New Perspectives in Analyzing Real Estate Developer Financial Statements

by Dan Boykin

This first in a series of articles surveys historical approaches to analyzing real estate business financial results, provides insight into developer financial reporting, and offers some alternatives to the current "make-do" partial data approaches. Some strategies for improving financial reporting also are presented.

Anyone who has tried to analyze a real estate developer's financial performance knows it's not easy. Having lived through the S&L crisis and the real estate "recession" of the late 1980s and early 1990s, many bankers and other capital providers are turning more to understanding the entire business of a developer enterprise as well as concentrating on the project economics and market analysis.

Because of their sizable capital needs, most developers of large commercial projects use multiple sources. A multiple-capital-source approach invariably requires multiple legal entities with separate financial reporting. The common problem is analyzing those multiple entities.

Purpose and Expected Outcome

The analysis of any developer's financial position must begin with an understanding of the purpose and expected outcome of the financial analysis—in a commercial credit, this is usually the identification of repayment sources. For real estate credit, the primary source of repayment is almost always project driven, so analyzing cash flow, balance sheet, and income statement at the business level is unlikely to shed much light on repayment of a specific project loan.

The objective, then, is some understanding of two basic issues:

1. The degree of flexibility a developer has retained in its business as a whole.
2. Financial strategy and what that means for the lender.

Regardless of the approach taken, the lender must:

- Identify and understand the risk profile of the real estate business.
- Determine whether the business can support priority outflows, service its debt, and pursue its strategic direction.
- Identify cash sources and uses, and understand the background for each.
- Know how much flexibility the business has to deal with problems.
- Determine the business's reliance on outside capital sources and the risks associated with those sources.

Dealing with the Data

Lenders have always had to

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deal with a smorgasbord of available data within real estate partnerships. A starting place, then, is to understand what is available in a typical transaction. While the form and substance of the items discussed here vary greatly, there are some similarities to keep in mind.

Typical financial statement information usually consists of some or all of the following:

- Personal statements of the individual developer/sponsor.
- Business financials of the development entity/sponsor organization—usually, equity method presentations.
- Project schedules or lists of properties—either partial, reflecting sponsor interest (proportionate), or full (sometimes called consolidated).
- Tax returns, both business and personal.

Typical Approaches Based on the Data

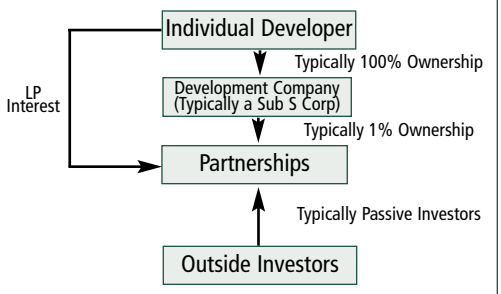
Most analysts use a variant of three popular approaches to analyzing this information because classic GAAP consolidated (and, of course, consolidating) statements are viewed as hard to get and/or prohibitively costly. There are variants among all three approaches as well as overlap.

1. NOI/operating approach—uses project schedules as a proxy for consolidation of the developer's business universe.
2. Individual/sponsor cash flow approach (also known as the tax return analysis approach).
3. Business approach—used with GAAP statements.

The approach selected is usually driven by the financial data available. This article uses a sample developer to demonstrate the approaches. It is important to note that this set of facts was taken from the same developer entity, on the same date, and using the same set of underlying facts regarding the business's performance for a given period. Figure 1 shows the organization of this typical developer.

Figure 1

Typical Real Estate Business Structure



The NOI approach. The financial services industry has long recognized the need for a global view of the borrower's business; thus, we require project statements or lists of some kind. Figure 2 shows a typical project schedule. The approach is simple in form and function: the NOI of each property is determined, these are added to an overall portfolio NOI, and the result is compared with debt requirements.

