Valuation hot topics

Facilitator: Mike Straneva, Ernst & Young LLP
Fair Value Accounting for Real Estate

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Mike focuses on due diligence and strategic planning for real estate operating companies and REITs and has provided a wide variety of real estate advisory services in his 30 years of professional practice. Mike has been involved in assisting companies apply accounting pronouncements including FIN 46 and FAS 141/142.

Mike is a CPA, a state certified real estate appraiser and Certified Insolvency and Reorganization Advisor (CIRA). He spent 12 years in the firm’s real estate audit practice group before specializing in real estate advisory services.
Presentation overview

► Current market observations
► Fair Value in Financial Reporting
  ► ASC 820 (Formerly FAS 157)
► Impairment Testing
  ► ASC 360 (Formerly FAS 144)
► Acquisition Accounting Methods
  ► ASC 805 (Formerly FAS 141R)
► Q&A – what lies ahead
Current market observations
Today’s economy: the glass is half full

- REITs and real estate enjoying unprecedented demand from domestic and foreign investors
- Debt liquidity wave
- US experiencing slowing growth but steady growth
- Unemployment at a normal level
- Real estate priced to perfection…or beyond
Currency wars

There are positive and negative effects of a stronger dollar:

- For countries outside the US it makes imports more expensive but helps exports.
- Refinancing US dollar denominated debt is more expensive.
- For foreign real estate investors looking to invest in the US, properties will be more expensive.
- But for US investors looking abroad, the stronger dollar makes foreign markets more attractive.
- European markets such as Spain, Italy and Ireland are already seeing greater US investment volume.
What will higher Fed funds rates mean since 5 and 10 year treasuries already increased?

► Most industry observers expect the Fed to raise rates in the second half of 2015. But recent global economic volatility may cause further delay.

► There is also no agreement as to how the Fed will implement its plan.

► The speed and extent to which rates rise will have a serious effect on commercial real estate over the coming years – both on cap rates and for property valuations.

Source: US Treasury
Oil prices have varied significantly over the years, as shown in the chart. The WTI spot price graph illustrates the price swings from January 2013 to July 2015, with a notable drop around 2014.

The second graph, "Texas employment vs. rig count March 2005-July 2015," compares the number of rig counts with the non-farm employment in Texas. The data indicates a correlation between the two, with peaks and troughs aligning over time.

Source: US EIA, US Census Bureau, Baker Hughes
US unemployment is shrinking

Unemployment rate Jan 2008 - Jul 2015
(seasonally adjusted)

Source: Bureau of Labor Statistics, Eurostat
Real estate priced to perfection…or beyond

“Going forward, we’re likely to see smaller price gains. With long-term interest rates up 100 basis points from their lows, commercial real estate valuations are now only fair vs. fixed income. Values may well continue to move higher, especially as pent-up demand from large institutional investors finds its way into the system, but the double-digit gains of past years are probably behind us.”

- Peter Rothemund, Green Street Advisors

Green Street Advisors Commercial Property Price Index vs. Premium/Discount to NAV Jan 07- Jul 15

Green Street Advisors Commercial Property Price Index is indexed to 100 in August 2007

Source: Green Street Advisors
US Economy: the glass is half empty

- Stock market volatility
- Slow or no growth in the emerging markets
- Real wage/income inequality
- Threat of interest rate increases could destabilize stock and real estate pricing
- Geopolitical instability and war
Stock market volatile – REITs had a great 2014 but all stock market returns are down in 2015

Performance: Real Estate vs. Broader Markets
Annual % Change

S&P 500
Dow Jones
FTSE/NAREIT All REIT

Source: NAREIT
Real estate as a fourth asset class

Prior to 1980 institutional investors paid very little attention to commercial real estate.

Now limited partners including pension funds, sovereign wealth funds, foundations and endowments view real estate as a significant component of their portfolios.

LPs are drawn to real estate because it offers portfolio diversification, competitive returns and is more accessible than it used to be.

S&P’s Dow Jones indices voted to categorize real estate as a stand-alone sector in 2016 after considering it a subsector under financials for many years.

Asset allocations by institutional investors

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REIT secondary equity offerings declining

Proceeds Raised by Investment Focus ($M)

* as of 7/10/2015
Source: NAREIT
Recent conversions and spin-offs include Windstream (telco), MGM Resorts (gaming/lodging), Gaming and Leisure Properties (gaming and lodging), Iron Mountain (document storage) and CBS Outdoor (billboards).

The IRS recently proposed a rule that clarified the definition of real estate to include “land, permanent structures and structural components” but what are qualified rents?

Will there be more conversions? There will be some, but conversion is not cheap, the process is long and complex, does not make sense for all C-corps, and there are stricter disclosure requirements and risks around legislative changes, market acceptance and operations/execution.
Non-traded REITs raised $15b in 2014. That compares to $20b in 2013, $13b in 2012 and $8.4b in 2011.

Analysts expect non-traded REITs and non-traded business companies to raise $30b in 2015 despite the blow that the NTR sector was dealt by the accounting scandal at American Realty Capital Properties.

One reason for the optimism is the $3.4b merger of Griffin-American Healthcare REIT II Inc. with NorthStar Realty Finance Corp which closed in late December 2014.

Much of the proceeds of that deal will be recycled as investors reinvest the capital.

There are also several liquidity events that have been announced including those by CNL Lifestyles Properties Inc., Industrial Income Trust, New York REIT and Philips Edison Grocery Center REIT.

