





Executive Summary

IFRS 16 is an International Financial Reporting Standard issued by the International Accounting Standards Board (IASB) that addresses the accounting for leases. Effective for annual periods beginning on or after January 1, 2019, IFRS 16 replaces the previous lease accounting standard IAS 17.

Prior to the adoption of IFRS 16, lease accounting under IAS 17 distinguished between two types of leases for lessees: operating leases and finance leases. Operating leases were off-balance sheet arrangements where lease payments were recorded as operating expenses, reducing operating income but not increasing reported liabilities. Finance leases, on the other hand, were capitalized on the balance sheet, recognizing both an asset and a corresponding liability, with interest and depreciation charged through the income statement.

IFRS 16 fundamentally redefined lease accounting by eliminating this distinction for lessees, mandating a single lessee accounting model that requires recognition of nearly all leases on the balance sheet. Lessees now recognize a right-of-use (ROU) asset, representing the right to use the leased asset over the lease term, and a lease liability, reflecting the present value of future lease payments discounted at the implicit or incremental borrowing rate.

This shift has considerable implications for financial statements and business valuation. Operating lease expenses, previously recognized as rental costs reducing EBITDA, are replaced by depreciation of the ROU asset and interest expense on the lease liability. Consequently, EBITDA increases materially since lease payments are no longer an operating expense, affecting key valuation metrics and leverage ratios. Total liabilities increase due to lease liabilities being capitalized, resulting in higher reported debt and gearing ratios.

|| IFRS 16 does not change underlying cash flows or fundamental business economics, but it considerably alters the financial metrics used in valuation, requiring new approaches to maintain analytical rigor.

Overall, IFRS 16 enhances transparency by bringing previously hidden lease obligations onto the balance sheet but introduces complexity in financial analysis and valuation, requiring careful adjustments and judicious use of lease data. Proper insight into lease terms, distinction between depreciation and interest components, tax effects, and the timing of the valuation relative to the lease term are critical to producing accurate and comparable valuation outcomes under the new standard.



Pre-IFRS 16 Financials

1.1 Pre-IFRS 16 Profit and Loss Statement

in AED millions	2020	2021	2022	2023	2024	2025
Revenue	680	850	1,020	1,173	1,349	1,551
<i>Growth</i>		25%	20%	15%	15%	15%
Gross Profit	204	272	337	387	459	496
<i>Gross margin</i>	30%	32%	33%	33%	34%	32%
Rental expense	50	50	50	50	50	50
Other expenses	23	25	28	31	34	37
EBITDA	131	197	259	306	375	409
<i>EBITDA margin</i>	19%	23%	25%	26%	28%	26%
Depreciation	20	22	24	27	29	32
EBIT	111	175	235	280	346	377
<i>EBIT margin</i>	16%	21%	23%	24%	26%	24%
Interest paid	10	10	10	10	10	10
PBT	101	165	225	270	336	367
<i>PBT margin</i>	15%	19%	22%	23%	25%	24%
Tax paid	9	15	20	24	30	33
Net Profit	92	150	204	246	305	334
<i>Net Profit margin</i>	14%	18%	20%	21%	23%	22%

1.2 Pre-IFRS 16 Balance Sheet

in AED millions	2020	2021	2022	2023	2024	2025
Share capital	30	30	30	30	30	30
Reserve	131	296	520	790	1,126	1,493
Shareholders equity	161	326	550	820	1,156	1,523
Short term borrowings	25	25	25	25	25	25
Current liabilities	50	50	50	50	50	50
Total borrowings	75	75	75	75	75	75
Equity & Liabilities	236	401	625	895	1,231	1,598
PPE	100	111	123	137	152	169
Current Assets	80	89	99	109	121	135
Cash	56	201	403	649	958	1,295
Total Assets	236	401	625	895	1,231	1,598



Post-IFRS 16 Financials

2.1 Post-IFRS 16 Profit and Loss Statement

in AED millions	2020	2021	2022	2023	2024	2025
Revenue	680	850	1,020	1,173	1,349	1,551
<i>Growth</i>		25%	20%	15%	15%	15%
Gross Profit	204	272	337	387	459	496
<i>Gross margin</i>	30%	32%	33%	33%	34%	32%
Rental expense	-	-	-	-	-	-
Other expenses	23	25	28	31	34	37
EBITDA	181	247	309	356	425	459
<i>EBITDA margin</i>	27%	29%	30%	30%	32%	30%
Depreciation	59	61	63	65	68	71
EBIT	122	186	246	291	357	389
<i>EBIT margin</i>	18%	22%	24%	25%	26%	25%
Interest paid	28	26	23	20	17	14
PBT	94	160	223	271	340	375
<i>PBT margin</i>	14%	19%	22%	23%	25%	24%
Tax paid	8	14	20	24	31	34
Net Profit	86	146	203	247	309	341
<i>Net Profit margin</i>	13%	17%	20%	21%	23%	22%

