

## **Aeroflot Group**

### **IFRS 16 Implementation**

**Conference Call Held on 11 June 2019 11:00 AM (UTC + 03:00)**

#### **Edited Transcript**

#### **Speakers:**

- Artem Glaznev, Head of IFRS and Budgeting
- Andrey Napolnov, Head of IR, Deputy Corporate Finance Director

#### **Participants asking questions:**

- Elena Sakhnova, VTB Capital
- Ivan Postevoy, VTB Capital
- Matvey Tayts, Sova Capital
- Alexey Ryabushko, Sberbank CIB
- Denis Vorchik, Uralsib

*Operator:* Ladies and gentlemen,

Welcome to Aeroflot Group IFRS 16 Implementation conference call. I will now hand you over to your host, Mr Andrey Napolnov, Head of IR. Sir, the floor is yours.

*Andrey Napolnov:* Good morning, everyone. I would like to welcome you to our special briefing on introduction of IFRS 16. Today we have two speakers, Artem Glaznev, Head of IRFS and Budgeting, who has been dealing with IFRS 16 for quite a while, and myself.

The standard is quite complicated and caused a number of significant changes in the presentation of airline's accounts globally. At the same time, I would like to highlight that there are different approaches to transition to the new accounting standard, including full retrospective and modified approaches. Different transition methods may result in material differences in P&L and the balance sheet. We used full retrospective approach to transit to the new standard we have restated Q1 2018. To understand the impact of the standard you need to look at last year's results and compare them with the restated ones. Q1 2019 is prepared and presented only under the new standard and all conclusions about the IFRS 16 impact on the recent quarter (the ones that we may refer to during this call) are purely analytical.

At the same time, contractual terms, age of the fleet, currency impact, environment and other factors are also very important when we think about and compare the impact of IFRS 16 on airlines' accounts.

With our Q1 results published, it will be a little easier to illustrate the changes. Let me give a short summary and outline the key changes that we would like to cover in the call. We are definitely going to speak about

- Balance sheet implications: the right of use, lease liability calculation, aircraft return obligations,

- P&L implications and all the lines that are impacted with a particular focus on maintenance with four types of maintenance expenses that are accounted in different ways now.
- Other implications, including hedge accounting.

I am sure that all participants of the call always have many questions on our business performance, expectations, dynamics of our annual costs and we are always ready to address them at our quarterly and follow-up conference calls, but I would like to highlight that this particular event is dedicated to the IFRS 16 implementation and the impact on Aeroflot Group results. And I kindly ask to stick to the agenda of the call.

Now, I would like give the floor to Artem Glaznev, who will address your key questions. We will start with a short presentation followed by a Q&A. To facilitate the digestion of this complicated topic I suggest switching to Russian with a consecutive interpretation into English. Artem, the floor is yours.

*Artem Glaznev (through interpreter):* Good morning, colleagues. Let me give you an overview of my presentation today. We will first discuss the statement of our financial position or essentially the balance sheet and will discuss the assets and liabilities there, then we will switch to P&L statement and will separately discuss the repairs there, and will finish with the discussion of the cash flow statement and the impact there.

Let us start with the assets in our statement of the financial position and I invite you to open our interim financial statement. For your convenience, we will follow it step by step. Let us start with the right-of-use assets. If you look at our balance sheet, the right-of-use assets recognised as at 31 March 2019 were RUB 673 bn.

Let us briefly discuss the breakdown of this amount. The main items that we have recognised on our balance sheet are leased assets. In total, there are about 1,000 items there: 45% is the aircraft that are either in operating or financial lease and 55% are other items and the remaining. By value, this RUB 673 bn, the leased assets of that amount is just over 70%. And the remaining balance (just under 30%) by value of that amount is attributed to other items, most of which are aircraft return obligations or in accounting terms asset retirement obligations (ARO) – our provision for returning the aircraft to the lessor (bringing the returned aircraft into the condition as required under the contract with the lessor). That provision includes our estimates of the costs that we will incur to bring the aircraft into the condition required by the contract to return it to the lessor, which includes the heavy checks that have to be implemented each 10 or 12 years. Specifically, we check the air frame, the engines, the chassis, the repainting of the aircraft, and changing the internal layout.

The asset retirement obligation would be equally reflected in the right-of-use assets on the assets side and also on the liabilities side, not under the lease line but under the provision for liabilities line and also in the financial position statement, which we will discuss later.

