On point.

Non-GAAP Financial Measures Used by REITs: Frequent SEC Comments

This note examines some of the issues raised in comment letters issued by the staff of the Securities and Exchange Commission's ("SEC") Division of Corporation Finance (the "Staff") to real estate investment trusts ("REITs") regarding their use of financial measures not presented in accordance with generally accepted accounting principles ("GAAP") in the United States ("non-GAAP financial measures"). We provide excerpts from, and links to, representative Staff comment letters. For each comment discussed, we offer drafting and other suggestions to address these frequent issues. This note is not intended to set forth an exhaustive list of comments that the Staff can issue relating to a REIT's use of non-GAAP financial measures. Staff comments can vary widely and depend on a particular registrant's business, financial condition and on specific facts and circumstances.

In recent years, the Staff has increased its focus on compliance with the presentation and disclosure requirements for the use of non-GAAP financial measures. Public companies are prohibited from presenting non-GAAP financial measures in ways that are misleading or that give them greater prominence than the comparable GAAP measures. These prohibitions apply to both the order of presentation and the degree of emphasis. In May 2016, the Staff updated its guidance on the use of non-GAAP financial measures and identified certain uses that the Staff considers misleading or providing undue prominence. This guidance, which has since been further updated, is available here: www.goo.gl/UiNFsA.

Common SEC Comments

Labeling

While REITs are permitted to present non-GAAP financial measures in their public disclosures in order to enable management to convey a clearer picture of the REIT's financial results to investors, the Staff is concerned with non-GAAP financial measures that are further adjusted from commonly understood non-GAAP financial measures and are referenced with a label that superficially mischaracterizes the adjusted non-GAAP financial measures. Examples of this type of "mislabeling" comment include:

> "Measures calculated differently from EBITDA should not be characterized as EBITDA and their titles should be distinguished from EBITDA, such as adjusted EBITDA." (*SEC Comment Letter to Camden Property Trust (June 8, 2016)*.)
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> "In arriving at FFO, you start with net income attributable to GGP Inc. and make adjustments for redeemable non-controlling interests and preferred stock dividends. As a result, it appears FFO and ultimately Company FFO, are attributable to common shareholders and redeemable non-controlling interest holders. Please clarify and/or revise the labeling of your non-GAAP financial measures in future filings to adequately reflect what is being presented." (*SEC Comment Letter to GGP Inc., (March 30, 2017)*.)

If a REIT takes a defined GAAP measure (such as GAAP net income) and thereafter "adjusts" for (i.e., excludes or includes) one or more expense or revenue items that are components of that GAAP measure (for instance, excluding an expense identified as "non-recurring"), then the resulting measure (called "adjusted net income," for example) is a non-GAAP financial measure. Similarly, EBITDA (earnings before interest, taxes, depreciation and amortization) is another common and widely used non-GAAP financial measure. It is a non-GAAP financial measure because the REIT takes GAAP earnings (i.e., net income as presented in the statement of operations under GAAP) and then adjusts for interest, taxes, depreciation and amortization components (which are elements derived from GAAP financial presentations) to arrive at a measure (EBITDA) that is not presented in accordance with GAAP.

The Staff generally acknowledges the use and acceptance of GAAP measures that are adjusted in order to present non-GAAP financial measures, such as EBITDA. However, the Staff is likely to comment if these commonly understood non-GAAP financial measures are further adjusted by a REIT without providing the investor with prominent disclosure and a clear identification of the adjustment made to that non-GAAP financial measure. REITs are advised to correctly describe what is being disclosed to investors. The adjustments to a commonly used non-GAAP financial measure should identify the adjustment in the title of the adjusted measure in order to distinguish it from other commonly accepted and understood non-GAAP financial measures. An example of this would be:

> "The Company determines FFO based upon the definition set forth by National Association of Real Estate Investment Trusts ("NAREIT"). The Company determines FFO to be its share of consolidated net income (loss) [attributable to common shareholders and redeemable non-controlling common unit holders] computed in accordance with GAAP, excluding real estate related depreciation and amortization, excluding gains and losses from extraordinary items, excluding cumulative effects of accounting changes, excluding gains and losses from the sales of, or any impairment charges related to, previously depreciated operating properties, plus the allocable portion of FFO of unconsolidated joint ventures based upon the Company's economic ownership interest, and all determined on a consistent basis in accordance with GAAP. As with the Company's presentation of NOI, FFO has been reflected on a proportionate basis." (GGP, Inc.).

Adjustments to Core Earnings

Another area of concern for the Staff is ensuring that adjustments to the frequently used non-GAAP financial measure "core earnings" are prominently explained to REIT investors. REITs often employ core earnings as a non-GAAP financial measure to characterize their core business and exclude adjustments that are considered by management to constitute non-core expenses or activities. Core earnings is typically defined as net income (loss) excluding realized and changes in unrealized gains (losses), gains (losses) on financial derivatives, and any other nonrecurring items of income (loss). Core earnings and similar metrics are typically useful for mortgage REIT investors because they provide an indication of a mortgage portfolio's performance based on its effective net yield.