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**Non-Traded REIT M&A**

<table>
<thead>
<tr>
<th>Buyer</th>
<th>Target</th>
<th>Announced Date</th>
<th>Announced Value ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independence Realty Trust</td>
<td>Trade Street Residential</td>
<td>5/11/2015</td>
<td>$556</td>
</tr>
<tr>
<td>Griffin Capital Essential Asset REIT</td>
<td>Signature Office REIT</td>
<td>11/24/2014</td>
<td>NA</td>
</tr>
<tr>
<td>Omega Healthcare Investors</td>
<td>Aviv REIT</td>
<td>10/31/2014</td>
<td>$2,156</td>
</tr>
<tr>
<td>Washington Prime Group</td>
<td>Glimcher Realty Trust</td>
<td>9/16/2014</td>
<td>$2,114</td>
</tr>
<tr>
<td>Select Income REIT</td>
<td>Cole Corporate Income Trust</td>
<td>9/2/2014</td>
<td>$2,041</td>
</tr>
<tr>
<td>Ventas, Inc.</td>
<td>American Realty Capital Healthcare Trust</td>
<td>6/2/2014</td>
<td>$2,030</td>
</tr>
<tr>
<td>American Realty Capital Properties, Inc.</td>
<td>Cole Credit Property Trust</td>
<td>3/21/2014</td>
<td>$73</td>
</tr>
</tbody>
</table>

Source: SNL Financial
The road ahead – real estate is priced to perfection

► Anticipate and prepare for inflation and interest rate increases.
► Prepare for lower gas prices.
► The residential is mixed with multifamily booming while single family in flux.
► The recovery spreads out to non 24/7 cities and to less favored asset classes like office, retail and industrial. These previously overlooked properties will now be the focus of investor opportunities.
► Many properties trading above replacement costs. Construction opportunities will continue. These previously overlooked properties will provide opportunities to conduct diligence on new deals – equity and debt.
► Public company multiples and ability to raise public debt as low rates will cause both real estate companies and non traditional real estate companies to consider going public.
► Debt is available for permanent refinancing and development at attractive rates.
► Have a business plan available for cap rate expansion.
Fair Value in Financial Reporting
Topic ASC 820 (SFAS 157)
Overview and effective date

FASB seeks more transparency in financial statements regarding fair value measurements
► Topic provides guidance on how to measure fair value
► Guidance became effective for fiscal years beginning after 11/15/2007
### What does the statement do?

<table>
<thead>
<tr>
<th>1. Provides guidance on how to measure fair value</th>
<th>5. Modifies the presumption that a transaction price is fair value; instead, provides indicators of when the transaction price may not be fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Clarifies the definition of fair value</td>
<td>6. Eliminates the ability to value a large position in a security that is actively traded using a block discount</td>
</tr>
<tr>
<td>3. Establishes that an asset should be valued based on its highest and best use</td>
<td>7. Establishes that for a restricted security the fair value measurement should include the effect of the restriction (regardless of the term of the restriction)</td>
</tr>
<tr>
<td>4. Requires that an issuer incorporate its own credit standing when measuring its own liability at fair value</td>
<td>8. Requires new disclosures about items measured at fair value and their income statement effect</td>
</tr>
</tbody>
</table>
“How does ASC 820 affect me in real estate?”

► Investments carried at fair value by real estate investment companies
► Assets measured at fair value for an impairment test under ASC 350 and ASC 360
  ► For example, impaired assets, long-lived assets held for sale, reporting units, and goodwill
► Certain assets and liabilities measured at fair value in a business combination under ASC 805 (i.e., intangible assets)
Definition of fair value

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

► Transaction price = entry price; fair value = exit price
► In many transactions, transaction price may be fair value
Highest and best use

Application to assets

- Fair value measurement assumes highest and best use by market participants
- ASC 820 criteria for highest and best use determination is consistent with standard Real Estate Appraisal Methodology
Valuation premise

- In-use – maximum value is derived from the operation of an asset in combination with other assets as a group
- In-exchange – maximum value is derived from the operation of an asset on a standalone basis
Fair value hierarchy

Standard establishes a **three-level hierarchy**

What is the purpose of the hierarchy?

- To maximize the use of observable market data and minimize the use of unobservable inputs
- To establish classification of fair value measurements for disclosure purposes

Fair value hierarchy prioritizes the inputs used in valuation techniques, not the valuation techniques
Observable and unobservable inputs

► **Observable inputs** are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

► **Unobservable inputs** are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.
Three-level input hierarchy

Level 1 inputs:
- Quoted prices (unadjusted) for identical assets or liabilities in active markets

Level 2 inputs:
- Observable market data other than level 1 inputs
  - Quoted prices for similar assets or liabilities in active markets
  - Quoted prices for identical or similar assets or liabilities in inactive markets

Level 3 inputs:
- Unobservable inputs:
  - Inputs derived through extrapolation or interpolation that cannot be corroborated by market data
Consistent with market, income or cost approaches

- Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used
  - In some cases – single technique
  - In other cases – multiple techniques
- Valuation techniques to be consistently applied

Real estate valuation techniques
Fair value best practices

► Providing documentation for all matters of professional judgment:
  ► Items selected to be valued
  ► Valuation methodology
  ► Significant assumptions used in valuation models

► Performing sensitivity analyses to identify key input variables

► Consistency checks and reconciliations built into the valuation process
  ► Internally consistent
    ► Within asset class/within timeframe/prior transactions/within segments
  ► External consistent
    ► Public filings/press releases/marketing material/benchmark analyses
Fair value potential mistakes

► Lack of documentation regarding selection of assumptions and basis for the analysis
► Failing to perform sensitivity analyses and reconciliation procedures
► Positions taken that are contradictory to published guidance
► Information in the allocation that contradicts other known (and discoverable) information
► Inconsistent assumptions in the valuation analysis of the one asset versus the valuation analysis of another asset
► Failing to adequately define and apply the concept of Market Participant
► Use of Prospective Financial Information ("PFI") that includes buyer-specific inputs
► Inconsistent models and analyses pre- and post-close
What is impairment?

