Seritage Growth Properties
Form 10-Q
May 04, 2018
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2018
or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______to _______

Commission File Number 001-37420

SERITAGE GROWTH PROPERTIES

(Exact name of registrant as specified in its charter)

Maryland	38-3976287
(State of Incorporation)	(I.R.S. Employer Identification No.)

500 Fifth Avenue, Suite 1530, New York, New York	10110
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (212) 355-7800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definitions of “large accelerated filer”, “accelerated filer”, “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of April 27, 2018, the registrant had the following common shares outstanding:

Class	Shares Outstanding
Class A common shares of beneficial interest, par value $0.01 per share	35,260,258
Class B common shares of beneficial interest, par value $0.01 per share	1,328,866
Class C common shares of beneficial interest, par value $0.01 per share	320,418

SERITAGE GROWTH PROPERTIES

QUARTERLY REPORT ON FORM 10-Q

QUARTER ENDED MARCH 31, 2018

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PART I. FINANCIAL INFORMATION
Item 1. Unaudited Condensed Consolidated Financial Statements
SERITAGE GROWTH PROPERTIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, amounts in thousands, except share and per share amounts)

	March 31, 2018	December 31, 2017
ASSETS		
Investment in real estate		
Land	$750,870	$799,971
Buildings and improvements	851,416	829,168
Accumulated depreciation	(148,926)	(139,483)
	1,453,360	1,489,656
Construction in progress	252,350	224,904
Net investment in real estate	1,705,710	1,714,560
Investment in unconsolidated joint ventures	330,322	282,990
Cash and cash equivalents	135,091	241,569
Restricted cash	177,419	175,665
Tenant and other receivables, net	32,021	30,787
Lease intangible assets, net	291,613	310,098
Prepaid expenses, deferred expenses and other assets, net	23,839	20,148
Total assets	$2,696,015	$2,775,817
LIABILITIES AND EQUITY		
Liabilities		
Mortgage loans payable, net	$1,130,793	$1,202,314
Unsecured term loan, net	143,590	143,210
Accounts payable, accrued expenses and other liabilities	99,063	109,433
Total liabilities	1,373,446	1,454,957
Commitments and contingencies (Note 9)		
Shareholders' Equity		
Class A common shares $0.01 par value; 100,000,000 shares authorized; 35,208,666 and 32,415,734 shares issued and outstanding as of March 31, 2018 and December 31, 2017, respectively	352	324
Class B common shares $0.01 par value; 5,000,000 shares authorized; 1,328,866 and 1,328,866 shares issued and outstanding as of March 31, 2018 and December 31, 2017, respectively	13	13
Class C common shares $0.01 par value; 50,000,000 shares authorized; 372,010 and 3,151,131 shares issued and outstanding as of	4	31

March 31, 2018 and December 31, 2017, respectively		
Series A preferred shares $0.01 par value; 10,000,000 shares authorized;		
2,800,000 shares issued and outstanding as of March 31, 2018		
and December 31, 2017; liquidation preference of $70,000	28	28
Additional paid-in capital	1,116,841	1,116,060
Accumulated deficit	(229,652)	(229,760)
Total shareholders' equity	887,586	886,696
Non-controlling interests	434,983	434,164
Total equity	1,322,569	1,320,860
Total liabilities and equity	$2,696,015	$2,775,817

The accompanying notes are an integral part of these condensed consolidated financial statements.

SERITAGE GROWTH PROPERTIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, amounts in thousands, except per share amounts)

	Three Months Ended March 31,	
	2018	2017
REVENUE		
Rental income	$37,079	$49,174
Tenant reimbursements	16,698	16,224
Total revenue	53,777	65,398
EXPENSES		
Property operating	7,241	4,742
Real estate taxes	11,381	12,422
Depreciation and amortization	34,667	58,663
General and administrative	7,797	6,274
Provision for doubtful accounts	61	39
Total expenses	61,147	82,140
Operating loss	(7,370)	(16,742)
Equity in (loss) income of unconsolidated joint ventures	(2,582)	1,002
Gain on sale of real estate	41,831	—
Interest and other income	680	78
Interest expense	(16,419)	(16,592)
Unrealized gain (loss) on interest rate cap	165	(471)
Income (loss) before income taxes	16,305	(32,725)
Provision for income taxes	(104)	(119)
Net income (loss)	16,201	(32,844)
Net (income) loss attributable to non-controlling interests	(5,873)	13,006
Net income (loss) attributable to Seritage	$10,328	$(19,838)
Preferred dividends	(1,228)	—
Net income (loss) attributable to Seritage common shareholders	$9,100	$(19,838)
Net income (loss) per share attributable to Seritage Class A and Class C common shareholders - Basic	$0.26	$(0.59)
Net income (loss) per share attributable to Seritage Class A and Class C common shareholders - Diluted	$0.26	$(0.59)
Weighted average Class A and Class C common shares outstanding - Basic	35,414	33,510

Weighted average Class A and Class C common shares		
outstanding - Diluted	35,501	33,510

The accompanying notes are an integral part of these condensed consolidated financial statements.

