New Perspectives in Analyzing Real Estate Developer Financial Statements

by Daniel Boykin

In this fifth article on real estate developer financial statement analysis, the author examines the reporting of financial results when differing legal entities function as one business unit. It doesn't take long to encounter equity method and consolidation concepts in this analysis. It is considered one of the major complicating factors in analyzing developer businesses.

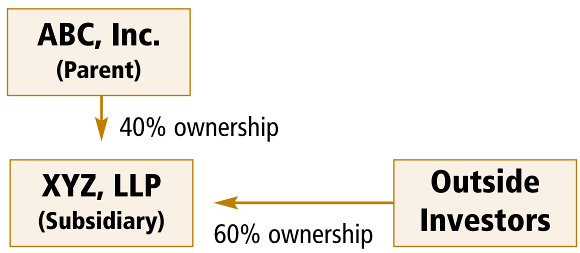
Analyzing financial statements that involve interrelated interests functioning as one business unit can be fairly complex. It is helpful to remember that the underlying economics of the transaction remains unaffected by the method of financial reporting. The only variance occurs in what is reported in the financial statements of the entity you are analyzing.

For the sake of simplicity, let's use a sample that is "stripped out" from a full financial statement. The skill gained from this more commonsense example can be built on for use in more complex situations.

The economic facts are basically as follows:

- ABC, Inc. invests $400,000 in a new subsidiary XYZ, LLP on the last day of 2001. ABC, Inc. is the entity this fictitious developer uses as the development company for all of its development projects.
- Another unrelated entity, Outside Investors, invests $600,000 in the same property transaction as a partner of XYZ, LLP.

A simplified organization chart for this example is shown below, followed by financial statement excerpts from the parent and the subsidiary just after this purchase.



ABC, Inc.
Balance Sheet Excerpt Year-End 2001
Immediately Following Investment

Assets	
Investment in XYZ, LLP	$400,000
Total Assets	400,000
Liabilities and Equity	
Equity	400,000
Total Liabilities and Equity	$400,000

Similarly, given the facts, the balance sheet of the subsidiary XYZ, LLP is as follows:

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XYZ, LLP
Balance Sheet Excerpt Year-End 2001
Immediately Following Investment

Assets	
Cash	$1,000,000
Total Assets	1,000,000
Liabilities and Equity	
Equity Interest, ABC, Inc.	400,000
Equity Interest, Outside Investors	600,000
Total Liabilities and Equity	$1,000,000

We have not shown the income statement as, for simplicity, we created this entity at the end of 2001. There is no income from XYZ, LLP. Similarly, for simplicity, we will concentrate on the excerpt to the income statement related to this transaction when we do show income generated by XYZ, LLP.

Now XYZ, LLP has located a property at the beginning of 2002. The purchase price is $4 million, financed with a 75% loan and 25% equity; we'll call the property "Main Street Plaza."

The balance sheet of XYZ, LLP then appears as follows:

XYZ, LLP
Balance Sheet Excerpt Beginning 2002
Immediately after Property Purchase

Assets	
Main Street Plaza	$ 4,000,000
Total Assets	4,000,000
Liabilities and Equity	
Loan Payable to National Bank	3,000,000
Equity Interest of ABC, Inc.	400,000
Equity Interest of Outside Investors	600,000
Total Equity	1,000,000
Total Liabilities and Equity	$ 4,000,000

The balance sheet for parent ABC, Inc. is unchanged, as is its economic interest. ABC, Inc. still owns its partnership interest in subsidiary XYZ, LLP. At this point, the only item left to judgment is how the parent ABC, Inc. will report any financial information related to XYZ, LLP when it prepares financial statements. We will look at the options in a minute. It is important to recognize that the issue of reporting applies only to the parent; the subsidiary is its own legal entity that will prepare its own financial statements.

As the year progresses, the property performs as planned, and the following is the resulting income statement for XYZ, LLP.