- The condition that exists when the carrying amount (book value) of a long-lived asset (or asset group) exceeds its fair value as of a measurement date.
- Impairment = carrying amount > fair value

When should an asset be tested?

- “A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable…”
ASC 360 impairment indicators

Indicators of impairment – triggering events

► Significant decrease in market prices of the asset
► Significant adverse change in extent or manner of use or physical condition
► Current period operating or cash flow loss/history of losses, projections of losses
ASC 360 impairment testing

Step 1
► Carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected from the use and eventual disposal of the asset.
ASC 360 impairment testing

Step 2

► If not recoverable under the first step, property is written down to fair value
► Measure impairment loss as the difference between carrying amount and fair value (NPV via DCF)
  ► At this point, ASC 820 (SFAS 157) becomes operative
  ► Fair value is from a market participant’s perspective, not the company’s
Acquisition Accounting Methods
Topic ASC 805 (SFAS 141R)
Distressed sale or just a bad market?

- Not all transactions in an inactive market are distressed
- Measuring fair value when the volume and level of activity has significantly decreased
  - Transactions or quoted prices may not be determinative of fair value; perform additional analysis
  - Consider change in valuation technique or use of multiple valuation techniques
- Determining whether a transaction is orderly
  - Cannot assume a quoted price is distressed; perform additional analysis
  - Appropriately weigh all evidence, based on facts and circumstances
  - Cannot ignore information that is available without undue cost and effort
### Lease accounting rule changes

<table>
<thead>
<tr>
<th>Potential changes</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>► All leases are on the balance sheet, no more operating leases</td>
<td>► Decision to buy vs. lease asset - a very different assessment</td>
</tr>
<tr>
<td>► Lessee would record all promised payments as a liability with an offsetting “right to use asset”</td>
<td>► Financial ratios and related debt covenants</td>
</tr>
<tr>
<td>► Lessor would keep the leased asset on its balance sheet. The lessor would record a receivable for the promised payments from the lessee and an offsetting performance obligation liability, or, possibly, derecognize a part of the leased asset</td>
<td>► Educating users of financial statements such as analysts and capital providers</td>
</tr>
<tr>
<td>► FASB is considering whether the US should have a fair value option (or even a requirement) for investment properties (including leased properties); if so, traditional lessor accounting likely to be retained</td>
<td>► If we have to go to fair value in order to retain the old lessor accounting-the usual fair value issues!</td>
</tr>
</tbody>
</table>
SEC focus on IFRS ----> timeline

- SEC issued a statement supporting IASB/FASB convergence efforts and IFRS
- Directed its staff to execute a “Work Plan” addressing issues related to the incorporation of IFRS into the U.S. reporting framework

February 24, 2010

- Continued execution of the Work Plan
- Winding down of IASB/FASB convergence efforts and completion of joint projects
- Likely decision by the SEC on future adoption of IFRS by U.S. issuers

2011

- “Target “ date for IFRS adoption would be for financial years in 2015 or 2016
- Possibility that the SEC will allow at least some companies the ability to “early adopt” before 2015 or 2016

2015–2016
Overview of ASC 805 (FAS 141R)

► Background
  ► Revised form of FAS 141
    ► Effective for annual periods beginning after December 15, 2008
    ► The following is a brief overview of ASC 805 as compared to the previous guidance:

<table>
<thead>
<tr>
<th>ASC 805 (FAS 141R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Record all assets acquired and liabilities assumed at fair value</td>
</tr>
<tr>
<td>Fair value determined per ASC 820 (FAS 157)</td>
</tr>
<tr>
<td>- exit price between knowledgeable, unrelated parties</td>
</tr>
<tr>
<td>- determined in accordance with the asset’s highest and best use by other market participants</td>
</tr>
<tr>
<td>Acquisition costs recognized separately from a business combination and generally expensed</td>
</tr>
</tbody>
</table>
**Business combination vs. asset acquisition**

ASC 805 defines a business combination as follows:

<table>
<thead>
<tr>
<th>Business:</th>
<th>An integrated set of activities and assets that is capable of being conducted and managed for the purposes of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members or participants.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business combination:</td>
<td>A transaction or other event in which an acquirer obtains control of one or more businesses.</td>
</tr>
</tbody>
</table>
Business combination vs. asset acquisition

Three elements of a business:

► Inputs: Economic resource that creates or has ability to create outputs when processes are applied to it
► Processes: System, standard or protocol that when applied to an input create or has ability to create outputs
► Outputs: Results of inputs and processes applied to those inputs that provide or have ability to provide a return (dividends, lower costs, other economic benefits) to investor or owners

To be considered a business, a set of activities and assets is required to have only inputs and processes, which together are, or will be, used to create outputs
Business combination vs. asset acquisition

► If the transaction does not meet the definition of a business, the transaction is accounted for as an asset acquisition
  ► Allocate the cost of the acquisition to individual asset components acquired and liabilities assumed on a relative fair value basis as discussed in ASC 805-50-30-3
  ► Cost of the acquisition = purchase price plus direct acquisition costs
  ► Goodwill and bargain purchase gains are not recognized in asset acquisitions
There are many differences in the accounting for a business combination versus an asset acquisition, including the following:

<table>
<thead>
<tr>
<th></th>
<th>Business Combination</th>
<th>Asset Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Measurement</td>
<td>Fair Value</td>
<td>Allocated Cost (based on relative fair value)</td>
</tr>
<tr>
<td>Contingent Consideration</td>
<td>Recognized at fair value on acquisition date</td>
<td>Recognized when it is probable that the liability has been incurred and the amount can be reasonably estimated</td>
</tr>
<tr>
<td>Acquisition Costs</td>
<td>Expense</td>
<td>Capitalize</td>
</tr>
<tr>
<td>Goodwill / Gain on bargain purchase</td>
<td>Recognized separately</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Business combination vs. asset acquisition