Recently, the Staff has requested that REITs explain and specify adjustments used to arrive at core earnings in order to clarify the items that an issuer is designating as non-recurring (and thereby excluded from the core earnings calculation). Examples of this type of comment include:

> "Please revise your disclosure of core earnings in future filings to include all of the disclosures required by Item 10(e) of Regulation S-K. In particular, please include a reconciliation of core earnings that begins with the most directly comparable GAAP measure. Your revised reconciliation should provide disaggregated disclosure of all the adjustments necessary to arrive at core earnings from the most directly comparable GAAP measure." (*SEC Comment Letter to Two Harbors Investment Corp. (March 29, 2018)*.)
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> "We note your presentation of core earnings, and the exclusion of non-cash (recovery of) provision for CRE loan losses. Please tell us your rationale for adjusting to exclude this amount from core earnings given it appears to be integral to operating your business. Additionally, tell us your basis for excluding incentive management fees, which are recurring operating expenses paid primarily in cash; refer to Item 10(e)(1)(i)(C) of Regulation S-K and Question 100.01 of the C&DIs on Non-GAAP Financial Measures." *(SEC Comment Letter to Resource Capital Corp. (December 1, 2017).)*
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> "We note that your measure of core earnings generally recognizes income earned from equity method investments as your initial capital investment amortized over the life of the project using a constant yield. We further note this methodology differs from the hypothetical liquidation at book value method used to calculate your share of earnings in your financial statements. Please tell us how you applied the guidance in question 100.04 in the C&DI related to Non-GAAP Financial Measures in determining your adjustments were appropriate." *(SEC Comment Letter to Hannon Armstrong Sustainable Infrastructure Capital, Inc. (June 26, 2017).)*

Typical adjustments to GAAP net income in order to arrive at core earnings include excluding gains or losses on disposals of investments and termination of interest rate swaps, gains or losses on foreign currency transactions, depreciation and amortization charges, and acquisition-related expenses. In response to these types of comments, REITs have explained to the Staff the method used to calculate core earnings and why management believes the particular method or exclusion is appropriate. For example, Two Harbors responded to the first comment above by including the following reconciliation of core earnings to net income (loss) and core earnings definition in its subsequent public filings:

> Non-GAAP Reconciliation:
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> > Net income (loss) available to common stockholders
> > Net realized (gain) loss on investments

Net unrealized (gain) loss on investments
Net realized and unrealized (gain) loss on derivative instruments
Net unrealized (gain) loss on [Federal Home Loan Bank] advances

Core Earnings:

"Core Earnings is a non-U.S. GAAP measure that Two Harbors defines as comprehensive (loss) income attributable to common stockholders, excluding "realized and unrealized gains and losses" (impairment losses, realized and unrealized gains and losses on the aggregate portfolio, reserve expense for representation and warranty obligations on mortgage servicing rights and non-cash compensation expense related to restricted common stock). As defined, Core Earnings includes interest income or expense and premium income or loss on derivative instruments and servicing income, net of estimated amortization on mortgage servicing rights. Dollar roll income is the economic equivalent to holding and financing agency residential mortgage-backed securities using short-term repurchase agreements. Two Harbors believes the presentation of Core Earnings, including dollar roll income, provides investors greater transparency into its period-over-period financial performance and facilities comparisons to peer REITs."

Question 100.03 of the Staff's updated Compliance and Disclosure Interpretations ("C&DIs") provides that a non-GAAP financial measure that is adjusted only for non-recurring charges and not for non-recurring gains, even if there were non-recurring gains that occurred during the same period, may violate Rule 100(b) of Regulation G for being misleading. In a number of comments, the Staff observed that the non-GAAP financial measures employed by REITs appeared to only exclude charges and not gains.

TBA Forward Contracts

The Staff may comment if there is not an enhanced discussion of income generated from to-be-announced ("TBA") forward contracts. This particularly is an area where REITs should be mindful to include a detailed discussion. The Staff may ask for more detail in this section, similar to the following comment:

"Please expand your disclosure in future filings to include an enhanced discussion of TBA dollar roll income. Please include the following in your revised disclosure: a discussion of why you believe dollar roll income represents the equivalent of interest income on the underlying security less an implied cost of financing." (*SEC Comment Letter to Annaly Capital Management, Inc. (April 20, 2017)*.)