SERITAGE GROWTH PROPERTIES

CONDENSED CONSOLIDATED STATEMENTS OF EQUITY

(Unaudited, amounts in thousands)

	Class A Common Shares	Amount	Class B Common Shares	Amount	Class C Common Shares	Amount	Series A Preferred Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Non-Controlling Interests	Total Equity
Balance at January 1, 2017	25,843	$258	1,589	$16	5,755	$58	—	$—	$925,563	$(121,338)	$619,754	$1,424,311
Net loss	—	—	—	—	—	—	—	—	—	(19,838)	(13,006)	(32,844)
Dividends and distributions declared ($0.25 per share and unit)	—	—	—	—	—	—	—	—	—	(8,492)	(5,477)	(13,969)
Vesting of restricted share units	4	0	—	—	—	—	—	—	(0)	—	—	—
Stock-based compensation	—	—	—	—	—	—	—	—	390	—	—	390
Share class exchanges, net (24,200 common shares)	(24)	(0)	—	—	24	0	—	—	—	—	—	—
Share class surrenders (149,053 common shares)	—	—	(149)	(2)	—	—	—	—	2	—	—	—
OP Unit exchanges (2,267,821 units)	2,268	23	—	—	—	—	—	—	67,059	—	(67,082)	—
Balance at March 31, 2017	28,091	$281	1,440	$14	5,779	$58	—	$—	$993,014	$(149,668)	$534,189	$1,377,888

Balance at January 1, 2018	32,416	$324	1,329	$13	3,151	$31	2,800	$28	$1,116,060	$(229,760)	$434,164	$1,320,860
Net income	—	—	—	—	—	—	—	—	—	10,328	5,873	16,201
Common dividends and distributions declared ($0.25 per share and unit)	—	—	—	—	—	—	—	—	—	(8,992)	(5,054)	(14,046)
Preferred dividends declared ($0.4375 per share)	—	—	—	—	—	—	—	—	—	(1,228)	—	(1,228)
Vesting of restricted share units	14	0	—	—	—	—	—	—	(0)	—	—	—
Stock-based compensation	—	—	—	—	—	—	—	—	869	—	—	869
Preferred stock offering costs	—	—	—	—	—	—	—	—	(88)	—	—	(88)
Share class exchanges, net (2,779,121 common shares)	2,779	28	—	—	(2,779)	(27)	—	—	—	—	—	1
Balance at March 31, 2018	35,209	$352	1,329	$13	372	$4	2,800	$28	$1,116,841	$(229,652)	$434,983	$1,322,569

The accompanying notes are an integral part of these condensed consolidated financial statements.

SERITAGE GROWTH PROPERTIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, amounts in thousands)

	Three Months Ended March 31, 2018	2017
CASH FLOW FROM OPERATING ACTIVITIES		
Net income (loss)	$16,201	$(32,844)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Equity in loss (income) of unconsolidated joint ventures	2,582	(1,002)
Gain on sale of real estate	(41,831)	—
Unrealized (gain) loss on interest rate cap	(165)	471
Stock-based compensation	869	390
Depreciation and amortization	34,667	58,663
Amortization of deferred financing costs	1,720	1,582
Amortization of above and below market leases, net	(234)	(195)
Straight-line rent adjustment	(2,453)	(1,534)
Change in operating assets and liabilities		
Tenants and other receivables	1,034	419
Prepaid expenses, deferred expenses and other assets	(4,229)	(687)
Accounts payable, accrued expenses and other liabilities	(502)	9,039
Net cash provided by operating activities	7,659	34,302
CASH FLOW FROM INVESTING ACTIVITIES		
Investment in unconsolidated joint ventures	(1,616)	(5,943)
Distributions from unconsolidated joint ventures	2,110	3,623
Net proceeds from sale of real estate	60,435	—
Development of real estate	(85,983)	(22,848)
Net cash used in investing activities	(25,054)	(25,168)
CASH FLOW FROM FINANCING ACTIVITIES		
Repayment of mortgage loans payable	(73,034)	—
Proceeds from Future Funding Facility	—	7,011
Payment of deferred financing costs	(363)	(1,446)
Common dividends paid	(8,877)	(8,447)
Non-controlling interests distributions paid	(5,055)	(5,477)
Net cash used in financing activities	(87,329)	(8,359)
Net increase (decrease) in cash, cash equivalents, and restricted cash	(104,724)	775
Cash, cash equivalents, and restricted cash, beginning of period	417,234	139,642
Cash, cash equivalents, and restricted cash, end of period	$312,510	$140,417

SERITAGE GROWTH PROPERTIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited, amounts in thousands)

