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EverestHoldings

Accounting Updates

Recent Trends

Lease Accounting: There appears to be significant change coming soon to the world of Commercial Real Estate in the form of lease accounting. Under current accounting standards, most real estate leases are recorded as operating leases – recorded as rental expense on the income statement. Under the new proposed standards, most real estate leases would be required to be capitalized – recorded on the balance sheet as an asset and a liability. The capitalization of operating leases impact a broad number of financial metrics used by companies, their investors and lenders, and would impact real estate values.

The new standards were created as a result of the SEC targeting lease accounting – with significant liabilities being off-balance sheet - as one of the areas contributing to financial lack of transparency. The new standards are anticipated to be finalized in early 2015, and effective in 2017; existing leases would not be grandfathered.

Under the new standards, U.S. companies as a whole (public and nonpublic) would record approximately $7.8 trillion of additional liabilities. For public companies alone, the additional liabilities are estimated to be over $2.0 trillion. Nearly two-thirds of all these liabilities are estimated to be specifically related to real estate.

How to record a real estate lease under the proposed Standards

At the commencement date, a tenant would measure and record:

•A lease liability (the liability would be equal to the lease payments to be made throughout the term of the lease)

•A right-of-use asset (the asset would be equal to the right to use the property throughout the term of the lease)

•The lease term generally includes extension periods

Financial Statement Impact

The proposed lease accounting changes, requiring the full long-term payments associated with the leases be shown on the balance sheets of the tenant as liabilities, would be devastating to many companies.

▪Lessee's balance sheets would be grossed up for the lease assts and lease obligations. These changes do not relate to changes in the underlying fundamentals of the business, but comparatively appear to imply changes.

▪Companies would likely be forced to reduced spending by deleveraging in order to deal with apparent increases in liabilities.

▪Changes in EBIDTA reporting – interest and amortization expense are not deducted in arriving at EBITDA while rent is (was).

▪Return on assets would decline as total assets (the denominator) would increase.

▪Companies are going to have to track and disclose real estate lease assets. Intel, URS and Chevron report that complying with the new standard would increase accounting costs by $6 million, up to $10 million and more than $50 million respectively.

▪The annual lease expenses for (interest and amortization) would not match lease expense for income tax purposes resulting in deferred income taxes.

Factors that impact corporate real estate strategy

Companies lease rather than own real estate for flexibility: their workforce expands and contracts, their locations needs change, and their financial metrics change. Generally speaking, an operating company can do better by investing resources in the business rather than real estate, as an asset class.

The new standards "bear no resemblance, economically or financially, to what happens contractually in a real estate lease". . . The National Association of Realtors

Accounting Updates - continued

Debt Impact

Critical impact of the proposed standard would be that certain loan covenants may be adversely impaired, forcing companies into violations of their loans.

▪Debt ratios may be skewed for financing – compliance with debt covenants or agreements between the bank and borrower, which usually prohibit companies from borrowing more than they are worth will be impacted .

▪Some companies could show more debt than allowed in their agreements and consequently be in default or have their credit lines revoked forcing economic slow down.

▪Furthermore, companies with higher debt ratios may be forced into increasing borrowing costs through higher loan rates.

▪Changes in EBIDTA may affect existing agreements related not only to loans, but also to compensation, earn outs and commissions.

Operating Leases Obligations Outstanding
Major Retailers

	Lease Debt	Stock Holders' equity	% equity
Office Depot	1.6 B	661 M	248%
Walgreens Co.	28.8 B	18.0 B	160%
CVS	23.0 B	38.0 B	61%
Whole Foods	5.6 B	3.8 B	147%
Sears	3.7 B	3.1 B	119%

Source: Credit Suisse, August 2010

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Impacts to real estate:

▪The lease versus buy decision. The leasing premium associated with a single tenant building may be effectively eliminated. Companies are going to consider the balance sheet impact when structuring leases and in deciding whether to lease or buy the underlying asset. Single-tenant building with long-term leases, may choose to purchase a building instead of leasing it.

▪Duration of Lease Terms and impact on Real Estate Value. Tenants will likely opt for shorter lease terms, with no renewal terms and elimination of contingent rents to shrink their balance sheets. This in turn, will diminish the value of commercial properties and therefore reduce the borrowing capacity of commercial real estate financing.

▪Availability of Capital. Investors such as pension funds, insurance companies and others choose real estate in order to match assets to their long-term obligations, and shortened lease terms may undermine the attractiveness of real estate assets. Ironically, lessors may have to respond through increasing contractual rents as a result of the availability of capital, and shorter lease terms.

▪NNN Lease Investments. The world of credit NNN leases, as a from of real estate investment will change, as credit tenants potentially move to ownership or shorter lease terms.

▪Increased Accounting Complexity and Subjectivity. As tenants are forced to pay higher costs to create and implementing extensive information systems to account for and processes leases in detail, lease negotiation costs may increase. Lessees would have to document and disclose their future renewal intentions and what rents they expect to pay, affecting their negotiation posture with their landlords.

Other potential accounting changes generally seen in Congressional efforts to advance comprehensive tax reform:

Like-Kind Exchange. Like-Kind or "1031 exchange" refers to Section 1031 of the U.S. Internal Revenue Code. This section provides that capital gain taxes can be deferred in cases of exchange of property held for productive use in at trade or business or for investment, provided the properties exchanged are comparable properties. The repeal of like-kind exchanges would increase federal revenues by more the $40 billion over 10 years. The provisions are considered to be a tempting target for both Republicans and Democrats determined to simply the tax codes as they begin 2015 with their initial tax reform plans.

Carried Interest Taxation. Carried interest or "typically a "promote" in the real estate industry is a financial interest in the long-term capital gain of a development given the general partner by the investors in the partnership. It is paid if the property is sold at a profit that exceeds the agreed upon returns to the investors and is designed to give the developer a stake in the ultimate success of the project. This serves to align the interest of the GP with the investors by allowing the GP to share in the upraise of the real estate venture and to compensate the GP for the risks taken during development of the project and the period prior to the sale o the property. Carried interest has traditionally been treated as capital gains , taxed at capital gains percentage.

Comprehensive tax reform discussions drafts introduced in both the House and Senate have eliminated capital gains treatments for carried interest. In the House 's reform legislation in the 113th Congress the provision exempted carried interest used in real estate partnership. The issue is expected to be raised again in the 114th Congress.

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