• Advantages. As an information tool, the NOI is relatively easy to obtain. Bankers have required these schedules for decades, and used them as a proxy for the consolidated business. This is also a starting place: If a business does not generate enough "profits" (in this case, expressed as NOI), then it will need other resources to service the debt load. Using other resources, like property sales or equity injections, is of limited sustainability.

• Disadvantages. The disadvantages of this approach are the same as those our commercial colleagues have learned over the last few years in using EBITDA. This is not anything more than one large source of cash in the overall change in cash position of the firm. Just as EBITDA has requirements and priorities it must fund other than just debt service, so too must the NOI be available for other claims, many of which, in an ongoing firm, are a priority to debt repayment (maintenance capital expenditures and tax payments are but a few).

Even with the disadvantages listed above, this approach has some value. For example, the company would appear to have some available debt capacity, as the operating portfolio appears to be under 60% leveraged as total debt is $26.2 million versus value of $46.6 million. In addition, the land is lowly leveraged, and the excess cash flow from the portfolio appears to easily support the other debt.

The individual/sponsor approach. Given the limitations of the NOI approach, many lenders have looked to the individual sponsor for a global view of the sponsor's entire business interests and demands. The U.S. has a long tradition of voluntary compliance with tax reporting. Because of the apparent completeness of tax reports, lenders have used tax returns as a proxy for the strength of a developer

enterprise's financial position.

The approach is fairly straightforward. Tax returns are examined and a consolidated cash flow statement of the sponsor is prepared. This is normally done in conjunction with an examination of personal statements. Similar to the NOI approach, a summation of fair value net worth is usually prepared. Figure 3 uses this approach to show a typical cash flow statement for our sample developer.

From Figure 3, it appears that the developer has a substantial net worth in relation to the debt load. Second, the "cash flow" appears to be a very strong number—more than $1.2 million annually. There do not appear to be any obvious lifestyle issues, other than the usual "toys" associated with this business (plane, boat, multiple residences, and so forth).

• Advantages. The individual/sponsor approach does sum the actual cash receipts the individual received from the business. In addition, it separates what belongs to the developer from what may be owned by other outside capital sources.

• Disadvantages. The disadvantages are the same as the advantages. The approach is nothing more than a list of dividends received, and tells nothing about how the cash flow was derived. It reveals nothing about financial strategy for conducting the business or sustainability of the cash flow stream.

Figure 2

Typical Property Schedule

Operating Properties Offices	Cost	Value	Excess	Loan	Equity	Annualized NOI	Annualized Debt Service	Annualized Cash Flow
Office I	$586,130	$3,820,000	$3,233,870	$1,036,710	$2,783,290	$447,875	$ (113,939)	$333,936
Office II	1,629,887	5,060,000	3,430,113	2,277,881	2,782,119	563,532	(250,349)	313,183
Office III	1,510,264	6,400,000	4,889,736	3,871,583	2,528,417	672,695	(425,503)	247,192
Office IV	6,216,704	5,350,000	(866,704)	5,350,000	0	271,110	(549,797)	(278,687)
Retail								
Center I	515,010	3,340,000	2,824,990	1,155,211	2,184,789	333,937	(126,962)	206,975
Center II	900,642	2,435,000	1,534,358	1,773,183	661,817	239,108	(194,880)	44,228
Center III	537,408	1,125,000	587,592	632,586	492,414	109,334	(69,524)	39,810
Center IV	422,952	1,270,000	847,048	572,338	697,662	135,254	(62,902)	72,352
Center V	507,438	1,226,000	718,562	729,917	496,083	111,606	(80,221)	31,385
Industrial								
Industrial I	396,291	1,264,000	867,709		1,264,000	71,770		71,770
Apartment								
Apartment I	2,256,603	4,610,000	2,353,397	2,904,550	1,705,450	503,280	(319,222)	184,058
Apartment II	1,336,185	1,660,000	323,815	680,052	979,948	143,254	(74,740)	68,514
Apartment III	3,105,219	3,740,000	634,781	2,604,323	1,135,677	348,309	(286,226)	62,083
Apartment IV	1,040,103	5,340,000	4,299,897	2,705,683	2,634,317	542,996	(297,365)	245,631
Total Op. Prop.	$20,960,836	$46,640,000	$25,679,164	$26,294,017	$20,345,983	$4,494,060	$(2,851,630)	$1,642,430
						Annualized Debt Service		1.57