2.2 Post-IFRS 16 Balance Sheet

in AED millions	2020	2021	2022	2023	2024	2025
Share capital	30	30	30	30	30	30
Reserve	124	284	507	778	1,118	1,493
Shareholders equity	154	314	537	808	1,148	1,523
Short term borrowings	25	25	25	25	25	25
Current liabilities	50	50	50	50	50	50
Lease Liability	200	166	129	89	46	-
Total borrowings	275	241	204	164	121	75
Equity & Liabilities	429	555	741	972	1,269	1,598
PPE	100	111	123	137	152	169
Right-of-Use Asset	193	154	116	77	39	-
Current Assets	80	89	99	109	121	135
Cash	56	201	403	649	958	1,295
Total Assets	429	555	741	972	1,269	1,598



Lease Capitalization

3.1 Lease Liability and Right-of-Use Assets calculation

in AED millions	2020	2021	2022	2023	2024	2025
Lease Liability Entry						
Lease payments	50	50	50	50	50	50
Present value factor @ 8%	0.926	0.857	0.794	0.735	0.681	0.630
Present value of Lease liabilities	46	43	40	37	34	32
Opening balance of Lease liabilities	231					
Opening balance	231	200	166	129	89	46
Add: interest @ 8%	18	16	13	10	7	4
Less: Lease payments	50	50	50	50	50	50
Closing balance	200	166	129	89	46	-
Right of Use Asset Entry						
RoU opening balance	231	193	154	116	77	39
Depreciation	39	39	39	39	39	39
RoU closing balance	193	154	116	77	39	-

Under IFRS 16, operating lease expenses are replaced by higher depreciation and interest charges. As a result, EBITDA increases, while EBIT and net profit remain relatively unaffected, since the rise in depreciation largely offsets the removal of lease expenses (as shown in Table 1.1 and 2.1).

At the balance sheet level, lease liabilities and corresponding right-of-use (ROU) assets are now recognized, leading to an increase in both total assets and total liabilities (as shown in Table 1.2 and 2.2). Consequently, ratios such as gearing (debt/equity) and net debt/EBITDA initially rise, but gradually decline over time as lease liabilities are amortized.

Previously, lease rentals of AED 50 million (as reported in Table 1.1) were included in operating expenses. Under IFRS 16, however, this treatment is replaced by recognition of a lease liability, classified as debt and accruing interest, along with a matching ROU asset that is depreciated over the lease term. This reflects the lessee's control over the underlying asset, as illustrated in Table 3.1.



Valuation Impact

Pre-IFRS 16 Discounted Cash Flow

	2021	2022	2023	2024	2025
EBITDA	197	259	306	375	409
Less: Depreciation	(22)	(24)	(27)	(29)	(32)
EBIT	175	235	280	346	377
Less: taxes	(16)	(21)	(25)	(31)	(34)
EBIT(1-T)	159	213	255	315	343
Add: Depreciation	22	24	27	29	32
Less: change in WC	(9)	(10)	(11)	(12)	(13)
Less: capex	(11)	(12)	(14)	(15)	(17)
FCFF	161	216	257	317	345
Discount Period (years)	0.5	1.5	2.5	3.5	4.5
WACC (9.74%)	0.955	0.870	0.793	0.722	0.658
PV of FCFF	154	188	204	229	227

Post-IFRS 16 Discounted Cash Flow

	2021	2022	2023	2024	2025
EBITDA	247	309	356	425	459
Less: Depreciation	(61)	(63)	(65)	(68)	(71)
EBIT	186	246	291	357	389
Less: taxes	(17)	(22)	(26)	(32)	(35)
EBIT(1-T)	169	224	265	325	354
Add: Depreciation	61	63	65	68	71
Less: change in WC	(9)	(10)	(11)	(12)	(13)
Less: capex	(11)	(12)	(14)	(15)	(17)
FCFF	210	265	306	366	394
Discount Period (years)	0.5	1.5	2.5	3.5	4.5
WACC (9.74%)	0.955	0.870	0.793	0.722	0.658
PV of FCFF	201	230	242	264	260