Example 1: Company A develops warehouses that are leased out to distribution companies and determines they want to enter a new market. Company A identifies and purchases a tract of land on which they will develop a new warehouse

- Input – Land
- Processes – none
- Outputs – none

As no processes are included, Company A did not acquire a business. The same conclusion would apply if the warehouse had been constructed but was not operating and had no processes in place. This transaction would be accounted for as an asset acquisition.
Business combination vs. asset acquisition

- Example 2: Company B acquires an operating hotel, the hotel’s employees, the franchise agreement, inventory, reservations system, and all “back office” operations
  - Input - long-lived assets, franchise agreement and employees
  - Processes – operational and resource management processes associated with operating the hotel
  - Outputs – revenues from operating the hotel

- Company B acquired a business. The company acquired all three components of a business (inputs, processes and outputs) and is capable of providing a return to its owners. This transaction would be accounted for as a business combination
Typical tangible and intangible assets

- **Tangible assets**
  - Land
  - Building (as-vacant)
  - Site Improvements
  - Unamortized tenant improvements (TIs)
  - Furniture, fixtures and equipment (FF&E)
  - Other Personal Property
Typical tangible and intangible assets

► Identifiable intangible assets
  ► Lease contracts
    ► Above/below market lease(s)
    ► Above/below market ground lease(s)
    ► Capital lease(s)
    ► Legal/marketing fees
    ► Leases in place
    ► Tenant relationships
    ► Unamortized leasing commissions
  ► Service contracts
  ► Favorable Purchase contracts
  ► Trade names
  ► Above/below market debt
### Example

<table>
<thead>
<tr>
<th></th>
<th>Allocated Value</th>
<th>Adjustment</th>
<th>Adjusted Allocated Values</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tangible</strong></td>
<td>ownership of 100.00%</td>
<td></td>
<td>ownership of 100.00%</td>
</tr>
<tr>
<td></td>
<td>Assets</td>
<td>Liabilities</td>
<td>Factor</td>
</tr>
<tr>
<td>Land</td>
<td>3,640,000</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Building</td>
<td>40,994,715</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Site Improvements</td>
<td>4,160,000</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Tenant Improvements</td>
<td>1,845,384</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Furniture, Fixtures &amp; Equipment</td>
<td>-</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td><strong>Total Tangible</strong></td>
<td>50,640,099</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>Intangible</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Above/(Below) Market Lease</td>
<td>2,143,577</td>
<td>3,151,290</td>
<td>1.00903</td>
</tr>
<tr>
<td>(Above)/Below Market Ground Lease</td>
<td>-</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Lease In Place</td>
<td>3,249,702</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Tenant Relationship</td>
<td>4,276,454</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Leasing Commissions</td>
<td>381,258</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td>Legal/Marketing Fees</td>
<td>220,322</td>
<td>-</td>
<td>1.00903</td>
</tr>
<tr>
<td><strong>Total Intangible</strong></td>
<td>10,271,312</td>
<td>3,151,290</td>
<td></td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquired Debt Mark-to-Market</td>
<td>-</td>
<td>2,281,559</td>
<td>1.0000</td>
</tr>
<tr>
<td><strong>Fair Value</strong></td>
<td>55,478,563</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Valuation process – overview

Key steps:
- Identify the acquirer
- Determine the acquisition date
- Recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree
Step 1: Identify the acquirer

For each business combination, one of the combining entities shall be identified as the acquirer.

The process of identifying the acquirer begins with determining the party that obtains control:

- General rule (U.S. GAAP) – The party that holds directly or indirectly greater than 50 percent of the voting shares has control.

Other factors to consider:

- Newly formed entity (“Newco”)
- Acquisitions involving companies with common (ordinary) shareholders
- Options, warrants, and convertible instruments
Valuation process – overview

Step 2: Determine the acquisition date

- The acquirer shall identify the acquisition date, which is the date it obtains control of the acquiree.
- The acquisition date is generally the closing date; however, if control of the acquiree transfers to the acquirer through a written agreement, the acquisition date can be before or after the closing date.
Valuation process – overview

► Step 3: Recognize and measure
  ► Recognize and measure identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree
  ► The following slides identify typical tangible and intangible assets and / or liabilities acquired in a real estate transaction (that is classified as a business combination) and the related valuation methodology
Valuation process – overview

► Fair value framework:
  ► In-Use Premise
    ► The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business). (ASC 820-10-35-10Ea)
  ► In-Exchange Premise
    ► The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis). (ASC 820-10-35-10Eb)
Balance sheet assets

- Current assets
  - Accounts receivable
  - Inventory
  - Supplies
- Property, plant and equipment
  - Land
  - Land improvements
  - Buildings
  - Furniture, fixtures, and equipment
- Intangible assets
  - Goodwill
  - Trade names
Valuation process – tangible assets

- Land
- Building (as-vacant)
- Land/site improvements
- Unamortized tenant improvements
- Furniture, fixtures, and equipment (FF&E)
- Other personal property
Valuation process – tangible assets