Development Properties	Cost	Fair Value	Excess	Loan	Equity
11.5 industrial acres	$1,142,917	$ 2,250,000	$ 1,107,083	$ 500,000	$ 2,250,000
Individual lot	206,301	301,801	95,500	0	301,801
22.0 acres of land	893,805	5,450,000	4,556,195	1,924,000	5,450,000
Oak Farms site	2,500,000	3,500,000	1,000,000	0	1,000,000
14.7 acres of land	1,092,221	1,348,000	255,779	0	1,424,000
Total Dev. Prop.	$5,835,244	$12,849,801	$7,014,557	$2,424,000	$10,425,801
CIP					
Apartment	3,772,437	3,772,437	0	2,484,725	1,287,712
Other	242,342	242,342	0	0	242,342
Total CIP & Land	$9,850,023	$16,864,580	$7,014,557	$4,908,725	$11,955,855

Classic business approach. One of the most important aspects of this approach is that we treat the business assets and liabilities as separate from the individual. This approach also requires the traditional GAAP cost basis balance sheet and income statement. For the sake of the illustration, we assume that we have this data.

Figure 3

Sample Developer

Excerpts from Personal Cash Flow Analysis Using Schedule K-1	
Recurring Sources	
Wages	$ 50,000
Distribution from partnerships	1,199,000
Net recurring cash inflow	**1,249,000**
Nonrecurring Sources	
Withdrawal from development company	935,000
Net cash inflow	**$ 2,184,000**
Cash Outflows	
Estimated living expenses	(500,000)
Personal debt service	0
Net recurring outflows	**($ 500,000)**
Miscellaneous	
Aircraft purchase	(689,000)
Net cash flow	$ 995,000
Recurring cash flow	**$ 749,000**

Personal Financial Statements Estimated Fair Market Value	
As of December 31, 1999	
Cash	$1,163
Personal effects	1,536
Boat	69
Airplane	689
Vacation residence	1,893
Personal residence	2,689
Investment in development company	9,011
Partnership interests	9,969
Total Assets	**$ 27,019**
Liabilities	
Payable to development company	2,835
Net Worth	**$ 24,184**

Figure 4

Analytical Illustration

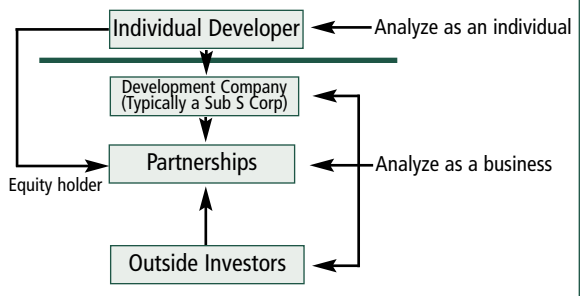


Figure 5

Classic Business Approach

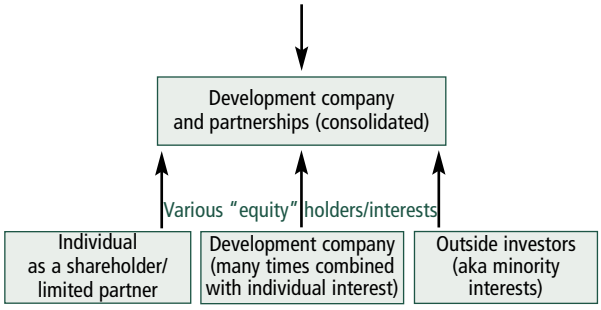


Figure 4 draws a conceptual line between the real estate business and the analysis of the individual. We analyze the individual as the key manager (entrepreneur) behind the business. We evaluate his capability as we would for any borrower. If we have this data, we can analyze the information—balance sheet, the income statement, and, most important, the consolidated cash flow statement—in a fashion similar to a traditional commercial business. Figure 5 shows the organization with the developer and outside partners all reflected as "stakeholders" (more about the accounting in a future article).

