BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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EPR Properties (EPR) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 4- (Acceptable)

It appears that 3Q may represent the bottom of COVID issues for EPR, thus we are keeping the same rating even with several issues in the quarter. We would need to see the improvement continuing in 4Q too. The company's rent collection is covering costs at this point to essentially have zero cash burn while it still has $1 billion in cash and liquidity on hand. We were expecting the dividend to return in 1Q21, but with many movie theaters remaining closed due to a delay in new blockbuster releases or operating below capacity with fewer movies – EPR is behind where we expected results to be at this point as closed theaters have been an issue into 3Q and 4Q20. We now expect a dividend to return later in 2021. It's still a REIT that will have to pay out a high percentage of earnings.

Changes in the accounting for Cineworld rent was the bulk of the drop in reported figures as converting that client to recognizing rent as received in cash meant EPR wrote off receivables as a reduction to revenue of $49.8 million. They missed forecasts by $42 million – this is the reason and actually beat forecasts. It also was a $0.67 hit to FFO, which came in at -$0.16 against forecasts of $0.45 – so the change in Cineworld rent recognition accounts for that shortfall too and beat forecasts there:

What improved?

- Cash rent being received is running high enough that EPR is not in a cash burn situation. It still has $1 billion in liquidity and appears to have survived COVID.
- Adjusting for rent receivables that were written down against revenues – revenue was basically flat in 3Q and 2Q at $105 million
- That is with nearly all non-theater properties open and 90% of properties either needed no rent deferrals/restructuring or have been addressed.

What deteriorated?

- Cineworld – the number two theater partner with EPR is only operating 2 of 53 theaters due to studios delaying the release of larger-budget movies. Cineworld may require greater rent relief.
- EPR converted its accounting of Cineworld to recognizing rent when received in cash – which led to the write-off of Cineworld receivables against revenue of $49.8 million or 67-cents per share.
- Other amendments for clients involved deferring 3-5 months of rent that will be paid over the life of the lease starting early in 2021. Given the lack of movies, these deferrals may stretch into more months and the commencement of repayment may not begin until later in 2021.
- Several other one-time items impacted 3Q. Several appear to incorporate a worst-case scenario such as reserving 100% against a note receivable or a deferred tax asset – it may set up EPR for some future income if these are partially reversed.

What to watch

- EPR stretched its covenant deferrals with the bank until the end of 2021 (from 1Q21). Part of this deferral stops EPR from paying a common dividend. We think once theaters are operating more regularly, EPR will opt out of the deferral with the banks.
- With 2020 movies hitting in 2021 along with others already planned for next year, the theaters may recover quicker once they have more content.

- EPR noted that it has dealt with 90% of clients at this point – it guided that rent could drop 5%-7% pre-COVID levels. If Cineworld does not require rent relief beyond deferrals, that projection may be too negative.

Rent Collection, Agreements, Deferrals

The biggest issue for EPR is movie studios delaying releases of blockbuster films until late 2020 and into 2021 due to COVID. As a result, movie theaters are either remaining closed or operating at low occupancy given a lack of movies to show. That sets up well for 2021, but it has made 2020 worse for longer.

The non-theater properties – except an indoor water park in NY are all open and several are even outperforming 2019 numbers as people simply want to get out of the house. All the ski resorts are expected to open on time too.

Cash collections as a percentage of what is due has been rising steadily:

3Q Sales	Oct	Sept	Aug	July
% of cash received	43%	48%	40%	35%

The 43% in October is due to EPR changing its treatment of Cineworld's Regal theaters – we'll discuss below. EPR expects to collect 40%-50% of cash due during 4Q. The key to that is the breakeven cash collection to prevent cash burn is about 46%. Thus, EPR appears to be past the worst of the COVID issues and unlikely to be losing cash going forward as it waits for theaters to reopen.

- Cineworld has only 2 of 53 properties with EPR that are open. EPR believes it may need to restructure the deal it has with Cineworld or simply continue to defer rent for a longer period. They restructured the deal with AMC in the 2Q and deferred rent, lowered base rent initially, and extended the length of the lease. Something similar could happen with Cineworld.

- Revenue at EPR is recognized as due from a tenant. Thus, revenue leads to a receivable being set up and then when cash is received, the receivable falls. **Because they are uncertain of Cineworld's collection status – EPR converted its recognition**

of revenue from Cineworld to a policy of recognizing revenue only as cash is received. This is the same situation they moved to with AMC in 2Q. **As a result, the Cineworld receivables were eliminated and were charged against revenues. The receivables totaled $49.8 million ($0.67 per share) and writing them off against revenue in the 3Q is why revenue saw such a large drop in 3Q.** Reported rental revenue was $55.6 million in 3Q, but $105 million before the receivable write-down. In 2Q, rental revenue was $105 million before a $7.5 million receivable write-down.

