Meeting notes Unit Economics WG Call – May 13, 2019

The Unit Economic WG's objectives were to give a progress report from the UE subcommittees, discuss the remaining challenges for the Unit Economic Working Group, and set tasks/goals ahead of the next call.

1. Time Value of Money

Discount factor vs. Financing costs

1. There is an overall concern that we could be double-counting the financing costs if we take the Present Value calculation of Average Expected Follow On Revenue, and also have a Financing Cost metric.
2. The members of the WG agreed that if we discount Average Expected Follow On Revenue, you also must discount all costs as some of your expenses are taking place over time; otherwise, the unit gross profit will be misleading. However, it is important to note that not all costs take place over time – for instance, Device Costs are booked right away, so this KPI would not be discounted
3. By performing a PV calculation for revenue and costs, it should account for all financing costs, and thus there will not be a need to have a separate Financing Cost KPI
4. If we are discounting expected follow on revenues, this should be over the real collection period and not just the contract. Typically, the contract period and average collection period differs.
5. Some members of the WG support the use of a PV calculation for revenue and costs since it provides a level playing field to all companies, including those that are funded mainly with equity capital
6. One major challenge with performing the PV calculation is the determination of the discount rate to use. Every company has their own discount rate which would then be difficult to compare across different companies. The solution would be to standardize the discount factor to a single figure used for all companies. Even though it may not be as accurate, by having a standard discount rate for all companies will make the KPIs easy to calculate and readily available.

Based upon the discussion there are two approaches to consider:

1. **PV of Revenue and Costs**
   - Using one standard discount rate.
   - Discount back over the lifetime of a product or on sales. This should most likely be the lifetime of a product, but no final decision has been made yet.
   - Not the most accurate, but simplistic and applicable for both capital structures (equity and debt).
   - By doing the PV calculation, it will not be necessary to have a separate Financing Cost KPI since it is accounted as part of the PV calculation
2. **Account for Financing Cost as a separate KPI instead of a PV.**
   - The challenges are that this depends on the different capital structures and business models. Moreover, cost of equity is higher than the cost of debt, so companies with more equity might be penalized.

- To calculate the financing cost, you must include all costs related to all sources of capital (debt, equity and others).

Conclusion:

Most members of the WG were in favor to do the first approach which would require the use of an arbitrary value for the discount rate and discount both the cost and revenue components. An accounting expert has been engaged, and we will pose this question to get his feedback/views. The WG members also discussed the possibility to show the revenue and cost KPIs on a nominal basis and PV calculated basis. This way, the user / investor may decide which one they would like to evaluate.

2. Risk of default/non-payment (Credit Cost)

Suggested Definition

$$[1 - Collection\ Rate]\ x\ Avg.\ Expected\ Follow\ On\ Revenue$$

1. Based on the survey results, it is clear that the suggested definition of Credit Cost is not accurate. By using [1- Collection Rate], it is misleading and only captures customers that may be paying late, but ultimately may not completely stop paying. Therefore, it might be better to look at the %write-off, since we are mainly interested in the potential payments that will never be collected.
2. However, how to define % write-off is currently not consistent across the different PAYGo companies and investors. The Portfolio Quality Working Group has defined a value-based write-off ratio, which is as follows:

$$\frac{Receives\ payables\ outstanding\ under\ contracts\ written\ off\ [180\ days]}{Total\ receivables\ outstanding\ [180\ days]}$$

180 days is the period for measurement. Currently no trigger for 'write-off'. This is a company decision. There is a trigger in PQ to indicate what is at risk., but it remains company policy to decide when something should be written-off. This might be challenging for comparability.

3. Goal of the KPI should be to capture the payments that you are never going to receive and not just the payments that are delayed.
4. Alternative proposed: % default rate x loss given default = credit loss
   a. Challenge would be to define the probability of 'default'.

Alternative KPI Proposed:

Provisioning for credit cost based on accounting guidelines

1. Under IFRS 9, PAYGo companies are required to provision for the revenue / expected payments you expect to lose. That's why you also need to have the probability of what you expect to lose.

2. The provision expense for credit costs is possibly more comparable than the write-off ratio (if IFRS 9 is followed) as write-off depends on the company policies. However, the challenges are as follows:
    a. Do you need to discount this cost the same way you discount all other costs for the PV calculation?
    b. What happens if a company does not use IFRS 9 accounting guidelines for the calculation of provision expense for credit costs?

Conclusion:

Provisioning for credit cost seems to be a better alternative. To calculate the provisioning cost, we can adopt IFRS 9. For the companies that already follow the IFRS 9 guidelines, they would not need to change their reporting. For others, we can include a tool within the dashboard to be created to calculate the provision based on .

3. Financing Cost

We talked about Financing Cost indirectly through the value of money. Options for Financing Cost are as follows:

1. PV – discount rate. We should make it clear that we use an arbitrary value if this method is chosen.
2. Other way of capturing financing cost. If we would not go for the present value approach, a calculation could be:
    - Interest Expense plus Commissions on resources borrowed for operational reasons/units.
    - However, this calculation avoids financing cost due to equity. This calculation becomes tricky with comparability as some PAYGo companies have more equity than debt in their capital structure. I f we decide to go with this calculation, we should make it clear that this does not include cost of equity.

Conclusion:

Preference for the PV method as it is more comparable for different business models and capital structures. As mentioned above, we will discuss this issue with the accounting expert to get his views/feedback.

4. Denominator for Calculation of KPIs on a Unit Basis

Three different options:

1. Active units
2. Assets in circulation (t) = all products that were sold, leased, or rented to the customer, including assets that have been repossessed or returned, but excluding assets which have been written off at a point in time (t).
3. Installed assets = number of assets that have been installed for customers.

To be able to use the Unified Framework, we would need to adopt one denominator that is consistently used for both Revenue and Cost KPIs. The preference would be to use all units installed and include all units written-off/repossessed as well. In this way, you would be able to calculate all

costs and revenues associated with those units regardless whether they are written-off or any other status. This would make more sense from a comparability perspective.

Conclusion:

To make a final decision on which approach is selected, we plan to test with dummy data (provided by some companies from the working group). We could also test whether value based, or quantity based would make more sense.

5. Additional KPIs to Consider

Average Overhead Fixed Costs

$$\frac{Fixed\ costs}{Total\ \#units\ or\ total\ value}$$

Although Fixed Costs are not part of the calculation of Unit Gross Profit, it is important to be comprehensive and have a metric that captures Fixed Costs. Overall opinion that it is good to include this KPI. However, it is tricky to estimate **what is fixed for different types of units and for what time period.**

It was suggested that if this metric was kept, it is best to rename it and define it as 'Breakeven Units to Cover Fixed Costs' to indicate the number of units you need to sell to cover the fixed costs. However, a major challenge would be how to determine the fixed costs which are associated to the units sold. In essence, this would require a methodology to allocate fixed costs to units which is fairly complex and arbitrary by companies.

Conclusion:

Good to keep it as a KPI, but we would have to think more how we can calculate the fixed costs. As of now, using a Breakeven number of units to cover Fixed costs seems to be the best alternative.

Average Repossession Costs

This is an important measure. Yet, not everyone has a repossession model.

Conclusion:

We should leave out this KPI for now as it is more of a secondary level KPI and not a headline KPI.

6. Next steps
1. Collect dummy data from WG members that volunteered to provide some data and build a sample model with examples which can be shared with the WG members to test the viability of the different KPIs
2. Next call end May/beginning of June to go through the examples and do the final check what we have defined so far.
3. Come to an agreement on the definition and formula of all KPIs