And then there are less material items – our scheduled checks, or in other words all our capitalised repairs, most of which are incurred on a six-year basis. Then there is capitalisation of material spare parts, which according to the new standard we have to capitalise and then amortise and depreciate according to their useful life. Also included in the right-of-use assets are the borrowing costs or the loan costs related to the capital spare parts of aircraft, but those are less material, and I don't think we need to delve into them further.

Those were the main items in the right-of-use assets. Importantly, we implement here an item-by-item accounting, i.e. an aircraft is divided into components such as airframe and engine and is depreciated separately. The airframe accounts for 75% of the total amount and the engine accounts for the remaining 25%. To measure the depreciation for airframe we use the useful life range of 9 to 20 years and for engines from 5 to 12 years. For your modelling, we would suggest that you use averages of those ranges. For the airframe that would be 12 years, and for the engine 10 years. The existence of the range is explained by the fact that we have to depreciate over the minimum term, either the term lease or useful life. If under the contract we have a purchase option, i.e. we may buy out the equipment, the aircraft at the end of lease, then we use 20 years, if not then we use the lower number. Also, among the items booked on the balance sheet we have buildings and various housing facilities whose useful life may be up to 36 years. For those items we would advise that you use an average useful life of 8 years.

There is also a category of other items, some 500 of them, which are less material and include things like check-in booths or other operating equipment that we use and the average useful life in the range of 2–14 years and for those we recommend that you use for your modelling an average life of five years.

Let us now move to discussing liabilities that are reflected in the financial position statement to see how they are made up at the recognition date. The total lease liability would be comprised of the total discounted value under all contracts with all the amendments and annexes. And the discount rate used in the lease liabilities is the incremental borrowing cost rate applicable to the period when we signed the respective lease agreements. Since we applied a fully retrospective approach, for historic items we used the borrowing costs which existed at the time or we looked at comparables and public sources to establish that rate.

And again, as we used a retroactive approach we recognised the right-of-use asset at a historic exchange rate, for example if an asset was booked in 2013, we used the book value and the amortised amount based on the exchange rate that could be as low as RUB 30 per USD. For liabilities, we also used a historic exchange rate when booked, but after that we remeasured the liability based on the rate at the time (for instance for liabilities as of the end of Q1 2019). If you were to compare the right-of-use assets on the balance sheet with the total of short-term and long-term lease liabilities, the liabilities will be higher because they are remeasured at the most recent exchange rate.

And the retrospective effect of the difference between the assets and liabilities also flowed through to the equity and was reflected in our financials as at the end 31 December 2018 and 1 January 2019 in accordance with the requirements of the IFRS standard.

I would like to separately mention – on the liability side – the asset retirement obligation which is essentially a provision for the liability related to the return of the aircraft (as we stated above) which is equal to the respective sum recognised in right-of-use assets. This provision is not in our view a debt because it comprises our estimate of the costs that would be incurred to bring the aircraft into the condition required when it has to be returned to the lessor.

This treatment is also corroborated by the fact that according to the standard this amount is to be discounted at a risk-free rate versus, for example, the lease obligations, which are discounted at the borrowing cost rate.

Let us now discuss the statement of profit or loss, and the items there, especially as they relate to the statement of financial position.

We will start this discussion with depreciation. In Q1 2019, the amount we recognised was approximately RUB 27 bn. Some 60% of the depreciation recognised in the reporting period relate to the assets on the balance sheet, which were the right-of-use assets. There are also several components related to capitalised repair and maintenance costs.

One of the components is the already mentioned provision to bring the aircraft into the condition required for its return to the lessor (ARO). That is some 25% of total depreciation for the period. There is also a component that relates to the capitalised repair costs we have put on the balance sheet, related mostly to six-year checks. That amount previously mentioned is just under 5%. Also, the depreciation of capitalised spare parts is much less material, under 1%. And the balance is the depreciation of the fixed assets and intangible assets previously existing, some 3%. From all the clarifications, we see that all the items recognised as right-of-use assets on the balance sheet, including items related to repair and maintenance, are included in the depreciation and smoothly amortised in the statement of profit or loss.

Let us now discuss the interest expense item in the statement of profit or loss. Whereas under the previous treatment the total operating lease payment consisted essentially of two parts – the principal and the interest, now, according to the new standard, there are again two elements – the principal, which is depreciated, and the interest is now below the operating profit, which has an impact on both the operating profit and EBITDA. In terms of the standard, this is a more adequate accounting treatment, because all the financial activities, such as foreign exchange impact and interest, should be reflected below the operating profit line under IFRS. That interest expense – because it is essentially an element of discounting as we discount the liability at the borrowing cost rate – generates interest expense in our financial statements. This accounts for some 80% of the interest expense in our statement of profit or loss. The balance, just under 20%, which is also a material amount, is interest expense related to the discounting of our obligation to return the aircraft to the lessor. The remaining items are less material and again you can understand them by analysing the detailed breakdown of the assets and liabilities on the balance sheet, especially the liabilities side.