	Three Months Ended March 31, 2018	2017
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash payments for interest	$21,105	$16,052
Capitalized interest	6,862	1,177
Income taxes paid	104	119
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES		
Development of real estate financed with accounts payable	$19,964	$5,899
Dividends and distribution declared and unpaid	14,046	13,969
Decrease in real estate, net resulting from deconsolidated properties	(58,190)	—
RECONCILIATION OF CASH AND CASH EQUIVALENTS AND RESTRICTED CASH		
Cash and cash equivalents	$135,091	$26,542
Restricted cash	177,419	113,875
Total cash, cash equivalents, and restricted cash shown in the statement of cash flows	312,510	140,417

The accompanying notes are an integral part of these condensed consolidated financial statements.

SERITAGE GROWTH PROPERTIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 – Organization

Seritage Growth Properties ("Seritage") was organized in Maryland on June 3, 2015 and was initially capitalized with 100 shares of Class A common shares. The Company conducts its operations through Seritage Growth Properties, L.P. (the "Operating Partnership"), a Delaware limited partnership that was formed on April 22, 2015. Unless the context otherwise requires, "Seritage" and the "Company" refer to Seritage, the Operating Partnership, and its subsidiaries.

On June 11, 2015, Sears Holdings Corporation ("Sears Holdings") effected a rights offering (the "Rights Offering") to Sears Holdings stockholders to purchase common shares of Seritage in order to fund, in part, the $2.7 billion acquisition of (i) 234 of Sears Holdings' owned properties and one of its ground leased properties, and (ii) its 50% interests in three joint ventures that collectively owned 28 properties, ground leased one property and leased two properties (the "Transaction"). The Rights Offering ended on July 2, 2015, and the Company's Class A common shares were listed on the New York Stock Exchange ("NYSE") on July 6, 2015.

On July 7, 2015, the Company completed the Transaction with Sears Holdings and commenced operations. The Company did not have any operations prior to the completion of the Rights Offering and the Transaction.

Seritage is a fully-integrated, self-administered, self-managed real estate investment trust ("REIT") primarily engaged in the real property business through the Company's investment in the Operating Partnership. As of March 31, 2018, the Company's portfolio consisted of interests in 249 properties totaling approximately 38.9 million square feet of gross leasable area ("GLA"), including 225 wholly owned properties totaling approximately 34.6 million square feet of GLA across 49 states and Puerto Rico (the "Wholly Owned Properties), and interests in 24 joint venture properties totaling over 4.3 million square feet of GLA across 13 states (the "JV Properties").

As of March 31, 2018, we leased space at 145 Wholly Owned Properties to Sears Holdings pursuant to a master lease agreement (the "Master Lease"), including 81 properties leased only to Sears Holdings and 64 properties leased to both Sears Holdings and one or more third-party tenants. The remaining 80 Wholly Owned Properties include 54 properties that are leased solely to third-party tenants and do not have any space leased to Sears Holdings, and 26 vacant properties. As of March 31, 2018, space at 22 JV Properties is also leased to Sears Holdings pursuant to lease agreements similar to the Master Lease (the "JV Master Leases"). Sears Holdings is the sole tenant at nine JV Properties and 13 JV properties are leased to both Sears Holdings and one or more third-party tenants. One JV Property is leased solely third-party tenants and one JV Property was vacant as of March 31, 2018.

The Master Lease and the JV Master Leases provide the Company and the JVs with the right to recapture certain space from Sears Holdings at each property for retenanting or redevelopment purposes.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

These condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q of the Securities and Exchange Commission ("SEC") and should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K, as amended, (the "Annual Report"), for the year ended December 31, 2017. Certain footnote disclosures which would substantially duplicate those contained in our Annual Report have been condensed or omitted from this quarterly report. In the opinion of management, all adjustments necessary for a fair presentation (which include only normal recurring adjustments) have been included in this quarterly report. Operating results of three months ended March 31, 2018 may not be indicative of the results that may be expected for any other interim period or for the year ending December 31, 2018. Capitalized terms used, but not defined in this quarterly report, have the same meanings as set forth in our Annual Report.

The accompanying condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The condensed consolidated financial statements include the accounts of the Company, the Operating Partnership, each of their wholly-owned subsidiaries, and all other entities in which they have a controlling financial interest or entities that meet the definition of a variable interest entity ("VIE") in which the Company has, as a result of ownership, contractual interests or other financial interests, both the power to direct activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. All intercompany accounts and transactions have been eliminated.

If the Company has an interest in a VIE but it is not determined to be the primary beneficiary, the Company accounts for its interest under the equity method of accounting. Similarly, for those entities which are not VIEs and over which the Company has the ability to exercise significant influence, but does not have a controlling financial interest, the Company accounts for its interests under the equity method of accounting. The Company continually reconsiders its determination of whether an entity is a VIE and whether the Company qualifies as its primary beneficiary.