There are, of course, differences in the business dynamic of a real estate business as opposed to a distributor or manufacturer. The analytical techniques appropriate to a developer enterprise that vary from a traditional commercial business will be addressed in a future article. Nonetheless, examination of a consolidated cash flow can be very revealing when it is available. Figure 6 shows a balance sheet, income statement, and cash flow statement on a consolidated basis of the sample developer.

In examining the consolidated statements—in particular, the consolidated cash flow—we can draw two conclusions that are quite different from those drawn using the first two approaches.

1. This cash flow shows strong earnings, similar to the conclusion drawn in the NOI method. Thus, the NOI method is an important part of this analysis. It responds to issues that will be examined in

Figure 6

Typical Development Company
Consolidated Balance Sheet as of 12/31
(Individual/developer LP interest treated as equity)

	1998 Cost Basis	1999 Cost Basis	1999 Fair Value
Assets			
Cash	$ 675	$ 911	$ 911
Accounts Receivable—Property Ops	94	169	169
Accounts Receivable from Shareholder	1,900	2,835	2,835
Accounts Receivable Other	324	278	278
Land for Future Development	2,188	5,835	12,850
Construction in Progress	0	4,015	4,015
Real Estate Held (net)	20,260	20,960	46,640
Other Investments	132	132	132
Other Assets	534	459	459
Total Assets	**$26,107**	**$35,594**	**$68,289**
Liabilities			
Accounts Payable	$ 387	$ 441	$ 441
Tenant Deposits	401	432	432
Notes Payable Operating Properties	24,478	26,294	26,294
Notes Payable CIP	0	2,485	2,485
Notes Payable Land	0	2,424	2,424
Notes Payable Unsecured	2,340	7,060	7,060
Total Notes Payable	26,818	38,263	38,263
Total Liabilities	**27,606**	**39,136**	**39,136**
Minority Interests	(2,012)	(2,667)	10,173
Total Equity	513	(875)	18,980
Total Liabilities and Equity	**$26,107**	**$35,594**	**$68,289**

more detail in future articles.

2. Property expansion is 100% funded by expansion of debt on the balance sheet. The excess of debt over property expansion is used to fund dividends, which were viewed as a strong cash flow in the sponsor analysis approach. This activity is clearly unsustainable.

Flexibility is extremely limited, as it is being used to fund an apparent expansion strategy, and this will affect future performance. In addition, while we do not know much about lifestyle issues, some of this dividend likely is equivalent to salary of the principal. So there is little available debt capacity, even though the LTVs and individual debt coverages from the NOI approach may suggest future borrowing capacity. To remain a going concern, something will need to be changed in this equation. Knowing this early on can give valuable decision-making insight to the banker being asked to fund a marginal project or being asked for concessions.

Now What?

Clearly, receiving the complete statements as shown in this example is a superior approach. On the other hand, finding the necessary data in a reasonable and cost-effective manner appears difficult. However, if we step back and examine the similarities in data received and the sources of that data, we will see that we are much closer to a complete balance sheet and income statement than it may at first appear. When combined with a strategy for improving the information received, a much better, more complete analysis is possible.

