

Article Title: ARCHIVE | Criteria | Insurance | Specialty: Insurance Broker Criteria: Explicitly Incorporating Non-Cancelable Operating Leases Into The Financial Analysis Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled, "Key Credit Factors: Criteria For Rating Insurance Brokers," published on May 29, 2013, which includes adopting, "2008 Corporate Criteria: Ratios And Adjustments," published on April 15, 2008. We rewrote the 2003 implicit interest formula in table 2 in this article to specify that the interest rate originally indicated was 10%.) Although Standard & Poor's Ratings Services has always qualitatively considered non-cancelable operating leases in its rating analysis, it is now explicitly doing so in its financial measurements. The criteria respond to the material use of non-cancelable operating leases by the broker industry as a significant off-balance-sheet financing vehicle. Brokers require a geographic reach of offices to best serve their clientele. These offices must be either purchased or leased. All things being equal, if a company chooses to finance the purchase or long-term use of office space, it would either issue debt and purchase the space or sign a long-term, non-cancelable operating lease. Both transactions are similar in that the corporation has committed itself to a long-term stream of payments. In a debt-financed purchase, the resulting asset, debt, and interest are readily ascertainable and are incorporated into the financial statements. A non-cancelable operating lease transaction is an off-balance-sheet transaction for which only the current-year lease payment is reflected in the financial statements. Incorporating non-cancelable leases into financial measurements will render Standard & Poor's quantitative analysis more transparent by reflecting all assets, liabilities, and interest payments—whether they are on or, in the case of non-cancelable operating leases, off the balance sheet. Application This enhancement in Standard & Poor's quantitative evaluation of insurance brokers was driven by the introduction of two key metrics into the rating methodology. Standard & Poor's has taken the total amount of minimum non-cancelable lease payments as reported in the notes to the 10-K and used this to calculate the net present value of this amount (assuming a 10% discounting rate) and the implicit interest on these leases. In disclosing this data, companies provide an annual breakdown of their minimum non-cancelable operating lease payments for the five upcoming years and then consolidate the remaining years. Standard & Poor's assumes that the annual lease payments in Years six and beyond will be equivalent to those made in Year five, and thus is able to calculate the life of the lease contracts and their net present value. The accompanying tables outline an example of the application of this criteria modification using a composite of Marsh & McLennan Cos. and Aon Corp.'s data as publicly reported in their 10-Ks as filed with the SEC.

Table 1 Incorporation of Non-Cancelable Leases Into Financial Measurements (MIL. \$)

	2003	2004	2005	2006	2007	2008	2009 - 2014
PUBLICLY REPORTED DATA							
AMOUNT ADDED FOR OPERATING LEASE ANALYTICAL ADJUSTMENT							
ADJUSTED DATA AS PER STANDARD & POOR'S REVISED CRITERIA							
Total assets	42,080	3,838	45,918				
Total capital	15,504	3,838	19,342				
Total obligations	5,555	3,838	9,393				
Interest expense	286	365	651				
EBIT	3,731	365	4,096				
EBITDA	4,436	365	4,801				
Fixed charges	344	365	709				
RATIOS							
ROA (%)	5.2	4.7					
Interest coverage (x)	13.0	6.3					
Fixed-charge coverage (x)	10.8	5.8					
Total obligations/total capital (%)	36.0	49.0					
EBITDA/total obligations (%)	79.0	51.0					
Operating cash flow/total obligations (%)	57.0	34.0					
Free cash flow*/total obligations (%)	30.0	18.0					

\*Free cash flow is defined as operating cash flows minus capital expenditures and dividends paid.

Table 2 Calculation of Net Present Value for 2003 FUTURE NON-CANCELABLE OPERATING LEASES (MIL. \$)

	2004	2005	2006	2007	2008	2009 - 2014
801						
738						
641						
556						
485						
513						
Interest rate assumption (%)	10					
2003 net present value	3,838					
2002 net present value	3,466					
Average net present value	3,652					
2003 implicit interest = average net present value x 10%	365					