To the extent such variable interests are in entities that cannot be evaluated under the VIE model, the Company evaluates its interests using the voting interest entity model. As of March 31, 2018, the Company holds a 63.8% interest in the Operating Partnership and is the sole general partner which gives the Company exclusive and complete responsibility for the day-to-day management, authority to make decisions, and control of the Operating Partnership. Through consideration of consolidation guidance effective for the Company as of January 1, 2016, it has been concluded that the Operating Partnership is a VIE as the limited partners in the Operating Partnership, although entitled to vote on certain matters, do not possess kick-out rights or substantive participating rights. Accordingly, the Company consolidates its interest in the Operating Partnership. However, as the Company holds what is deemed a majority voting interest in the Operating Partnership, it qualifies for the exemption from providing certain of the disclosure requirements associated with investments in VIEs.

The portions of consolidated entities not owned by the Company and the Operating Partnership are presented as non-controlling interests as of and during the periods presented.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant assumptions and estimates relate to fair values of acquired assets and liabilities assumed for purposes of applying the acquisition method of accounting, the useful lives of tangible and intangible assets, real estate impairment assessments, and assessing the recoverability of accounts receivables. These estimates are based on historical experience and other assumptions which management believes are reasonable under the circumstances. Management evaluates its estimates on an ongoing basis and makes revisions to these estimates and related disclosures as experience develops or new information becomes known. Actual results could differ from these estimates.

Segment Reporting

The Company currently operates in a single reportable segment which includes the acquisition, ownership, development, redevelopment, management, and leasing of retail properties. The Company’s chief operating decision maker, its Chief Executive Officer, assesses and measures the operating and financial results for each property on an individual basis and does not distinguish or group properties based on geography, size, or type. The Company, therefore, aggregates all properties into one reportable segment due to their similarities with regard to the nature and economics of the properties, tenants, and operations.

Accounting for Real Estate Acquisitions

Upon the acquisition of real estate, the Company assesses the fair value of acquired assets and liabilities assumed, including land, buildings, improvements and identified intangibles such as above-market and below-market leases, in-place leases and other items, as applicable, and allocates the purchase price based on these assessments. In making estimates of fair values, the Company may use a number of sources, including data provided by third parties, as well as information obtained by the Company as a result of its due diligence, including expected future cash flows of the property and various characteristics of the markets where the property is located.

The fair values of tangible assets are determined on an "if vacant" basis. The "if vacant" fair value allocated to land is generally estimated via a market or sales comparison approach with the subject site being compared to similar properties that have sold or are currently listed for sale. The comparable properties are adjusted for dissimilar characteristics such as market conditions, location, access/frontage, size, shape/topography, or intended use, including the impact of any encumbrances on such use. The "if vacant" value allocated to buildings and site improvements is generally estimated using an income approach and a cost approach that utilizes published guidelines for current replacement cost or actual construction costs for similar, recently developed properties. Assumptions used in the income approach include capitalization and discount rates, lease-up time, market rents, make-ready costs, land value, and site improvement value.

The estimated fair value of in-place tenant leases includes lease origination costs (the costs the Company would have incurred to lease the property to the current occupancy level) and the lost revenues during the period necessary to lease-up from vacant to the current occupancy level. Such estimates include the fair value of leasing commissions, legal costs and tenant coordination costs that would be incurred to lease the property to this occupancy level. Additionally, the Company evaluates the time period over which such occupancy level would be achieved and includes an estimate of the net operating costs (primarily real estate taxes, insurance and utilities) incurred during the lease-up period, which generally ranges up to one year. The fair value of acquired in-place tenant leases is included in lease intangible assets on the condensed consolidated balance sheets and amortized over the remaining lease term for each tenant.

Identifiable intangible assets and liabilities are calculated for above-market and below-market tenant and ground leases where the Company is either the lessor or the lessee. The difference between the contractual rental rates and the Company's estimate of market rental rates is measured over a period equal to the remaining non-cancelable term of the leases, including significantly below-market renewal options for which exercise of the renewal option appears to be reasonably assured. Above-market tenant leases and below-market ground leases are included in lease intangible assets on the condensed consolidated balance sheets; below-market tenant leases and above-market ground leases are included in accounts payable, accrued expenses and other liabilities on the condensed consolidated balance sheets. The values assigned to above-market and below-market tenant leases are amortized as reductions and increases, respectively, to base rental revenue over the remaining term of the respective leases. The values assigned to below-market and above-market ground leases are amortized as increases and reductions, respectively, to property operating expenses over the remaining term of the respective leases.

The Company expenses transaction costs associated with business combinations in the period incurred; these costs are included in acquisition-related expenses within the condensed consolidated statements of operations. The Company capitalizes transaction costs associated with asset acquisitions; these costs are allocated to the fair values of the net assets acquired, included within the condensed consolidated balance sheets and depreciated or amortized over the remaining life or term of the acquired assets.