- **Land – sales comparison approach**

<table>
<thead>
<tr>
<th>Subject</th>
<th>Sale 1</th>
<th>Sale 2</th>
<th>Sale 3</th>
<th>Sale 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale/Valuation Date</td>
<td>Jul-13</td>
<td>Dec-12</td>
<td>Aug-11</td>
<td>Jun-11</td>
</tr>
<tr>
<td>Sale/Listing/Quoted Price</td>
<td>$7,300,000</td>
<td>$5,000,000</td>
<td>$5,700,000</td>
<td>$3,100,000</td>
</tr>
<tr>
<td>Size (Acres)</td>
<td>63.66</td>
<td>35.65</td>
<td>42.15</td>
<td>20.94</td>
</tr>
<tr>
<td>Price per Acre</td>
<td>$114,672</td>
<td>$140,252</td>
<td>$135,231</td>
<td>$148,042</td>
</tr>
</tbody>
</table>

### Market Conditions
- Adjusted Price per Acre
- 0% | 5% | 5% | 0%

### Conditions of Sale
- Adjusted Price per Acre
- 0% | 0% | 0% | -5%

### Location
- 10% | 0% | 0% | 0%
- 0% | -5% | 0% | 0%
- 0% | 0% | 0% | 5%

### Access / Visibility
- 0% | 0% | 0% | 0%

### Zoning / Use
- 0% | 0% | 0% | 0%

### Topography / Shape
- 10% | -5% | 0% | -10%

### Size
- 0% | 0% | 0% | 0%

### Other
- 20% | -10% | 0% | -5%

### Total Adjustments
- Total Adjusted Price per Acre
- $137,606 | $132,539 | $141,993 | $133,608

### Weight assigned to comparable
- 25% | 25% | 25% | 25%

### Concluded Value Per Acre: $136,400
Valuation process – tangible assets

- Building (as-vacant)
  - Cost Approach: An informed purchaser would not pay more for a property than the cost of producing a substitute property with equal utility (MVS or construction comparables)
  - Income Approach, “Go Dark” Analysis
    - Utilize a discounted cash flow (“DCF”) model based on the assumption that the building is initially vacant and leased up over a period of time to stabilization
    - Land value and site improvement value are deducted from the value determined through the DCF to arrive at the building value
  - Reconcile the Income Approach and Cost Approach to determine a final value estimate for the building
    - Discussion of Residual Approach
Valuation process – tangible assets

<table>
<thead>
<tr>
<th>Analysis Period</th>
<th>Annual Cash Flows</th>
<th>PV of cash flows @ 9.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 Jan-2014</td>
<td>$829,777</td>
<td>$729,158</td>
</tr>
<tr>
<td>Year 2 Jan-2015</td>
<td>$1,121,845</td>
<td>$1,074,533</td>
</tr>
<tr>
<td>Year 3 Jan-2016</td>
<td>$1,770,351</td>
<td>$1,427,227</td>
</tr>
<tr>
<td>Year 4 Jan-2017</td>
<td>$1,815,331</td>
<td>$1,342,651</td>
</tr>
<tr>
<td>Year 5 Jan-2018</td>
<td>$1,548,413</td>
<td>$1,050,673</td>
</tr>
<tr>
<td>Year 6 Jan-2019</td>
<td>$1,874,171</td>
<td>$1,166,711</td>
</tr>
<tr>
<td>Year 7 Jan-2020</td>
<td>$1,258,933</td>
<td>$719,003</td>
</tr>
<tr>
<td>Year 8 Jan-2021</td>
<td>$1,864,866</td>
<td>$977,122</td>
</tr>
<tr>
<td>Year 9 Jan-2022</td>
<td>$1,966,333</td>
<td>$945,218</td>
</tr>
<tr>
<td>Year 10 Jan-2023</td>
<td>$1,756,135</td>
<td>$774,472</td>
</tr>
<tr>
<td><strong>Total Cash Flow</strong></td>
<td><strong>$15,806,155</strong></td>
<td><strong>$10,206,768</strong></td>
</tr>
<tr>
<td><strong>Property Resale @ 8% Cap Rate</strong></td>
<td><strong>$28,157,208</strong></td>
<td><strong>$11,893,909</strong></td>
</tr>
<tr>
<td><strong>Total Property Present Value</strong></td>
<td></td>
<td><strong>$22,100,677</strong></td>
</tr>
</tbody>
</table>

**Rounded to Thousands**

- Less: Land Value $6,360,468
- Less: Site Improvements $2,015,000

**Building As-If Vacant** $13,724,532
Valuation process – tangible assets

▶ Site improvements and FF&E
▶ Methodology: cost approach
  ▶ Estimate the RCN (replacement cost new) for each site improvement and FF&E component via industry survey data or cost comparables and adjust the cost for depreciation (physical deterioration, functional and external obsolescence)
  ▶ Physical deterioration is generally calculated using the age/life method (effective age/economic life)
Valuation process – tangible assets

► Unamortized Origination Costs (TI/LC)
  ► Methodology: Cost Approach
    ► Represents the value associated with “cost avoidance” of acquiring an in-place lease. Part of the market cost to execute a similar lease are costs related to tenant improvement (TI) allowances given as an inducement to rent the space. Other costs include leasing commission (LC) and legal/marketing expenses
    ► The values of TIs and LCs are estimated to be the market tenant improvement allowance and the market leasing commission, respectively, multiplied by the percentage of the original lease term remaining
## Valuation process – tangible assets

### Unamortized tenant improvements

<table>
<thead>
<tr>
<th>Ste</th>
<th>Tenant Name</th>
<th>SF</th>
<th>Lease End Date</th>
<th>Current Term (Mos.)</th>
<th>Remaining Term (Mos.)</th>
<th>Est. of Market TI ($/SF)</th>
<th>Tot. Market TI for Orig. Lease</th>
<th>Market TI/Mo.</th>
<th>Remaining Unamort. TIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>Micron Tech</td>
<td>31,538</td>
<td>8/21</td>
<td>134</td>
<td>98</td>
<td>$25.00</td>
<td>$788,450</td>
<td>$5,884</td>
<td>$576,628</td>
</tr>
<tr>
<td>200</td>
<td>Frontier</td>
<td>83,662</td>
<td>11/22</td>
<td>138</td>
<td>113</td>
<td>$25.00</td>
<td>$2,091,550</td>
<td>$15,156</td>
<td>$1,712,646</td>
</tr>
</tbody>
</table>