Here, the REIT responded by including a proposed section of its future disclosure that incorporated the changes requested by the Staff. The new section reads as follows:

"From time to time, we enter into to-be-announced forward contracts (TBAs) as an alternate means of investing in and financing Agency mortgage-backed securities. A TBA contract is an agreement to purchase or sell, for future delivery, an Agency mortgage-backed security with a specified issuer, term and coupon. A TBA dollar roll represents a transaction where TBA contracts with the same terms but different settlement dates are simultaneously bought and sold. The TBA contract settling in the later month typically prices at a discount to the earlier month contract with the difference in price commonly referred to as the "drop." The drop is a reflection of the expected net interest income from an investment in similar Agency mortgage-backed securities, net of an implied financing cost, that would be foregone as a result of settling the contract in the later month rather than in the earlier month. The drop between the current settlement month price and the forward settlement month price occurs because in the TBA dollar roll market, the party providing the financing is the party that would retain all principal and interest payments accrued during the financing period. Accordingly, TBA dollar roll income generally represents the economic equivalent of the net interest income earned on the underlying Agency mortgage-backed security less an implied financing cost.

TBA dollar roll transactions are accounted for under US GAAP as a series of derivatives transactions. The fair value of TBA derivatives is based on methods similar to those used to value Agency mortgage-backed securities. The Company records TBA derivatives at fair value on its Consolidated Statements of Financial Condition and recognizes periodic changes in fair value as Net gains (losses) on trading assets in the Consolidated Statements of

Comprehensive Income (Loss), which includes both unrealized and realized gains and losses on derivatives (excluding interest rate swaps).

TBA dollar roll income is calculated as the difference in price between two TBA contracts with the same terms but different settlement dates multiplied by the notional amount of the TBA contract. Although accounted for as derivatives, TBA dollar rolls capture the economic equivalent of net interest income, or carry, on the underlying Agency mortgage-backed security (interest income less an implied cost of financing). TBA dollar roll income is reported as a component of Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss)."

The Staff was satisfied with the detailed response provided above.

Undue Prominence

Undue prominence is another area of Staff focus. In particular, locating a non-GAAP financial measure in front of a GAAP financial measure is likely to generate a Staff comment. For example, the Staff has issued the following comments:

> "You discuss funds from operations and company-defined funds from operations before you discuss your financial information prepared in conformity with U.S. GAAP. This presentation appears to put greater prominence on your non-GAAP measures, which is inconsistent with Question 102.10 from the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your future periodic filings." (*SEC Comment Letter to Black Creek Diversified Property Fund Inc. (January 13, 2017).*)
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> "You disclose the non-GAAP financial measure funds from operations with greater prominence than financial information prepared in conformity with U.S. GAAP, which is inconsistent with Question 102.10 from the updated Compliance and Disclosure Intrepretations issued on May 17, 2016. Please review this guidance when preparing your future periodic filings." (*SEC Comment Letter to CIM Commercial Trust Corp. (September 12, 2016*).)

Because these types of comments are strictly about ordering or presentation of information, most REITs simply agree to relocate the non-GAAP financial measure as requested by the Staff in future filings. By ensuring that GAAP financial measures are placed before, and given greater prominence than, non-GAAP financial measures, REITs can avoid this type of comment.

Usefulness of the Metric

The Staff will also ask how non-GAAP financial measures are used and how useful these are to investors. This information will help the Staff decide whether the measure serves a useful purpose. An example of this type of comment includes:

> "Please expand your disclosure to provide a more detailed discussion of the reasons why management believes the measures of FFO as adjusted and FAD are useful non-GAAP measures for investors." (*SEC Comment Letter to HCP, Inc. (September 27, 2016).*)

In responding to such a comment, it is helpful to explain the purpose behind the non-GAAP financial measure. For example, HCP, Inc. responded:

> "Management believes that FFO as adjusted provides a meaningful supplemental measurement of our FFO run-rate and is frequently used by analysts, investors and other interested parties in the evaluation of our performance as a REIT. At the same time that NAREIT created and defined its FFO measure for the REIT industry, it also recognized that 'management of each of its member companies has the responsibility and authority to publish financial information that it regards as useful to the financial community.' We believe stockholders, potential investors and financial analysts who review our operating performance are best served by an FFO run-rate earnings measure that includes, in addition to adjustments made to arrive at the NAREIT defined measure of FFO, other adjustments to net income (loss). FFO as adjusted is used by management in analyzing our business and the performance of our properties, and we believe it is important that stockholders, potential investors and financial analysts understand this measure used by management. We use FFO as adjusted to: (i) evaluate our performance in comparison with expected results and results of previous periods, relative to resource allocation decisions,

(ii) evaluate the performance of our management, (iii) budget and forecast future results to assist in the allocation of resources, (iv) assess our performance as compared with similar real estate companies and the industry in general and (v) evaluate how a specific potential investment will impact our future results. Other REITs or real estate companies may use different methodologies for calculating an adjusted FFO measure, and accordingly, our FFO as adjusted may not be comparable to those reported by other REITs."

The Staff is less likely to issue a comment if the REIT includes a detailed explanation of the usefulness of the non-GAAP financial measure in its filing. If more detail is provided, the Staff generally gains a better understanding of the non-GAAP financial metric that is being used.

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