Real Estate Investments

Real estate assets are recorded at cost, less accumulated depreciation and amortization.

Expenditures for ordinary repairs and maintenance will be expensed as incurred. Significant renovations which improve the property or extend the useful life of the assets are capitalized. As real estate is undergoing redevelopment activities, all amounts directly associated with and attributable to the project, including planning, development and construction costs, interest costs, personnel costs of employees directly involved and other miscellaneous costs incurred during the period of redevelopment, are capitalized. The capitalization period begins when redevelopment activities are underway and ends when the project is substantially complete.

Depreciation of real estate assets, excluding land, is recognized on a straight-line basis over their estimated useful lives as follows:

Building:	25 – 40 years
Site improvements:	5 – 15 years
Tenant improvements:	shorter of the estimated useful life or non-cancelable term of lease

The Company amortizes identified intangibles that have finite lives over the period they are expected to contribute directly or indirectly to the future cash flows of the property or business acquired, generally the remaining non-cancelable term of a related lease.

On a periodic basis, management assesses whether there are indicators that the value of the Company's real estate assets (including any related intangible assets or liabilities) may be impaired. If an indicator is identified, a real estate asset is considered impaired only if management's estimate of current and projected operating cash flows (undiscounted and unleveraged), taking into account the anticipated and probability weighted holding period, are less than a real estate asset's carrying value. Various factors are considered in the estimation process, including expected future operating income, trends and prospects and the effects of demand, competition, and other economic factors. If management determines that the carrying value of a real estate asset is impaired, a loss will be recorded for the excess of its carrying amount over its estimated fair value. No such impairment losses were recognized for the three months ended March 31, 2018 or March 31, 2017.

Investments in Unconsolidated Joint Ventures

The Company accounts for its investments in unconsolidated joint ventures using the equity method of accounting as the Company exercises significant influence, but does not control these entities. These investments are initially recorded at cost and are subsequently adjusted for cash contributions, cash distributions, and earnings which are recognized in accordance with the terms of the applicable agreement.

On a periodic basis, management assesses whether there are indicators, including the operating performance of the underlying real estate and general market conditions, that the value of the Company's investments in unconsolidated joint ventures may be impaired. An investment's value is impaired only if management's estimate of the fair value of the Company's investment is less than its carrying value and such difference is deemed to be other-than-temporary. To the extent impairment has occurred, the loss is measured as the excess of the carrying amount of the investment over its estimated fair value. No such impairment losses were recognized for the three months ended March 31, 2018 or March 31, 2017.

Cash and Cash Equivalents

The Company considers instruments with an original maturity of three months or less to be cash and cash equivalents. Cash and cash equivalents balances may, at a limited number of banks and financial institutions, exceed insurable amounts. The Company believes it mitigates this risk by investing in or through major financial institutions and primarily in funds that are insured by the United States federal government.

Restricted Cash

Restricted cash represents cash deposited in escrow accounts which generally can only be used for the payment of real estate taxes, debt service, insurance, and future capital expenditures as required by certain loan and lease agreements, as well as legally restricted tenant security deposits. As of March 31, 2018, the Company had approximately $177.4 million of restricted cash, including $154.2 million reserved for redevelopment costs, tenant allowances and leasing commissions, deferred maintenance, environmental remediation and other capital expenditures, $ 19.5 million reserved for basic property carrying costs such as real estate taxes, insurance and ground rent, and $ 3.7 million of other restricted cash which consisted primarily of prepaid rental income.

Tenant and Other Receivables

Accounts receivable includes unpaid amounts billed to tenants, accrued revenues for future billings to tenants for property expenses, and amounts arising from the straight-lining of rent. The Company periodically reviews its receivables for collectability, taking into consideration changes in factors such as the tenant's payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates, and economic conditions in the area where the property is located. In the event that the collectability of a receivable with respect to any tenant is in doubt, a provision for uncollectible amounts will be established or a direct write-off of the specific rent receivable will be made. For accrued rental revenues related to the straight-line method of reporting rental revenue, the Company performs a periodic review of receivable balances to assess the risk of uncollectible amounts and establish appropriate provisions.

Revenue Recognition

Rental income is recognized on a straight-line basis over the non-cancelable terms of the related leases. For leases that have fixed and measurable rent escalations, the difference between such rental income earned and the cash rent due under the provisions of the lease is recorded as deferred rent receivable and included as a component of tenant and other receivables on the condensed consolidated balance sheets.

In leasing tenant space, the Company may provide funding to the lessee through a tenant allowance. In accounting for a tenant allowance, the Company will determine whether the allowance represents funding for the construction of leasehold improvements and evaluate the ownership of such improvements. If the Company is considered the owner of the improvements for accounting purposes, the Company will capitalize the amount of the tenant allowance and depreciate it over the shorter of the useful life of the improvements or the related lease term. If the tenant allowance represents a payment for a purpose other than funding leasehold improvements, or in the event the Company is not considered the owner of the improvements for accounting purposes, the allowance is considered to be a lease incentive and is recognized over the lease term as reduction of rental revenue on a straight-line basis.

