We have another question now. It comes from the line of Elena Jouronova. You can go ahead. Your line is now open.

Elena Jouronova:

Hello everyone and, first of all, thanks for organising this call. I have three questions. First: can you please confirm that you had conversations with banks and by now realise that credit conditions will not worsen despite the higher Net Debt / EBITDA?

Natalia Gaynullina:

Yes, we have had these conversations and the new standard will not affect our credit lines as we started preparing for this earlier. Moreover, in all our credit agreements we have a provision that covenants are calculated only for financial liabilities and financial performance figures as if the previous standard is applied. Therefore, there is no effect on our financial covenants.

Elena Jouronova:

But do you think that new credit lines could potentially be at risk?

Natalia Zagvozdina:

I think that over time, the financial institutions will probably transform their approach to addressing the financial covenants for the sector, because Moody's, Fitch and S&P rating agencies have already done so. I think it is only a matter of time for banks to formalise it. But then again, it will be a new benchmark for the Net Debt / EBITDA that is acceptable and not beyond the industry average limit. Earlier, the Net Debt / EBITDA was some 2x–3x, but I guess that with the new standard, the banks will have it somewhere between 3x–4x. But again, this conversation for us have not started, all the existing credit lines for us have a special clause that all the existing covenants are calculated based on IAS 17.

Elena Jouronova:

OK, it makes sense. Then, the second question: you mentioned at the beginning of the call that IFRS 16 is not going to impact the way X5 does business and concludes rental agreements. Does that mean X5 does not intend to conclude more leases based on the percentage of revenue condition instead of the fixed rate?

Natalia Zagvozdina:

I think it is a business decision and nothing is changing in this area because of the switch to another reporting method. When we can and when it makes business and economic sense, we sign lease agreements linked to revenue, but the market realities are that lessors prefer fixed payments with, as you know, some indexation. It also does not mean that all of a sudden, we might start signing shorter-term agreements. No. As we have said, it does not change the way we have been conducting that part of our business.

Elena Jouronova:

OK, then the other question. I am sorry if I missed it, but I do know that the right-of-use assets on the balance sheet will be less than the present value of outstanding lease obligations and the difference is an equity. Is there a way to calculate this difference for the purpose of updating the numbers and the model?

Natalia Zagvozdina:

We are afraid we cannot provide you with enough ammunition to calculate it now for the year. If you are patient, let us wait for 25 April when we will release the first set of accounts under both standards. There will be a conference call and we will have the numbers in front of us. Maybe then we will have a more meaningful discussion.

Elena Jouronova:

No, I just meant methodologically, because we have IFRS specialists on the line, maybe they could explain that without telling me any numbers; methodologically, what should be deducted from the present value of lease obligations to get to the right-of-use assets on the balance sheet. Is that something like depreciation or a particular cost? I think it was explained, but I probably missed it.

Andrey Dyadechko:

Hello, this is Andrey Dyadechko, Head of IFRS Reporting. I would say that the main thing you should know to calculate that difference is the remaining life of the exact lease and the full life of the same lease. Knowing that, I mean the difference between the remaining life and the full life, you can say what amount of deprecation has to be depreciated before the first day of transition. That is the figure you will see in the equity.

Elena Jouronova:

OK, now it is clear. One more clarification. I think that X5 did have leases in foreign currency in Moscow, is that still the case?

Natalia Zagvozdina:

Hold on a second.

Operator:

We have no further questions coming from the phone lines, please continue.

Andrey Vasin:

I am afraid we cannot provide any further information on your question as of now. Thanks for understanding.

Elena Jouronova:

OK. Thank you.

Operator:

Again, just to remind everyone: if you wish to ask any question press "*1" on your telephone and wait for your name to be announced.

Natalia Zagvozdina:

All right. Thank you very much for attending our call today, dear colleagues. Next time we will meet with some of you who are based in Moscow on Wednesday, when we will commence our non-deal roadshow with the management. We will speak with you later when we release Q1 numbers. Have a good day. Thank you.

Operator:

Ladies and gentlemen, that does conclude our conference call for today. Thank you for participating, you may all disconnect.