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"Pulling the Trigger" On Impairment Losses: Perspective Regarding Wipeouts, Write-Downs, Discounted Cash Flow And Positioning By Public Real Estate Companies

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The author discusses the asset categories targeted by commercial real estate companies for impairments, distinguishes between write-downs versus wipeouts, and thereby seeks to provide additional perspective for the evaluation of risk within a somewhat murky commercial real estate environment, indicating that opportunities for managers to take write-downs are increasing.

Public real estate companies have taken a total of over $5 billion in impairment charges since the worsening of the financial crisis in September 2008 through the summer of 2009, a minor level of impairment considering these same companies have collective balance sheet assets in excess of $400 billion. "Triggering events" provide the catalyst and justification for decisions to declare assets as impaired and were either categorized as write-downs or wipeouts by this REMCO analysis. The distinction is that potentially recoverable impairment charges, the write-downs, tend to have a discretionary aspect, with management weighing objectives such as maximizing stockholder value and capital conservation, to determine how these objectives will be served by taking immediate charges to income. Potentially recoverable impairments may involve assets that are unquestionably more than temporarily impaired, and management policies that contribute toward clean and even understated balance sheet presentation demonstrate commitment to exemplary financial reporting standards. Wipeouts lack flexible dimension, certain events have transpired and the resulting impairment charges are unavoidable. Unfortunately for the real estate industry as a whole, wipeouts are on the rise due, for instance, to situations triggered by unresolved debt maturity issues. This article discusses the asset categories targeted by commercial real estate companies for impairments, distinguishes between write-downs versus wipeouts, and thereby seeks to provide additional perspective for the evaluation of risk within a somewhat murky commercial real estate environment, indicating

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that opportunities for managers to take write-downs are increasing.

Wipeouts

The triggers for impairment classified as wipeouts within this article, are charges that ensue from irreversible financial decisions resulting in asset losses. A wipeout occurs when title is conveyed to property at less than carrying value. Listing assets for sale with a brokerage company at less than book value constitutes the developmental stage of a wipeout. Shutting down an offshore subsidiary and writing off associated expenditures, as one Denver based industrial REIT did with their Chinese investments, is an example of an irretrievable investment. Tenant bankruptcies can result in wipeouts from the loss of value for in-place leases. Losing a property to lender foreclosure due to debt maturity that could not be successfully renegotiated results in a wipeout for the owner, any value carried on the books associated with that venture is subject to impairment charge. Some public companies have refused to fund capital calls provoked by debt maturities on joint venture assets resulting in wipeout losses. Wipeout situations represent losses that are not recoverable.

Write-Downs

Write-downs are opportunities for managers, pursuant to long-term decline in the fair value of certain assets below book value, to take actions that result in non-cash charges to income. Write-downs can result generally from asset underperformance due to market deterioration in comparison to expectations. Some activities may not currently be profitable, such as for-sale housing divisions or condominium conversions necessitating project abandonment, shutting down entire divisions, closing offices, severance related right-sizing expenditures, and lease termination costs. Faulty accounting and cost controls can be a trigger as well, such as higher than budgeted completion costs for a project, costs sufficiently high that planned project capital structure is significantly altered, also leading to project abandonment. Some balance sheets are not able to withstand the shock of impairment, so discretionary impairments tend to be understated. There are examples of companies that have been completely consumed by impairments resulting in delisting of the public company. Other companies view write-downs as an opportunity to conserve capital at a time when the cost of capital has increased and availability has declined.