XYZ, LLP
Income Statement Year-End 2002

Revenues	$ 500,000
Costs of Sales	-100,000
Gross Margins	400,000
SG&A Expenses	-100,000
Interest Expense	-200,000
Net Income	$ 100,000

We will assume that the income earned by XYZ, LLP is owned by the investors in the same proportion as their original investment in the entity—that is, 40% to ABC, Inc. and 60% to Outside Investors.

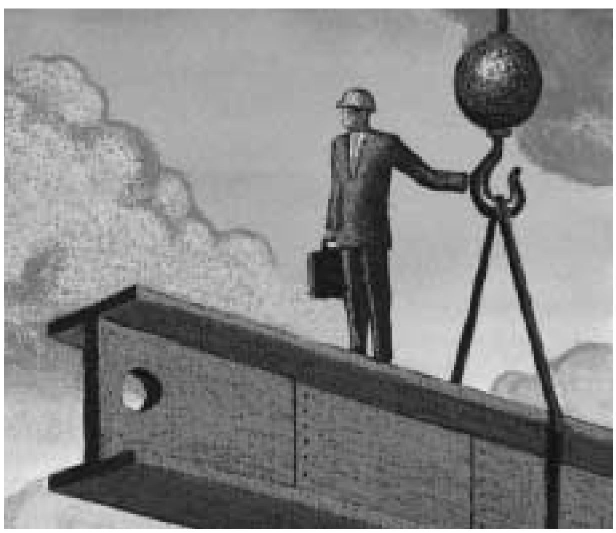
The balance sheet for XYZ, LLP after these earnings is as follows:

XYZ, LLP
Balance Sheet Excerpt End-of-Year 2002

Assets	
Cash	$ 100,000
Main Street Plaza	4,000,000
Total Assets	4,100,000
Liabilities and Equity	
Loan Payable to National Bank	3,000,000
Equity Interest of ABC, Inc.	440,000
Equity Interest of Outside Investors	660,000
Total Equity	1,100,000
Total Liabilities and Equity	$ 4,100,000

Reporting Options Available to ABC, Inc.

In beginning to gain a working understanding of and familiarity with reporting options, it is important to understand who the parent entity actually is—in this case, ABC, Inc. The concepts can be expanded to more complex organizations once the basics are understood.



From an analysis perspective, the only complicating financial reporting facts relate to the parent. ABC, Inc. owns a partnership interest in XYZ, LLP; it does not own (directly) anything else in relation to its subsidiary. For simplicity, we will stick with this example.

When it comes time for the parent to prepare basic financial statements (balance sheet and income statement), there is a limited amount of data that can be provided (excluding detailed footnote disclosures, which can be extensive). These can be summarized as follows:

	Option 1	Option 2	Option 3
Income Statement	Nothing	The parent's "share of the earnings"	The entire income statement, adjusted for what does not belong to the parent.
Balance Sheet	Original Cost	The parent's share of the current "equity" in the subsidiary	The entire balance sheet of the subsidiary, with an allowance (identification) of what does not belong to the parent.

Again, really all that changes is what financial data is chosen to be disclosed by ABC, Inc. relating to its interest in XYZ, LLP. Let's consider the three options available.

Option 1, aka The Cost Method. Although rarely seen in the real estate world, this option does surface from time to time. ABC, Inc. simply reports its investment in XYZ, LLP at original cost on the balance sheet. Nothing is reported on the income statement unless a dividend or distribution is received. When cash is actually received, it is most commonly reported as investment income.

If the investment is ever disposed of, a gain or loss would be recognized. But other than lower of cost or market considerations, that is about it for this method.

Option 2, aka The Equity Method. The idea behind this method is touched on in the table shown on the previous page. Widely used in real estate, this is also an Income Tax Return method of reporting. (There is provision for a *consolidated return*, but that is beyond the scope of this article.) It is important to remember that all that changes from the previous method is the amount and degree of basic financial statement disclosure. The basic idea is that the reporting entity (in this case, ABC, Inc.) shows (or claims) its share of the earnings in the subsidiary in the parent's financial statements.