### Unamortized leasing commissions

<table>
<thead>
<tr>
<th>Ste</th>
<th>Tenant Name</th>
<th>SF</th>
<th>Lease End Date</th>
<th>Current Term (Mos.)</th>
<th>Remaining Term (Mos.)</th>
<th>Remaining Contract Rent</th>
<th>Market LC Rate</th>
<th>Remaining Unamortized LCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>Micron Tech</td>
<td>31,538</td>
<td>8/21</td>
<td>134</td>
<td>98</td>
<td>$3,272,069</td>
<td>6.75%</td>
<td>$220,865</td>
</tr>
<tr>
<td>200</td>
<td>Frontier</td>
<td>83,662</td>
<td>11/22</td>
<td>138</td>
<td>113</td>
<td>$14,278,315</td>
<td>6.75%</td>
<td>$963,786</td>
</tr>
</tbody>
</table>
Valuation process – intangible assets

► Lease contracts
  ► Above/below market lease(s)
  ► Above/below market ground lease(s)
  ► Capital lease(s)
  ► Legal/marketing fees
  ► Leases in-place
  ► Tenant relationships
  ► Unamortized leasing commissions

► Service contracts
  ► Favorable purchase contracts
  ► Trade names
  ► Above/below market debt
Valuation process – intangible assets

Above/below market lease

Methodology: Income Approach

- Discount the difference between the contract rent and market rent over the remaining term of each tenant’s lease
- Significant judgment exists with regard to the treatment of renewal options. Consider the following when assessing renewal options:
  - Is the renewal within the control of the tenant?
  - Does the renewal provide economic benefit to the tenant?
Above/below market lease contracts (cont.)

<table>
<thead>
<tr>
<th>Suite No.</th>
<th>Type</th>
<th>Square Feet</th>
<th>Market Rent Test</th>
<th>Discounted Contract Rent</th>
<th>Discounted Market Rent</th>
<th>Discounted Rent Difference</th>
<th>Total Above Market</th>
<th>Total Below Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-600</td>
<td>Industrial</td>
<td>252,000</td>
<td>Below Market</td>
<td>$1,181,920</td>
<td>$1,337,595</td>
<td>$(155,675)</td>
<td>$0</td>
<td>$(155,675)</td>
</tr>
<tr>
<td>B-300</td>
<td>Industrial</td>
<td>40,100</td>
<td>Below Market</td>
<td>$84,002</td>
<td>$109,180</td>
<td>$(25,178)</td>
<td>$0</td>
<td>$(25,178)</td>
</tr>
<tr>
<td>B-400</td>
<td>Industrial</td>
<td>40,140</td>
<td>At Market</td>
<td></td>
<td></td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>B-800</td>
<td>Industrial</td>
<td>35,477</td>
<td>Above Market</td>
<td>$306,482</td>
<td>$236,291</td>
<td>$70,191</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>C-200</td>
<td>Industrial</td>
<td>235,760</td>
<td>Below Market</td>
<td>$1,866,635</td>
<td>$2,076,933</td>
<td>$(210,298)</td>
<td>$0</td>
<td>$(210,298)</td>
</tr>
<tr>
<td>D-200</td>
<td>Industrial</td>
<td>24,020</td>
<td>Above Market</td>
<td>$91,520</td>
<td>$81,024</td>
<td>$10,496</td>
<td>$10,496</td>
<td>$0</td>
</tr>
<tr>
<td>D-400</td>
<td>Industrial</td>
<td>9,725</td>
<td>At Market</td>
<td></td>
<td></td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>D-500</td>
<td>Industrial</td>
<td>12,450</td>
<td>At Market</td>
<td></td>
<td></td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>D-700</td>
<td>Industrial</td>
<td>25,950</td>
<td>At Market</td>
<td></td>
<td></td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>B-600</td>
<td>Industrial</td>
<td>36,523</td>
<td>NAP</td>
<td></td>
<td></td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$80,687</td>
<td>$(391,151)</td>
</tr>
<tr>
<td><strong>Total (Rounded)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$81,000</td>
<td>$(391,000)</td>
</tr>
</tbody>
</table>
Lease in-place (forgone rent)

Methodology: Income Approach

- Represents the value related to the economic benefit for acquiring the property with in-place leases as opposed to a vacant property.
- Measured as the income (rent and expense reimbursement revenue) over the estimated amount of time that it would take to lease the space to stabilized occupancy.
- The value of the Lease In-Place should not exceed the value of the remaining cash payments under the lease.
Lease in-place (cont.)