We would also like to discuss two elements related to that: the first one is the new component in the operating lease for items that are non-material and are on lease for less than one year, and the variable lease payments related to them.

The second one is the revaluation related to foreign exchange gains and losses. Whereas we previously applied hedging to our assets under finance lease, we now also apply hedging to aircraft in operating lease.

The revaluation that relates to those liabilities in the period first goes to the equity in the hedging provision line. The basis for this treatment is essentially that our foreign exchange revenue hedges our leased items. Non-cash FX loss that was previously attributed to equity via comprehensive income is realised as we make payments on either operating or finance lease. So, essentially, as we make those payments, we see the realisation of the exchange rate difference that was previously included in the hedging provision. It is this particular element in the operating lease that is reflected during the period in the foreign exchange gains/losses for the period under IFRS 16.

I suggest that we now move to the discussion of all the items on the statement of profit or loss related to repair and maintenance to give you an overview and understanding of each of them.

First of all, I would like to say that the previously existing repair and maintenance element has been modified by the standard that we are discussing today. Because a part of expenses that was previously recognised as repair and maintenance expenses is now reflected as depreciation of the

assets on the balance sheet, the repair and maintenance costs that we currently have on the statement of profit and loss include all the current repairs that are not capitalised, for anything under two years, i.e. any unscheduled repair and the write-off of non-capitalised spare parts.

The second element is the medium-intensity repairs that are booked on the balance sheet and then depreciated, and the most representative of them are six-year checks.

The third element includes the biggest capitalised items, for example overhaul before the aircraft return to the lessor, twelve- and ten-year checks, and six-year checks where applicable, for such items as engines, chassis and the like.

Those three elements impact new repair and maintenance cost that the company recognises in its statement of profit or loss.

I would like to separately discuss two elements of our statement of financial position: financial assets under lease agreements that have current and non-current components. The current component is RUB 1.5 bn, and the non-current component is RUB 19 bn. Essentially, these are payments to lessors for heavy forms of maintenance. Under some contracts, we have the obligation to make those payments to lessors. We receive those payments back as we make the actual repairs. You can see the movement of this balance sheet item on the statement of profit or loss, lines Payments for financial assets under aircraft lease contracts and Repayment of financial assets under aircraft lease contracts. According to IFRS, these elements are also reflected at present value. The discounted component for those elements is recorded in the interest income line.

Then, in our non-current assets, we have other non-current assets. That includes advances to repair service providers that are not explained in the interim financial statements, but the explanation is provided in the annual financial statements. These are so called power-by-hour payments that are reflected as advances, not at present value, so they are not discounted, and they are used as repairs are made.

Now I would like to briefly discuss the cash flow statement. Essentially, we have a new or additional depreciation and new interest expense that we use to adjust the cash flows. That relates to our operating cash flow. Then, in the investment cash flows you will see the heavy forms of maintenance that I mentioned previously. In the financial cash flow related to debts, we have a bigger amount. Whereas previously only the financial lease was reflected, now there are new payments of the principal and interest according to the new IFRS.

With that we suggest that we open the line for Q&A.

*Matvey Tayts:* I have two questions. The first one is about interest expenses. In your statement of profit or loss, you had RUB 3 bn in other expenses, which was substantially a refund for excises. How was this amount transferred from the statement of profit or loss to the statement of cash flows? You can see it in the interest paid under lease contracts.

*Artem Glaznev:* Yes, you are right. This amount is now reflected in depreciation and interest payments.

*Matvey Tayts:* In your statement of cash flows, you have these new right-of-use assets (non-cash transactions as part of the investing activities). Is this also a new item and can you please comment on that?

*Artem Glaznev:* This line was there under the previous standard as well, but essentially, the composition of it has changed under the new standard. And so the amount is also different.

*Ivan Postevoy:* My question is about other operating income and expenses, net, in the statement of profit and loss. It is now above RUB 3 bn. What is included in this in line?

*Andrey Napolnov:* Ivan, this line includes the recovery of excises – payments we have had since 2015. After the restatement almost RUB 3 bn change in the maintenance reserve was capitalized. So maintenance accounting under IFRS16 is the reason behind the increase in that line.

*Alexey Ryabushko:* My first question is about asset retirement obligations. How much is it in monetary terms? You have said that 70% of that is aircraft. But what is the value?