Discounted Cash Flow and Impairment Charges

Once decisions are made to take impairment charges, quantitative issues move to the forefront. Impairment charges can be determined through investment evaluations that involve cash flow analysis then determination of the holding period for an asset. Impairment decisions are based upon cash flows and a reversion of an investment at a stated capitalization rate after a holding period then are compared to present book value. Impairment calibrations that utilize capitalization rates and/or discount rates usually constitute the rationale, and may be internally generated or with the assistance of third parties. Some managers use “cap rates” as the selected discount rate for DCF analysis, which assumes cash flows are comparable on a present value basis with the unleveraged returns from the investment. Other managers are more influenced by equity return rates in constructing DCF models, adjusted for specific situation risks. Deci-

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sions of whether to discount future cash flows varies with management policy, impairment charge directives do not specifically encourage the process. Discounted cash flow analysis ("DCF") is a best practice for most real estate investments, however, so the fact that DCF is not necessarily standard practice for impairment determination seems to be a bit out-of-step with financial practices within the real estate industry.

The process of quantifying impairments has been complicated by a scarcity of true market transactions during this credit crisis. Several recent market transactions are presented in light of the current impairment charge calibration challenge. The market information is a gauge of not only trends in overall capitalization rates, but when combined with leverage analysis permits computation of equity return rates. Equity return rates provide guidance for market derived discount rates and yield insight to returns being demanded by investors. Performing commercial properties and loans that reflect current underwriting standards made to credit worthy borrowers are important indicators for a range of discount rate selections that are appropriate for specific situations.

Loan transaction data is especially vital for discount rate determination because this data enables equity rates of return to be calculated. The returns to equity are of critical concern to any new investor, including those concerned with analyzing portfolios of troubled real estate assets. The discount rate rationale for a troubled loan portfolio may begin with the equity returns from performing loans to credit worthy borrowers then additional risk premiums may be factored into the calibration commensurate with the analysis of the particular portfolio. Discount rate determination needs to factor in performing loan trends including mortgage rates, which have been increasing, and the loan to value ratios, which have been declining, both of which have important bearing on the equity return rate and applicable discount rate selection.

The transactions presented to provide specific examples of current trends in overall capitalization rates, and equity return rates, represent recent purchases by REITs. The deals were leveraged transactions meaning that equity return rates were not equal to overall capitalization rate. The types of assets involved are some of the most desirable performing assets that real estate investment has to offer, sale leaseback transactions for Cracker Barrel restaurants and CVS drugstores, both of which would certainly have been representative of multiple competing offer situations prior to the credit crisis. All of the transactions are examples of positive leverage in that the equity return rate is higher than the leverage rate, in spite of rising commercial mortgage rates.

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Market Based Rates of Return from selected transactions

	Description	Date	Cap Rate*	Treasury Rate**	Risk Premium	Mortgage Return Rate	Equity Return Rate
1.	7 industrial properties	12/10/2008	7.10%	3.60%	3.50%	5.58%	8.81%
2.	369,000sf shopping center	1/30/2009	8.56%	2.80%	5.76%	5.60%	12.48%
3.	15 freestanding restaurants	8/31/2009	9.50%	3.30%	6.20%	5.95%	12.65%
4.	10 drugstores	9/18/2009	8.30%	3.45%	4.85%	6.88%	10.29%

* overall capitalization rate

** 10 year Treasury Bond rate as of the date of the transaction

Data provided by Termzsheets.com, a commercial real estate loan reporting service.

Conclusion

In an era of rising capital costs, capital conservation strategies have increased in importance, and, like so many good things, need to be balanced with other objectives. Discounted cash flow analysis should play a greater role in the determination of impairment charges. The proportion of impairments that constitute wipeout style losses for public companies, estimated by REMCO as unrecoverable situations, represented only 42.2 percent of the total charges, or approximately $2.1 billion, the minority category of total impairment charges taken. Write-downs may be due to increasing capitalization rates as reflected by fair value computations. Capitalization rates are rising, as indicated by recent market transactions and this should provide ample opportunities for managers to take write-down style impairment charges. Write-downs may play a role in capital conservation programs by providing an immediate charge to income thereby potentially improving cash flow. The ability of public real estate companies to take advantage of write-down situations while avoiding wipeouts, effectively conserving and protecting capital, will contribute toward not only survival but prosperity within a capital constricted business environment.

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