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EPR Properties (EPR) EQ Update- 6/20 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 lowering our earnings quality rating to 4- (Acceptable) from 4+ (Acceptable)

After a very messy 2Q'20, it appears EPR is now past the worst of the COVID issues. The primary reason we are cutting the rating from 4+ to 4- is a larger percentage of current earnings are non-cash. EPR reported $60 million in rent and $3.5 million in mortgage loan income as revenue – but increased accounts receivable. When total revenue was $106.4 million in the quarter, that's a sizeable part that came in as non-cash.

Against estimates for FFOAA (Funds from Operations as Adjusted), EPR missed by 14 cents in 1Q20 and 22-cents in 2Q20. For 1Q, the company began recognizing rent from AMC Theaters when received in cash. That caused a write-off of $12.5 million in accounts receivable from AMC which was a 15-cent hit to FFOAA. The new policy, in that case, was more conservative and we will discuss AMC below. For 2Q, tenants whose rent recognition for revenue was changed to "recognized when received" was $35.4 million or 46-cents of FFOAA. In reality, EPR beat forecasts in both periods when adjusting for recognizing rent when received in cash from some tenants.

- **EPR recognized $60 million in deferred rent as revenue in the 2Q – but it became accounts receivable not cash flow.** This inflated all its REIT defined income measures too. Cash flow from operations was negative in 2Q due to this.

- **There was a 3-cent headwind from calculating per-share FFOAA by not assuming the conversion of preferred shares.** The calculation would have been antidilutive in 2Q and should remain so in 3Q also.

- **EPR adopted a more conservative revenue recognition policy for several tenants by waiting until the cash is received to record revenue. As it reworked some leases, this resulted in $44.7 million of reduced revenue in 2Q against a $49.5 y/y decline.**

- **On the rent deferrals – EPR said 18% of properties did not require one and 67% are now complete. In the bulk of cases, the average deferral was 5-months and will be collected over time without rent reductions.** It should help revenue and cash flow in 2021 as the deferred rent collection begins. **EPR said it expects to see rent reductions of only about 5%-7% of pre-COVID figures or about $32-$42 million per year.**

- **AMC has completed some large restructuring. Even before COVID – AMC's large debt balance was a risk for EPR and was nearly 18% of revenues.** AMC has boosted liquidity, converted a large amount of debt to extend maturities and lower cash interest expense for a year. **It also has an agreement on rent deferral with 75% of its landlords and has reduced rent expense. AMC will still be heavily leveraged in our view at 5.5x EBITDA on a best-case scenario and likely still above 6x. However, it has the liquidity and cost structure to get through 2020 as its theaters continue reopening.**

- **EPR gave AMC some significant relief, cutting fixed rent by 21% ($25.6 million), deferring rent from 2Q for as long as 14 years, and collecting 15% of gross revenues rather than the new fixed rent for the rest of 2020.**

- **In return, AMC and EPR rolled 46 properties into a single master lease and extended the term by 9-years with rent increases of 7.5% every 5-years.** This new structure and lower cost makes it less likely that AMC tries to restructure with EPR again should AMC's debt level later prove too burdensome. Given the numbers both sides are talking about – AMC may be more likely to try to get other landlords to accept an EPR type deal. This does not eliminate – but mitigates one of EPR's largest risks in our view.

- **EPR's credit facility has a relief period through 1Q21. This preserves EPR's sizeable liquidity as its remaining tenants reopen. However, it does prevent EPR from paying a dividend on the common stock unless required to maintain REIT status with the IRS.** EPR can terminate the relief early provided it can prove it is in compliance with the covenants. We think EPR will be able to do so and believe it will resume dividends in 2021 as its remaining tenants reopen and rent deferrals are past them.

Deferred Rent Was Recognized into Income – But Didn't Come in as Cash

This is one of the bigger quality of earnings issues we have with the 2Q results. EPR deferred $60.0 million of rent due from tenants in the quarter. That's not a surprise. Essentially all the properties were closed for parts or all of the quarter and EPR had given guidance that it would work with tenants.

The issue we have is deferred rent was still recognized as revenue and flowed into Accounts Receivable instead of Cash. Rental Revenue was $97.5 million in 2Q or 92% of total revenue. Receivables rose by $62.3 million from 1Q to 2Q. The net result was Cash from Operations became -$31.6 million in 2Q:

	2Q20	1Q20
Rental Rev.	$97.5	$135.0
Seq. Change A/R	$62.5	-$14.3
Cash from Ops	-$31.6	$89.0

This large source of non-cash revenue and thus income is not being adjusted for in the company's various REIT metrics:

2Q REIT Stats	As Reported	Adj. For Cash Rent Only
FFO	$13.0	-$47.0
FFOAA	$31.4	-$28.6
AFFO	$33.3	-$26.7
Adj. EBITDA	$77.8	$17.8

- FFO is Net Income adjusted for gains, losses, impairments plus depreciation.

- FFOAA is FFO plus any other impairments, bad debt expense, plus all transaction costs and financing costs.

- AFFO is FFOAA that adds back stock compensation, all other amortization of non-real estate assets and deferred financing fees and then subtracts maintenance cap-ex and straight-line rental income/expenses.

- Adj. EBITDA is standard EBITDA without JV income, gains/losses, impairments, bad debt expense, transaction expenses, and costs of refinancing.

The net result is all the metrics include the $60 million in non-cash rent. That's 79-cents of FFOAA in 2Q20 against the reported 41-cents. In the discussion of the deferred rent, the bulk will not begin repayment until 2021 and is expected to occur over a period greater than one year.