The Company commences recognizing revenue based on an evaluation of a number of factors. In most cases, revenue recognition under a lease begins when the lessee takes possession of or controls the physical use of the leased asset. Generally, this occurs on the lease commencement date.

Tenant reimbursement income arises from tenant leases which provide for the recovery of all or a portion of the operating expenses and real estate taxes of the respective property. This revenue is accrued in the same periods as the expenses are incurred.

Accounting for Recapture and Termination Activity Pursuant to the Master Lease

Seritage 100% Recapture Rights. The Company generally treats the delivery of a 100% recapture notice as a modification of the Master Lease as of the date of notice. Such a notice and lease modification result in the following accounting adjustments for the recaptured property:

– Accrued rental revenues related to the straight-line method of reporting rental revenue that are deemed uncollectable as result of the lease modification are amortized over the remaining shortened life of the lease from the date of notice to the date of vacancy.
– Intangible lease assets and liabilities that are deemed to be impacted by the lease modification are amortized over the shorter of the shortened lease term from the date of notice to the date of vacancy or the remaining useful life of the asset or liability.

A 100% recapture will generally occur in conjunction with obtaining a new tenant or a real estate development project. As such, termination fees, if any, associated with the 100% recapture notice are generally capitalized as either an initial direct cost of obtaining a new lease or a necessary cost of the real estate project and depreciated over the life of the new lease obtained or the real estate asset being constructed or improved.

Seritage 50% Recapture Rights. The Company generally treats the delivery of a 50% recapture notice as a modification of the Master Lease as of the date of notice. Such a notice and lease modification result in the following accounting adjustments for the recaptured property:

– The portion of accrued rental revenues related to the straight-line method of reporting rental revenue that are subject to the lease modification are amortized over the remaining shortened life of the lease from the date of notice to the date of vacancy. The portion of accrued rental revenues related to the straight-line method of reporting rental revenue that is attributable to the retained space is amortized over the remaining life of the Master Lease.
– The portion of intangible lease assets and liabilities that is deemed to be impacted by the lease modification is amortized over the shorter of the shortened lease term from the date of notice to the date of vacancy or the remaining useful life of the asset or liability. The portion of intangible lease assets and liabilities that is attributable to the retained space is amortized over the remaining useful life of the asset or liability.

Sears Holdings Termination Rights. The Master Lease provides Sears Holdings with certain rights to terminate the Master Lease with respect to properties that cease to be profitable for operation by Sears Holdings. Such a termination would generally result in the following accounting adjustments for the terminated property:

– Accrued rental revenues related to the straight-line method of reporting rental revenue that are subject to the termination are amortized over the remaining shortened life of the lease from the date of notice to the date of vacancy.
– Intangible lease assets and liabilities that are deemed to be impacted by the termination are amortized over the shorter of the shortened lease term from the date of notice to the date of vacancy or the remaining useful life of the asset or liability.
– Termination fees required to be paid by Sears Holdings are recognized as follows:
  • For the portion of the termination fee attributable to the annual base rent of the subject property, termination income is recognized on a straight-line basis over the shortened life of the lease from the date the termination fee becomes legally binding to the date of vacancy.
  • For the portion of the termination fee attributable to estimated real estate taxes and property operating expenses for the subject property, prepaid rental income is recorded in the period such fee is received and recognized as tenant reimbursement revenue in the same periods as the expenses are incurred.

Derivatives

The Company's use of derivative instruments is limited to the management of interest rate exposure and not for speculative purposes. In connection with the issuance of the Company's Mortgage Loans and Future Funding Facility, the Company purchased for $5.0 million an interest rate cap with a term of four years, a notional amount of $1,261 million and a strike rate of 3.5%. The interest rate cap is measured at fair value and included as a component of prepaid expenses, deferred expenses and other assets on the condensed consolidated balance sheets. The Company has elected not to utilize hedge accounting, and therefore, the change in fair value is included within change in fair value of interest rate cap on the condensed consolidated statements of operations. For the three months ended March 31, 2018, the Company recorded a gain of $0.2 million compared to a loss of $0.5 million for the three months ended March 31, 2017

Stock-Based Compensation

The Company generally recognizes equity awards to employees as compensation expense and includes such expense within general and administrative expenses on the condensed consolidated statements of operations. Compensation expense for equity awards is generally based on the fair value of the common shares at the date of the grant and is recognized (i) ratably over the vesting period for awards with time-based vesting and (ii) for awards with performance-based vesting, at the date the achievement of performance criteria is deemed probable, an amount equal to that which would have been recognized ratably from the date of the grant through the date the achievement of performance criteria is deemed probable, and then ratably from the date the achievement of performance criteria is deemed probable through the remainder of the vesting period.

