Updating the Operating Lease Obligation Discount Rate

As part of our commitment to providing the best and most transparent company valuation models, we are constantly reviewing and adapting our processes and methodologies to changing market conditions and accounting rules. We recently discovered an opportunity to improve the discount rate for capitalizing operating lease payments.

This report explains the update and details the impact is has on our models and Risk/Reward ratings.

When You Will See the Change: Thursday, July 30

This update will go into effect on our site the morning of Thursday, July 30. Affected companies will be marked with the Analyst Note "Updated Operating Lease Discount Rate."

The Update: Lowering the Operating Lease Obligation Discount Rate

Due to the actions of the Federal Reserve, interest rates have been, and remain, at all time-lows. We do not see this interest rate environment changing anytime in the near future, and believe that low interest rates are the new normal.

As a result, we are lowering the discount rate we use to discount operating lease payments from 5.07% to 4.45%, a decrease of 62 basis points.

What is the Operating Lease Obligation Discount Rate?

Operating leases do not transfer ownership of an underlying asset, and payments are made over time for usage of the asset. Prior to Accounting Standards Update 2016-02, operating leases were not reported on a firm's balance sheet. However, we have always included the effects of operating leases in our models.

For the balance sheet adjustments, we add the present value of the future minimum lease payments, discounted by the operating lease obligation discount rate, to our calculation of Invested Capital. For the income statement adjustments, we add the implied interest for the debt funding the capitalized leases to our calculation of net operating profit before-tax (NOPBT) and net operating profit after-tax (NOPAT).

Impact on our Models

This update will impact multiple calculations in our models, which are outlined below.

1. A firm's NOPBT and NOPAT will be lower, as the implied interest costs for operating leases, which we add to NOPAT, will be lower.
2. Cash operating taxes will also be lower because NOPBT is lower.
3. Invested capital will increase due to the larger value of the present value of operating leases.
4. A firm's weighted average cost of capital (WACC) will decline since we treat operating leases as debt and debt has a lower cost of capital compared to equity. This change will also lead to higher terminal values in our DCF.
5. The fair value of total debt will increase, due to the higher present value of operating leases.
6. Return on invested capital (ROIC) will decline due to a lower NOPAT and higher invested capital.

How the Update Impacts your Portfolio and Stock Ratings

Any stock with a rating impacted by the operating lease obligation discount rate update will be flagged with the Analyst Note "Updated Operating Lease Discount Rate". For more information Analyst Notes, click here.

We expect around 20 stocks to be significantly impacted by this update and may see a downgrade in their overall Risk/Reward rating. We'll provide a list of all stocks affected on or before July 23, 2020.

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

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The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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