The application is rather straightforward: When ABC, Inc. prepares its income statement, it reports the earnings from the investment as part of net income. This is shown in the excerpt below:

ABC, INC.
Income Statement Excerpt Year-End 2002

Income from Investment in XYZ, LLP	$ 40,000

Note: This title "Income from Investment in XYZ, LLP" has many other titles in actual practice, such as Investment Income; Income from JVs; Income from Equity Investment; Equity Income; Equity in Income; Equity in Income of Unconsolidated JVs, and so forth. This alone can complicate the understanding.

The astute observer will likely ask, Where do the earnings show up on the balance sheet? Here it gets a bit tricky, but the concept is really quite simple. The reported investment is increased on the balance sheet. Essentially, the asset is increased as earnings are recognized, even though the earnings are not received. For readers who prefer debits and credits, it looks like this:

	Debit	Credit
Investment in XYZ, LLP (balance sheet asset)	$40,000	
Income from Investments (in this case XYZ, LLP)		$40,000

When this method of reporting is used, the income statement and balance sheet of the parent ABC, Inc. will appear as follows:

ABC, Inc.
Balance Sheet Excerpt Year-End 2002

Assets	
Investment in XYZ, LLP	$440,000
Total Assets	440,000
Liabilities and Equity	
Equity (owned by shareholder(s) of ABC, Inc.)	440,000
Total Liabilities and Equity	$ 440,000

The balance sheet has been increased by the amount of earnings recognized (but not received in this case).

Important analytical considerations. This method of reporting is widespread among real estate businesses, and understanding the analytical considerations is important to the analysis of the overall business:

1. The earnings are not cash. They are recognition of the equity in (or the parent's right to) the earnings of the subsidiary.

2. On the balance sheet we see only the net equity (hence the term *equity method*) in the entity. We have no idea what other resources are at work or at risk (i.e. loans or other investor claims).
3. Similarly, on the income statement we see only the equity in the earnings (or the parent's claim, thus the term *equity method*). We have no way to analyze the performance of the entity that generated those earnings.
4. When a distribution is received (cash or otherwise) from the investment, the investment is reduced by the amount of the distribution. It is essentially a liquidation of the investment (or conversion to cash or another asset). This is the only cash effect. The balance sheet changes and the income statement income are not cash.
5. A negative investment is possible if distributions exceed the investment (plus earnings), as in the case of a property refinancing (by the subsidiary) and subsequent distribution of the proceeds (to the parent).

Special comment on tax returns. Generally, tax returns are an equity method presentation. Both individual and business returns are required to report their share of income in *flow-through* entities (for example, LLP, LLC, GP, LP, S-Corp). The concepts discussed here apply, but the reporting format is quite different due to differing items of income and expense being subject to varying and differing treatments under the tax code.

Option 3, aka Consolidation. The third option is to include the full amount of the resources involved as part of the parent financial statements. The fundamental concept behind a consolidation is the presentation as one economic entity of several related entities. For simplicity, we will discuss only parent/subsidiary relationships, and only in the situa-

Figure 1

Consolidating Worksheet Balance Sheet—FYE 2002

	ABC, Inc (Parent)	XYZ, LLP (Subsidiary)	Sum	Eliminations	ABC, Inc. Consolidated
Assets					
Cash	-0-	100,000			100,000
Investment in XYZ, LLP	440,000	-0-		(440,000)	-0-
Main Street Plaza	-0-	4,000,000			4,000,000
Total Assets	$ 440,000	$4,100,000	$4,540,000	$ (440,000)	$ 4,100,000
Liabilities and Equity					
Loan Payable to National Bank		$ 3,000,000	$3,000,000	-0-	$ 3,000,000
Equity Interest of Individual Investors in XYZ, LLP		$ 660,000	660,000	-0-	660,000
Equity Interest of ABC, Inc.		$ 440,000	440,000	(440,000)	-0-
Equity Interest of ABC, Inc. Shareholder(s)	440,000	-0-	440,000	-0-	440,000
Total Liabilities and Equity	$440,000	$4,100,000	$4,540,000	(440,000)	$ 4,100,000