- Reporting rent when collected in cash is actually a more conservative accounting policy. But the lag impact of receivables had to be cleared and that is what this move did.

- **Cineworld and EPR have not reworked their agreement. We speculated this was a risk last quarter and it could follow similar terms of the AMC deal** which included a 21% reduction in rent along with higher rent increases in the future. It also included 6-months (July-December of 2020) where rent would be 15% of revenues rather than a fixed rent figure. Also, deferred rent from April-June would be amortized into rent over the longer lease term starting in 2021. **Thinking a similar approach may happen with Cineworld – EPR said it could see a permanent rent reduction level of 5%-7% of pre-COVID rents.**

- **Many of the theaters had rent deferred by EPR in April for a few months with the idea that they would be in a more normal operating period in the fall. The deferred rent was expected to be amortized into rent starting in 2021. EPR is thinking those deferred rent payments may be further pushed out before beginning.** Keep in mind, these deferrals were not going to double the client's rent. The goal was to repay 3 months of rent over several years. That source of earnings may not kick in during 1Q21.

Overall, it looks like EPR is getting to near the end of this situation. There should be some movies for the holidays that start to get theaters moving again. They have already addressed 90% of rent issues and 19 of the top 20 clients are paying them now or have a new agreement. There could be more deferred rent before 2021 and the commencement of deferred rent may be delayed longer. And the key to us is the company's cash collection rate is high enough that there is not a cash burn so it still has $1 billion in cash and liquidity available.

EPR also extended the covenant waivers on its bank lines through the end of 2021. These waivers allow them to pay their preferred dividends – but a common dividend is only feasible if required to maintain REIT status. Thus, the return of a dividend is probably more likely to happen in 3Q21 instead of 1Q21.

Several Other Items Impacted 3Q results as Well

In 3Q, EPR reported that FFO was -$0.51 and AFFO was $0.04 per share. We can see several items that appear one-time in nature that negatively impacted both figures.

- $5.7 million credit loss – this is to fully reserve a note receivable from a client. This hurts EPS and FFO but was added back to Adjusted FFO for 8-cents. We would regard this as taking advantage of COVID and simply clearing the decks writing a note to zero. If anything is recovered, it will help future EPS.

- $11.6 million impairment – this was on two Eat & Play properties where the remaining lease appears too short to fully recover the carrying value. This impairment was added back to FFO and AFFO for 15-cents. Hopefully, this real estate can generate future cash flows beyond the current lease. This should reduce depreciation slightly going forward which helps EPS but doesn't impact either FFO or AFFO.

- $18.4 million allowance reserve against deferred tax assets on Canadian theaters as EPR is not certain it will get to use the tax assets in the future. This was only added back to AFFO for 24-cents. We see this as taking advantage of COVID again. We would not be surprised if post-COVID there are future earnings here and some of the tax benefits can be used. This could be an allowance that partially reverses into income in the future.

- The receivable write-off against revenue from Cineworld was not added back to any of the metrics – that was 67-cents. However, AFFO did add back the part considered straight-line rent of $18 million or 24-cents.

- AFFO also subtracts a maintenance capital spending figure. It jumped in the 3Q as part of its transfer of CLA properties to another operator. This is normally about $2 million per quarter and jumped to $9 million. The $7 million increase cost AFFO about 9-cents. We see this as a one-time event.

A more realistic FFO figure to us would add back the tax allowance and the Cineworld receivable write off. It already adds back the impairment of assets figure. That would be an FFO of $0.40 instead of -$0.51. The company adds back some transaction costs of 4-cents and the credit loss of 8-cents to $0.52 but omits the Receivable charge against revenues and reports -$0.16.

A more realistic AFFO figure would add back all the receivablse charge, not just the straight-line rent portion, and the 1-time maintenance spending increase of 9-cents. That would make AFFO rise from $0.04 to $0.56.

Negatively impacting all metrics was revenue lost as the Kartrite waterpark property was closed in NY during the summer. That reduced other income by about $11.3 million and other expense by about $9 million or a net $2.3 million – about 3-cents. That property is more seasonal and likely won't be producing any revenue in 4Q or 1Q.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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