<table>
<thead>
<tr>
<th>Suite Number</th>
<th>Occupied Square Feet</th>
<th>% of Total</th>
<th>Contract Base Lease Term - Months</th>
<th>Market Base Lease Term - Months</th>
<th>Concluded Remaining Term - Months</th>
<th>Market Percent Remaining</th>
<th>PV of Total Forgone Rent</th>
<th>PV of Total Expense Loss</th>
<th>Total Lease In Place</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-600</td>
<td>252,000</td>
<td>35.4%</td>
<td>60</td>
<td>60</td>
<td>17</td>
<td>29%</td>
<td>$551,241</td>
<td>$171,964</td>
<td>$723,205</td>
</tr>
<tr>
<td>B-300</td>
<td>40,100</td>
<td>5.6%</td>
<td>26</td>
<td>60</td>
<td>8</td>
<td>14%</td>
<td>$84,770</td>
<td>$24,409</td>
<td>$109,180</td>
</tr>
<tr>
<td>B-400</td>
<td>40,140</td>
<td>5.6%</td>
<td>46</td>
<td>60</td>
<td>21</td>
<td>36%</td>
<td>$117,073</td>
<td>$27,391</td>
<td>$144,464</td>
</tr>
<tr>
<td>B-800</td>
<td>35,477</td>
<td>5.0%</td>
<td>60</td>
<td>60</td>
<td>17</td>
<td>29%</td>
<td>$103,473</td>
<td>$24,207</td>
<td>$127,680</td>
</tr>
<tr>
<td>C-200</td>
<td>235,760</td>
<td>33.1%</td>
<td>68</td>
<td>60</td>
<td>50</td>
<td>84%</td>
<td>$257,858</td>
<td>$160,882</td>
<td>$418,740</td>
</tr>
<tr>
<td>D-200</td>
<td>24,020</td>
<td>3.4%</td>
<td>108</td>
<td>60</td>
<td>8</td>
<td>14%</td>
<td>$66,401</td>
<td>$14,622</td>
<td>$81,024</td>
</tr>
<tr>
<td>D-400</td>
<td>9,725</td>
<td>1.4%</td>
<td>63</td>
<td>60</td>
<td>35</td>
<td>59%</td>
<td>$31,910</td>
<td>$6,638</td>
<td>$38,548</td>
</tr>
<tr>
<td>D-500</td>
<td>12,450</td>
<td>1.7%</td>
<td>46</td>
<td>60</td>
<td>21</td>
<td>36%</td>
<td>$40,851</td>
<td>$8,494</td>
<td>$49,345</td>
</tr>
<tr>
<td>D-700</td>
<td>25950</td>
<td>3.6%</td>
<td>72</td>
<td>60</td>
<td>36</td>
<td>61%</td>
<td>$80,417</td>
<td>$17,707</td>
<td>$98,124</td>
</tr>
<tr>
<td>B-600</td>
<td>36523</td>
<td>5.1%</td>
<td>0</td>
<td>60</td>
<td>0</td>
<td>0%</td>
<td>NAP</td>
<td>NAP</td>
<td>NAP</td>
</tr>
</tbody>
</table>

Total/Average Rounded 712,145 | $1,790,310 $1,790,000
Valuation process – intangible assets

► Tenant/Customer Relationships
  ► Methodology: Income Approach
    ► Represents the PV of the NOI difference expected if a tenant renews their lease versus if they vacate and the owner is required to find a new tenant
    ► Most appraisers believe tenant relationships are uncommon
  ► Estimated NOI difference is calculated as the sum of the following items multiplied by the renewal probability:
    ► Monthly market rent and expense recoveries at the end of the current lease term for the estimated months vacant before a new tenant is in place
    ► Difference in TI allowance required and leasing commissions paid at the end of the current lease term for a new tenant versus a renewal tenant
  ► The expected NOI value is then discounted from the end of the current lease term to the acquisition date to estimate the current value of the tenant relationship
Assumed property-level debt

Methodology: Income Approach

If property-level debt was assumed as part of the transaction, the debt should be fair valued in accordance with specific mortgage terms in relation to current market terms as of the acquisition date to determine if a favorable / unfavorable condition exists.

<table>
<thead>
<tr>
<th>Property</th>
<th>Principal Balance</th>
<th>Current occupancy</th>
<th>Asset Value</th>
<th>Contract Interest Rate</th>
<th>Maturity Date</th>
<th>Remaining Term</th>
<th>Market Interest Rate</th>
<th>Rate Difference</th>
<th>PV @ Discount Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>$15,119,261</td>
<td>24%</td>
<td>$29,033,652</td>
<td>52%</td>
<td>6.00%</td>
<td>01/10/15</td>
<td>2.0</td>
<td>6.42%</td>
<td>0.42%</td>
</tr>
<tr>
<td>Property B</td>
<td>$10,101,266</td>
<td>100%</td>
<td>$16,998,490</td>
<td>59%</td>
<td>6.00%</td>
<td>01/10/15</td>
<td>2.0</td>
<td>6.42%</td>
<td>0.42%</td>
</tr>
<tr>
<td>Property C</td>
<td>$9,582,851</td>
<td>100%</td>
<td>$29,332,000</td>
<td>33%</td>
<td>4.95%</td>
<td>05/10/13</td>
<td>-</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Property D</td>
<td>$35,500,000</td>
<td>100%</td>
<td>$39,060,028</td>
<td>58%</td>
<td>4.45%</td>
<td>02/01/20</td>
<td>7.0</td>
<td>4.67%</td>
<td>0.22%</td>
</tr>
</tbody>
</table>
Valuation process – intangible assets

► Recognize and measure goodwill
  ► Goodwill shall be recognized as of the acquisition date and measured as the excess of (a) over (b)
    ► (a) The aggregate of the following:
      ► The consideration transferred measured in accordance with ASC 805-30-30-1, which generally requires acquisition-date fair value
      ► The fair value of any non-controlling interest in the acquiree
      ► In a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree
    ► (b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with ASC 805
Valuation process – intangible assets

- Recognize and measure a bargain purchase gain
  - Bargain purchases occur if the acquisition-date amounts of the identifiable net assets acquired, excluding goodwill, exceed the sum of
    - (i) the value of consideration transferred;
    - (ii) the value of any non-controlling interest in the acquiree; and
    - (iii) the fair value of any previously held equity interest in the acquiree
  - A bargain purchase should be recognized in earnings (profit or loss) and attributed to the acquirer
## Valuation process – adjustment factor