Consolidating Worksheet Income Statement—Year Ended 12/31/2002

	ABC, Inc (Parent)	XYZ, LLP (Subsidiary)	Sum	Eliminations	ABC, Inc. Consolidated
Revenues		$ 500,000	$ 500,000		$ 500,000
Costs of Sales		-100,000	-100,000		-100,000
Gross Margins		400,000	400,000		400,000
SG&A Expenses		-100,000	-100,000		-100,000
Interest Expense		-200,000	-200,000		-200,000
Income from Investment in XYZ, LLP	40,000		40,000	(40,000)	-0-
Net Income of XYZ, LLP Belonging to ABC, Inc.		40,000			
Net Income of XYZ, LLP Belonging to Outside Investors		60,000			(60,000)
Total Net Income	$ 40,000	$ 100,000	$ 140,000	($ 40,000)	$ 40,000

tion in this sample of only one level of subsidiary entity. Understanding the concept allows application to more complex situations.

Under the equity method, we showed that what is reported is the "net" investment on the balance sheet and the "net" earnings on the income statement. All that changes in a consolidation is the amount of disclosure about how the net numbers shown in an equity method presentation are derived. So in essence, a consolidation can be thought of as a "gross" presentation. Remember, however, that the fundamentals remain unchanged: the interest that the parent company (ABC, Inc. in this case) has in the investment is unchanged. Therefore, the parent earnings should be unchanged, and the "net" investment (net worth in this example) should be unchanged.

The process of consolidation is done on a worksheet of some kind. In concept, all that is done is to remove the "net number," be it in the income statement or on the balance sheet, and replace it with (gross) numbers that equal the net number. The worksheet for ABC, Inc. is shown in Figure 1.

The consolidating worksheets look a bit odd to the analyst who is new to its use, but all that is done is to replace the net numbers previously presented with gross numbers that have the same net value.

- In the case of the balance sheet for ABC, Inc., the net investment of $440,000 was replaced with assets of $4.1 million; liabilities of $3 million; and claims of "outside investors" of $660,000. The net investment of the parent remains $440,000 (i.e., its equity remains unchanged).
- In the case of the income statement for ABC, Inc., the net investment income of $40,000 was replaced with sales of $500,000, total (all) costs of $400,000, and a "claim" on the earnings by the outside partners of $60,000. The reported income of the parent remains at $40,000.

In most instances, the outside partner interests are referred to as *minority interests*. Not because they have a minority stake, but because their claim is on some, but not all, the assets in the consolidated entity.

Analytical considerations. First and foremost, the most important part of the analysis is to understand precisely the nature of what is being reported in the statements being examined. This is one of the more complex aspects of real estate business financial reporting and analysis. With that, there are a few advantages and disadvantages to the various methods discussed in this article.

1. The equity method is net, so it takes debt and the assets off the balance sheet. This practice has been widely criticized lately, but it is in fact an acceptable practice under certain circumstances.
2. The consolidation is gross, so we know more about the full range of resources and the performance. But, the minority interest is not easily identified. In our example, we used one subsidiary. In reality, there are numerous subsidiaries, and the consolidated statement can lead to erroneous conclusions. For example, a very liquid consolidated statement may have all the liquidity owned by the minority partners.

What to do? Look at the pieces in either case. If you have statements with equity method (or cost, for that matter) investments, obtain the statements on the individual entity and analyze them as appropriate. Should you receive consolidated statements, get the consolidating worksheets, or consoldating statements.

But the borrower does not prepare them? Not so! How can the "equity method" be employed if we do not know what the performance and position of the investee entity is? Similarly, even the most capable accountant has yet to prepare a real consolidation in his or her head. Worksheets are a necessity, even in our simple example.

Finally, this reporting makes the most capable analyst cross-eyed. This is but one of many reasons that analyzing a real estate business is geometrically more difficult than a standard commercial credit. ❐

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