Concentration of Credit Risk

Concentrations of credit risk arise when a number of operators, tenants, or obligors related to the Company's investments are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations, including those to the Company, to be similarly affected by changes in economic conditions. As of March 31, 2018, a majority of the Company's real estate properties were leased to Sears Holdings, and the majority of Company’s rental revenues were derived from the Master Lease (see Note 5). Until the Company further diversifies the tenancy of its portfolio, an event that has a material adverse effect on Sears Holdings’ business, financial condition or results of operations could have a material adverse effect on the Company’s business, financial condition or results of operations. Sears Holdings is a publicly traded company that is subject to the informational filing requirements of the Securities Exchange Act of 1934, as amended, and is required to file periodic reports on Form 10-K and Form 10-Q with the SEC. Refer to www.sec.gov for Sears Holdings publicly-available financial information.

Other than the Company's tenant concentration, management believes the Company's portfolio was reasonably diversified by geographical location and did not contain any other significant concentrations of credit risk. As of March 31, 2018, the Company's portfolio of 225 Wholly Owned Properties and 24 JV Properties was diversified by location across 49 states and Puerto Rico.

Earnings per Share

The Company has three classes of common stock. The rights, including the liquidation and dividend rights, of the holders of the Company’s Class A common shares and Class C non-voting common shares are identical, except with respect to voting. As the liquidation and dividend rights are identical, the undistributed earnings are allocated on a proportionate basis. The net earnings (loss) per share amounts are the same for Class A and Class C common shares because the holders of each class are legally entitled to equal per share distributions whether through dividends or in liquidation. Class B non-economic common shares are excluded from earnings per share computations as they do not have economic rights.

All outstanding non-vested shares that contain non-forfeitable rights to dividends are considered participating securities and are included in computing earnings per share pursuant to the two-class method which specifies that all outstanding non-vested share-based payment awards that contain non-forfeitable rights to distributions are considered participating securities and should be included in the computation of earnings per share.

Recently Issued Accounting Pronouncements

In February 2017, the Financial Accounting Standards Boards (“FASB”) issued Accounting Standards Update (“ASU”) 2017-05, “Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets” to provide guidance for recognizing gains and losses from the transfer of nonfinancial assets. The standard requires a company to derecognize nonfinancial assets once it transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial assets to noncustomers. Additionally, when a company transfers its controlling interest in a nonfinancial asset, but retains a non-controlling ownership interest, the company is required to measure any non-controlling interest it receives or retains at fair value. An entity may elect to apply the amendments in ASU 2017-05 either retrospectively to each period presented in the financial statements (i.e. the retrospective approach) or retrospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption (i.e. the modified retrospective approach). We adopted this update on January 1, 2018 with no impact to beginning retained earnings/accumulated deficit because there were no open contracts at the time of adoption.

During the three months ended March 31, 2018, the Company entered into a transaction in which it sold a portion of its investment in a consolidated property and retained joint control of the entity. (See Footnote 4 to the Notes to the Company’s Condensed Consolidated Financial Statements for additional disclosure regarding this transaction).

In January 2017, the FASB issued ASU 2017-01 which changes the definition of a business to exclude acquisitions where substantially all of the fair value of the assets acquired are concentrated in a single identifiable asset or a group of similar identifiable assets. While there are various differences between the accounting for an asset acquisition and a business combination, the Company expects that the largest impact will be the capitalization of transaction costs for asset acquisitions which are expensed for business combinations. ASU 2017-01 is effective, on a prospective basis, for interim and annual periods beginning after January 1, 2019. The Company adopted the guidance on the issuance date effective January 5, 2017 on a prospective basis and it did not have an impact on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 provides classification guidance for eight specific topics including debt extinguishment costs, contingent consideration payments made after a business combination, and distributions received from equity method investees. ASU 2016-15 is effective, on a retrospective basis, for interim and annual periods beginning after December 15, 2017; early adoption is permitted. The Company adopted ASU 2016-15 on the effective date, January 1, 2018, and applied the cumulative earnings approach to classify distributions received from our equity method investees. The adoption changes our statements of cash flows so that distributions from unconsolidated joint ventures in excess of cumulative equity in earnings are now classified as inflows from investing activities for each period presented. These distributions were previously classified as inflows from operating activities.

In February 2016, with a subsequent update made in January 2018 and finalized in March 2018, the FASB issued ASU No. 2016-02 “Leases (Topic 842)” (“ASU 2016-02”) to amend the accounting guidance for leases. The accounting applied by a lessor is largely unchanged under ASU 2016-02. However, the standard requires lessees to recognize lease assets and lease liabilities for leases classified as operating leases on the balance sheet. Lessees will recognize in the statement of financial position a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it will recognize lease expense for such leases generally on a straight-line basis over the lease term. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted.