Pre-IFRS Valuation

in AED million	Value
Perpetual Growth Rate	3.80%
Terminal Value	3,975
PV of Terminal Value	2,616
Sum of PV of FCFFs	1,001
Enterprise Value	7,593
Less: Debt	(75)
Add: Cash	1,295
Equity Value	8,812
Outstanding Shares	100Mn
Per Share Equity Value	88

Post-IFRS Valuation

in AED million	Value
Perpetual Growth Rate	3.80%
Terminal Value	4,538
PV of Terminal Value	2,987
Sum of PV of FCFFs	1,197
Enterprise Value	8,723
Less: Debt	(75)
Add: Cash	1,295
Equity Value	9,943
Outstanding Shares	100Mn
Per Share Equity Value	99

Although IFRS 16 does not change a business's underlying cash flows, its accounting treatment impacts free cash flow to the firm (FCFF) by eliminating rental expenses from EBITDA calculations, resulting in a higher EBITDA and subsequently increased FCFF over the lease period. This upward adjustment in FCFF leads to a corresponding increase in business valuation and in this example, the valuation increased by 12.5%.

Particulars	Value
Risk Free Rate	3.85%
Equity Risk Premium	4.45%
Asset Beta	0.85
D/E Ratio	4.92%
Equity Beta	0.89
CAPM Cost of Equity	7.80%
Small Size Premium	2.20%
Asset Specific Premium	0.00%
Modified Cost of Equity	10.00%
Interest coverage ratio	38
Cost of Debt	4.79%
Marginal Tax Rate	9.00%
Post-Tax Cost of Debt	4.36%
Debt to Capital Ratio	4.69%
WACC	9.74%

Particulars	Value
Risk Free Rate	3.85%
Equity Risk Premium	4.45%
Asset Beta	0.85
D/E Ratio	4.92%
Equity Beta	0.89
CAPM Cost of Equity	7.80%
Small Size Premium	2.20%
Asset Specific Premium	0.00%
Modified Cost of Equity	10.00%
Interest coverage ratio	28
Cost of Debt	4.79%
Marginal Tax Rate	9.00%
Post-Tax Cost of Debt	4.36%
Debt to Capital Ratio	4.69%
WACC	9.74%

The discount rate, represented by WACC, will not change because we are valuing the company after the lease term has ended. During the lease term, the higher debt arising from lease liabilities increases the company's financial leverage and systematic risk, which is reflected in an elevated Beta. This increase in Beta subsequently raises the WACC, resulting in a lower valuation. Therefore, the timing of valuation relative to the lease term critically influences the discount rate and overall valuation outcome.



Our Thoughts

The IFRS 16 accounting change raises enterprise value, exemplified by a 12.5% valuation increase in this example. However, this effect may be offset during the lease term by increased financial leverage, which elevates beta and the weighted average cost of capital (WACC), mitigating valuation gains.

Accurate valuation under IFRS 16 requires detailed adjustments in cash flow modeling, depreciation, interest, tax implications, and discount rates. The example underscores the need for careful analytical rigor to ensure valuation comparability and to avoid distortions caused by changes in accounting rather than business fundamentals.

IFRS 16 introduces a fundamental change in lease accounting by requiring lessees to recognize nearly all leases on their balance sheets as right-of-use (ROU) assets and corresponding lease liabilities. A critical and challenging judgment under IFRS 16 is the determination of the lease term, defined as the non-cancellable period of the lease plus any periods where the lessee is reasonably certain to extend or not terminate the lease. This judgment significantly affects the measurement of lease liabilities and ROU assets.

In the UAE context, lease term determination gets complicated due to complex extension and termination clauses embedded in contracts, unlike more standardized leases in mature markets. The “reasonably certain” threshold requires assessing all relevant facts and economic incentives, making it a subjective and nuanced decision. For instance, companies may extend average lease terms from 5 to 8 years based purely on judgment, causing substantial inflation in lease liabilities.

Government-linked entities (GLEs) in the UAE, benefiting from implicit sovereign support, often have access to favorable lease terms. IFRS 16’s uniform accounting approach does not reflect these advantages, potentially leading to systematic undervaluation of such companies relative to peers without similar benefits.

Finally, despite investments in technology, approximately 40% of UAE companies still manage lease accounting manually, increasing compliance risks and limiting strategic use of lease data. This highlights an ongoing challenge in the effective adoption and application of IFRS 16.



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