To gain a better approach from the improved data, we need to examine the data sources. Virtually all the types of financial information listed previously originate from the same or similar source documentation. The project schedules are usually prepared from the books of the individual partnerships, while the tax returns are similarly prepared. In fact, the project schedules often are prepared from the books of account for each partnership at the same time as the tax returns. So it is not only possible, but also probable, that the tax return and the project schedules are from the same source and contain large amounts of the same data. Last, U.S. income tax form 1065 K-1, which has traditionally been held as a cash flow proxy for a developer's business, can be prepared only after the underlying form 1065 (partnership tax return) has been completed. Form K-1 is only an income-reporting document, while form 1065 has a cost basis, tax-law-driven balance sheet and income statement and, thus, a cash flow statement. We will have a more complete and useful analysis if we simply examine the form 1065 balance sheet and income statement.

There are many important analytical considerations in taking this approach to a real estate developer's business, not the least of

Figure 7
Typical Development Company

Consolidated Income Statement as of 12/31/99
(Individual/developer LP interest treated as equity)

	1999 Cost Basis
Revenues	$ 6,083
Less: Cost of revenues	(1,172)
Less: Depreciation—operating properties	(1,094)
Gross profit	3,817
SG&A	(938)
Operating profit	2,879
Interest expense	(2,363)
Profit from continuing operations	516
Loss on sale of assets	(136)
Net profit before interest of outside partners	380
Less: Interest of outside partners in net profit	(568)
Consolidated net income	**$ (188)**
Dividends	$(1,200)

Bank-Prepared Company Cash Flow as of 12/31/99
(Individual/developer LP interest treated as equity)

Net Income	(188)
Noncash charges	
Depreciation	1,094
Minority income	568
	1,474
Miscellaneous	
Changes in other A/R & receivable property operations	(29)
Changes in AP & deposits	85
Change in other assets	75
	131
Distributions	
Dividends	(1,200)
A/R to shareholder	(935)
Distributions to other partners	(1,223)
	(3,358)
Property Acquisitions	
Land acquisition	(3,647)
CIP	(4,015)
RE held	(1,794)
Total Acquisitions	(9,456)
Additional Debt	11,445
Change in Cash	**$ 236**

which is a thorough understanding of equity method and consolidation techniques and concepts. In addition, numerous analytical tools and techniques can be employed in the analysis that are not within the scope of this article. These will be covered in future installments in the series.

At this point what can an analyst do? A few steps can help begin the process:

1. Obtain the underlying partnership balance sheet and income statement (form 1065 or equivalent) on each of the entities in the developer's universe.
2. Make sure project schedules and supporting real estate collateral-specific documentation are of the same date as the statements.
3. Simply add together the balance sheets and income statements as a first step. While this is far from a perfect consolidation (or combination, depending on the ownership structure), this is the first step in the process.
4. Think ahead and accept incremental improvement—it's highly unlikely that good results will come overnight. Seek to improve the financial reporting over the life of what will hopefully be a long and profitable relationship. If, for example, you have received only the 1065 K-1 forms in the past, request the actual partnership return in advance of its preparation. At that point, it may be as simple as the accountant preparing an extra photocopy.
5. Take a fresh look at the data you have been receiving. In one bank, with a relationship that had literally hundreds of partnerships, a fresh examination found that the CPA had provided a "sum" of all the hundreds of partnerships balance sheets and income statements as a footnote (a 50-page footnote, but a footnote) for years. While it was not a CPA-audited consolidation, the first step had already been completed. Further examination revealed substantially more financial strength than the NOI and sponsor approaches had shown.

Important Analytical Considerations for Any Approach

If cash flow and cash flow analysis were just one number, the large U.S. banks would have reduced the judgment part of our jobs to mathematical formulas, and we would not be needed. Cash flow analysis is the understanding of the entire statement. We are paid for our judgment and interpretation skills, so we should always use common sense.

In analyzing a developer's statements, consider and answer all the following questions:

- What is generating cash?
- What is consuming cash?
- What are the business reasons for it?
- What does it mean for my risk profile?
- What are the priority cash uses?
- What are the business's strategic objectives? ❐

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