In March 2018, the FASB finalized changes with respect to optional transition relief and approved a practical expedient for lessors that would permit lessors to make an accounting policy election to not separate non-lease components from the associated lease components, by class of underlying asset, if the following two criteria are met: (1) the timing and pattern of transfer of the lease and non-lease components are the same and (2) the lease component would be classified as an operating lease if accounted for separately. For leases where we are the lessor, we currently believe that we will elect the optional transition relief and that we will meet the noted criteria to not be required to bifurcate and separately report non-lease components, such as common area maintenance revenue, for operating leases on our consolidated statements of operations. As a result, we currently believe that leases where we are the lessor will be accounted for in a similar method to existing standards with the underlying leased asset being reported and recognized as a real estate asset. The FASB is expected to issue an Accounting Standards Update codifying these changes in the coming months. We currently expect to adopt ASU 2016-02 using the practical expedients proposed in the standard and the changes approved by the FASB and do not believe that this change will have a material impact on our consolidated financial statements.

In May 2014, with subsequent updates issued in August 2015 and March, April and May 2016, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”) and the related FASB ASU Nos. 2016-12 and 2016-20, which provide practical expedients, technical corrections, and improvements for certain aspects of ASU 2014- 09. ASU 2014-09 was developed to enable financial statement users to better understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The update’s core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Companies are to use a five-step contract review model to ensure revenue is recognized, measured and disclosed in accordance with this principle. Those steps include the following: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to each performance obligation in the contract, and (v) recognize revenue when or as the entity satisfies a performance obligation. The Company estimates the total transaction price, which generally includes a fixed contract price and may also include variable components. Variable components of the contract price are included in the transaction price to the extent that it is probable that a significant reversal of revenue will not occur. The Company recognizes the estimated transaction price as revenue as it satisfies its performance obligations.

The Company adopted ASU 2014-09 on the effective date of January 1, 2018 using the modified retrospective method. Management concluded that the majority of total revenues consist of rental income from leasing arrangements, which is specifically excluded from the standard. As of January 1, 2018, the Company began accounting for the sale of real estate properties under Subtopic 610-20 which provides for revenue recognition based on transfer of ownership.

During the three months ended March 31, 2018, the Company contributed its property located in Santa Monica, CA to a new joint venture and sold a 49.9% interest in the venture. The Company estimated the total transaction price, which includes fixed and variable components, pursuant to ASC 606. The variable component of the transaction will be re-measured at each reporting date until stabilization. (See Footnote 4 to the Notes to the Company's Condensed Consolidated Financial Statements for additional disclosure regarding this transaction).

Note 3 – Lease Intangible Assets and Liabilities

Lease intangible assets (acquired in-place leases, above-market leases and below-market ground leases) and liabilities (acquired below-market leases), net of accumulated amortization, were $291.6 million and $13.9 million, respectively, as of March 31, 2018 and $310.1 million and $14.5 million, respectively, as of December 31, 2017. The following table summarizes the Company's lease intangible assets and liabilities (in thousands):

March 31, 2018

Lease Intangible Assets	Gross Asset	Accumulated Amortization	Balance
In-place leases, net	$530,349	$ (255,408)	$274,941
Below-market ground leases, net	11,766	(559)	11,207
Above-market leases, net	8,925	(3,460)	5,465
Total	$551,040	$ (259,427)	$291,613

Lease Intangible Liabilities	Gross Liability	Accumulated Amortization	Balance
Below-market leases, net	$19,658	$ (5,713)	$13,945
Total	$19,658	$ (5,713)	$13,945

December 31, 2017

Lease Intangible Assets	Gross Asset	Accumulated Amortization	Balance
In-place leases, net	$542,655	$ (249,569)	$293,086
Below-market ground leases, net	11,766	(508)	11,258
Above-market leases, net	8,925	(3,171)	5,754
Total	$563,346	$ (253,248)	$310,098

Lease Intangible Liabilities	Gross Liability	Accumulated Amortization	Balance
Below-market leases, net	$19,658	$ (5,182)	$14,476
Total	$19,658	$ (5,182)	$14,476

Amortization of acquired below-market leases, net of acquired above-market leases, resulted in additional rental income of $0.2 million and $0.2 million for the three months ended March 31, 2018 and March 31, 2017, respectively. Future amortization of these intangibles is estimated to increase rental income as set forth below (in thousands):

Remainder of 2018	$(738)
2019	(923)
2020	(789)
2021	(775)
2022	(486)

Amortization of acquired below-market ground leases resulted in additional property expense of $50 thousand for the three months ended March 31, 2018 and March 31, 2017, respectively. Future amortization of below-market ground leases is estimated to increase property expenses as set forth below (in thousands):

Remainder of 2018	$152
2019	