<table>
<thead>
<tr>
<th>Tangible Assets</th>
<th>Fair Values</th>
<th>Allocated Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Liability</strong></td>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Land</td>
<td>$18,900,000</td>
<td>$ -</td>
</tr>
<tr>
<td>Building Improvements</td>
<td>$31,855,949</td>
<td>$ -</td>
</tr>
<tr>
<td>Site Improvements</td>
<td>$1,143,051</td>
<td>$ -</td>
</tr>
<tr>
<td>Furniture, Fixture &amp; Equipment</td>
<td>$1,222,165</td>
<td>$ -</td>
</tr>
<tr>
<td>Tenant Improvements</td>
<td>$1,466,842</td>
<td>$ -</td>
</tr>
<tr>
<td><strong>Total Tangible Assets</strong></td>
<td>$54,588,007</td>
<td>$ -</td>
</tr>
</tbody>
</table>

| Intangible Assets                |               |               |               |               |
| **Assets**                       | **Liability** | **Assets** | **Liability** |
| Favorable/Unfavorable Leases     | $450,550      | $(1,638,989) | 1.0106 $455,310 | $(1,656,306) |
| In Place Leases                  | $1,092,848    | $ -         | 1.0106 $1,104,395 | $ - |
| Leasing Commissions              | $1,106,439    | $ -         | 1.0106 $1,118,130 | $ - |
| Legal Fees                       | $63,029       | $ -         | 1.0106 $63,695 | $ - |
| **Total Intangibles**            | $2,712,867    | $(1,638,989) | $2,741,531 | $(1,656,306) |

| Fair Value                       | $55,661,886   | $56,250,000 |
| Purchase Price                   | $56,250,000   |             |
| Adjustment Factor                | 1.0106        |             |
Valuation process – adjustment factor

► **Adjustment factor:**
  ► The variance between the purchase price and the sum of the individually calculated asset components

► **ASC 805 does not discuss the concept of an adjustment factor**
  ► The guidance contemplates that any difference between the purchase price and fair value attributable to an identified acquired asset or liability represents goodwill or a bargain purchase gain

► **Adjustment factors are common in real estate acquisitions as valuation is dependent on various assumptions**
  ► Cost approach: industry averages, measuring depreciation
  ► Income approach: cap and discount rates, market rent
  ► Sales comparison approach: adjustments, availability of comps
Valuation process – property type specifics

► Apartments

► **Above/below market lease**: given that apartments typically have leases of 12 months or less, the above/below market lease intangible is typically small

► **Lease in-place**: apartment business combinations typically include a lease in-place intangible related to the in-place occupancy. Absorption is a key assumption, as it relates to the time (months) necessary to lease the property to the occupancy level on the acquisition date
Valuation process – property type specifics

► Hotels

► **Advanced bookings:** hotel business combinations can include an intangible asset related to advanced bookings. A market participant may assess advanced bookings and ascribe value to the bookings

► **Management contract:** in hotel business combinations, it is common to assess the above/below market value associated with a management company. The assessment compares the management contract rate to market rates

► **Trade name:** to operate a hotel under a certain trade name ("flag") like Marriott or Hilton may hold some inherent value

► **Franchise fees:** there can be value in the one time, up-front fee that is paid to operate under the franchisor
Valuation process – property type specifics

Senior living and medical office

- leased fee vs fee simple (subject to s/t leases)
- tenant relationship:
  - master leased to operator / seller
  - entrepreneurial incentive
  - goodwill
Use of a third-party specialist

Third-party specialists

Many companies engage third-party specialists, or subject matter experts, to assist with the fair value determinations. Auditors will typically perform the following procedures:

- Evaluate the specialist’s professional credentials (MAI, licensed appraiser)
- Assess the specialist’s professional reputation
- Assess the validity, completeness, and accuracy of the specialist’s work
- Maintain controls to ensure that complete and accurate data is provided to the specialist and that the specialist’s findings are reviewed and approved
Recent PCAOB inspections have yielded observations related to the auditor's procedures over fair value estimates such as:

- In situations where companies engaged a third-party valuation specialist, inadequate procedures performed by the audit team over the reliability of data provided to the third-party firm, key assumptions underlying the estimate of fair value and the assessment of the reasonableness of the fair value estimates furnished by the third-party valuation firm to management;
- Inadequate procedures performed by the audit team related to assessing differences in fair value estimates recorded by management and independently obtained or formed by the audit team;
- Inadequate procedures performed by the audit team to test the fair values of certain identifiable intangible assets acquired in a business combination; specifically, there was no evidence of procedures performed, other than inquiry, over the reasonableness of attrition-rate assumptions.
Inadequate procedures performed by the audit team related to the auditor's assessment of key assumptions underlying the estimate of fair value for modeled investment securities and investment securities for which a limited market exists and fair value estimates were furnished by a pricing service or broker-dealer.
The following are key themes related to business combinations noted in SEC comment letters:

- Below market leases
  - How have fixed rate renewal options been considered in both valuation and amortization period?
  - Consideration of probability of renewal
- Valuation – third party appraisals
  - Consider obtaining consent from appraiser
  - How the information obtained from third party was used
The following are sample SEC comments related to below-market leases:

“We note that you amortize below-market lease intangibles over the initial term plus the term of any below-market fixed rate renewal option. Please tell us how you determine the likelihood that a lessee will execute a below market lease renewal option.”

“We note that your response to prior comment x. Please tell us management's basis for using the xx% threshold to assessed probability, including any references to authoritative literature. Within your response, please tell us your historical renewal rates for leases between the 0% and xx% discount range or provide to us a quantification of the changes to your financial statements had you not used the xx% threshold to determine probability.”