*Andrey Napolnov:* Alexey, do you mean assets or liabilities?

*Alexey Ryabushko:* You can comment on both. But you have mentioned 70% talking about the assets.

*Artem Glaznev:* As we previously mentioned, our provisions for the return of the right-of-use assets is some 20%, which equals RUB 140 bn. You can see a matching amount on the liability side. It is discussed in our Notes.

*Alexey Ryabushko:* My next question is about your lease liabilities. You have said that they will be revalued due to changes in exchange rates, but will there be any remeasurements because of changes in LIBOR, which some of your contracts are linked to?

*Artem Glaznev:* Yes, because of the changes in interest rates, there is some revaluation element, but it has an impact on the interest expense, not the liability. Any changes in the rates will be reflected in the interest expenses.

*Alexey Ryabushko:* Essentially, it will have an effect on the statement of profit or loss but not on the balance sheet. I see.

My third question – I am not sure that you can answer it now, maybe you can to discuss it offline – is about the breakdown of lease liabilities in Q1 2018 and Q1 2019. I can see that there is RUB 15 bn in repayment of the principal element. What are other elements, if you can answer that?

*Andrey Napolnov:* Sure, Alexey, we will answer that after the call, but basically, there were some aircraft additions, changes in exchange rates and debt repayment. Quite straightforward. But we will discuss it offline in person.

*Alexey Ryabushko:* Thank you.

*Elena Sakhnova:* If we look at Q1 2018 as stated initially and restated, we can see that maintenance costs changed by 50% and the repair and maintenance was included in capitalised expenses. Will this trend continue going forward?

*Artem Glaznev:* No, I do not think that this proportion will hold, because on the assets side, as we recognise new aircraft and other items along with repairs, we will put them on our balance sheet at new exchange rates and thus the impact on profit or loss will be different. At some point in the future, it will stabilise as most of our recognised aircraft will be new and the recognised repairs

will also be for the new aircraft and valued at the current exchange rate. I hope that answers your question.

*Elena Sakhnova:* My question was more about the Q2, Q3 and Q4 2018 restatements. Will the proportion hold in this case? What will it be like?

*Artem Glaznev:* We do have some seasonality when it comes to repairs. This might have an impact, but, by and large, the proportion that you have seen in the first restatements should hold. I would like to remind you that Q1 and Q4 account for the largest number of repairs, which are capitalised, and that seasonality may have an impact, but I cannot carve in stone the exact ratio at the moment.

*Elena Sakhnova:* Thank you. My second question is about other income and expenses and the RUB 3 bn added during the restatement. What should we expect for Q2, Q3 and Q4 2018 restated? Will you add something to, or subtract something from the initial figures, or everything has been reflected?

*Artem Glaznev:* The trend should continue. If the amounts were bigger for the other quarters, there may actually be some deductions. But overall, the mechanism will remain the same.

*Elena Sakhnova:* In 2018, your maintenance costs were equal to RUB 45 bn. Should I expect that approximately half of that, which is RUB 22.5 bn, will be capitalised in the restated financials?

*Andrey Napolnov:* Elena, apart from the operating costs line that you are referring to, there was RUB 8.5 bn in other operating income and expenses (disclosed in Note 9 to the financial statements for 2018). If you were to take this maintenance line in operating costs, this would be the amount in question, give or take. But as Artem says, seasonality, exchange rate fluctuation may result in the different proportion.

*Elena Sakhnova:* Very clear. Thank you.

*Denis Vorchik:* My question is about your provisions for returning aircraft to the lessor. How much of these provisions are linked to RUB vs USD?

*Artem Glaznev:* Most of these provisions are FX-linked.

*Denis Vorchik:* Thank you.

*Operator:* Our next question comes from Alexey Ryabushko, Sberbank CIB. Sir, please go ahead.

*Alexey Ryabushko:* If I remember it correctly, there was a ca. RUB 1 bn positive effect on your Q1 2018 bottom line from the restatement. Have you done the exercise to see what the potential effect is for Q1 2019?

*Artem Glaznev:* As we discussed, most of the effect for 2018 was driven by exchange rates. We have not done the exercise for 2019 because we have no audited financial statements prepared in accordance with the previous methodology.

*Artem Glaznev:* I guess the main drivers behind this effect can be understood using the comparatives for 2018.

*Operator:* Thank you, ladies and gentleman. We have no other questions at this moment. Dear speakers, back to you for the conclusion.

*Andrey Napolnov:* Since we do not have any other questions, that concludes our call. Thank you for participating. We will be ready to answer any follow-up questions you might have. Goodbye.