So, in the near-term, EPR should start collecting more of the rent recognized as revenue in cash, but 3Q may still show some transition to a larger receivable balance. During 2021, the cash flow should get a tailwind from the falling receivable balance.

Preferred Stock Conversion Is Anti-Dilutive Now

Before COVID, EPR adjusted its results for common shares by adding back the preferred dividends for its series C and E shares and then using a larger number of fully diluted shares.

Diluted Results	2Q20	1Q20	2019
FFOAA	$31.4	$75.9	$423.2
Add Prf Div on C&E class	$0.0	$3.9	$15.5
Diluted FFOAA	$31.4	$79.8	$438.7
Diluted Shares	76.3	82.4	80.6
FFOAA/Share	$0.41	$0.97	$5.44

In 2Q20, this calculation would have been anti-dilutive and resulted in an FFOAA/share of $0.44 adding back the preferred dividends of $3.9 million and adjusting for an additional

3.8 million shares. Thus, EPR lost about 3-cents in adjusted results in the 2Q from this item alone. This equation remains anti-dilutive and a headwind for results until FFOAA reaches about $76 million again per quarter. Collecting receivables from deferred rent will help cash flow in 2021, but not the FFOAA stat as the income has already been realized.

There is some other deferred rent that may help reverse this situation faster.

Recognizing Revenue When Cash Is Received Is a More Conservative Method

While EPR has $60 million in revenue that it deferred but still recognized into income – it has also deferred revenue in some other cases where it considered full collection less than probable. In those cases, EPR did not recognize it as revenue or have it build-up as receivables. This is actually where the decline in Rental Revenue has been seen:

Rental Rev.	2Q20	2Q19	1Q20	1Q19
Minimum Rent	$89.6	$134.4	$138.2	$130.5
Tenant Reimb.	$4.2	$5.8	$3.7	$6.1
% Rent	$1.5	$4.1	$2.8	$1.4
Straight Line Rent	$2.7	$2.5	$2.8	$2.2
Straight Line Rent Write-off	-$0.5	$0.0	-$12.5	$0.0
Rental Rev.	$97.5	$147.0	$135.0	$140.3

In 1Q20, the big change was not tenants deferring rent – it came in a $12.5 million write-off of receivables. This related to AMC coming into the start of the lockdowns. At the time, EPR said, "*the Company believes it is prudent to begin recognizing revenue for AMC on a cash basis. Accordingly, the Company recorded a non-cash write-off of straight-line rent receivable of approximately $12.5 million for the quarter ended March 31, 2020 related to AMC as well as two small tenants where a similar assessment was made that cash accounting is appropriate.*" Without the write-off, revenue would have grown y/y in 1Q20. In 2Q20, a smaller change was the loss of percentage rent that is paid by tenants when their business revenue exceeds certain thresholds. Closing the businesses during the lockdowns in 2Q made it very unlikely many would top that target and it fell from $4.1 million to $1.5 million y/y.

The larger 2Q'20 change was $35.4 million of deferred revenue where EPR changed the recognition policy of waiting until cash is received to book it. Much of this involved companies where rent terms were reworked. Another $9.3 million of deferred revenue concerns tenants where EPR could not deem payment "probable" and also converted those to revenue recognition when cash is received. That is $44.7 million of revenue and much of it could come in overtime vs. the y/y drop of $49.5 million. EPR gave the stats for the deferrals.

- 18% of annual revenue comes from properties requiring no deferral.

- 67% of annual revenues comes from properties where a deferral agreement has been executed already.

- The remaining, 1% is vacant, 1% has approved the agreement, and 13% are pending. The view is the 13% pending will likely follow similar deals already executed.

- The average deferral represents 5-months of rent.

- The 5-months of deferred rent on average will be repaid over an average of 32 months and the payments on deferred rent commence 11 months after the deal on average.

- With the $60 million of deferred revenue already recognized, over $40 million deferred but won't be recognized until cash is received, and EPR's estimate of another $40 million in deferrals in 3Q – There could be $142 million of total deferrals which starts to amortize into revenue (about $80 million) and cash flow (about $140 million) by spring/summer of 2021.

- Based on current annualized rent – that is 23% of the total. So, EPR will essentially get an extra quarter of cash payments spread over about 3 years in many cases.

- EPR received 15% of rent in April, 28% in July and 21% for 2Q overall – so the trend is moving in the right direction. Also, the tenants are paying their other bills such as common-area maintenance and taxes.

We have four takeaways from this:

- The bulk of the deferrals have already happened so the worst should be past them. The bulk of deferrals include repayment of all deferred rent going forward.

- During 2Q, EPR only listed \$2.8 million in rent abatements and \$3.8 million in rent concessions (\$4.9 million and \$3.8 million for 1H20). The company is forecasting that total rent reductions at only 5%-7% of pre-COVID figure or about \$32-\$42 million in lower rent – and much of that resulted in longer leases and a greater percentage of revenue rent payments. Also, before COVID – rent was already about \$7 million higher per quarter due to recently added/opened properties.

- Converting more customers to recognizing revenue when cash is received is more conservative. Plus, the issue in 2Q where rent was deferred but still recognized as revenue may be past its zenith at this point.

- One of our concerns in the original EPR report was that lease renewals had reduced rent in 3 or the last 4 years. In many of these deferral agreements, EPR has seen lease terms extended, which reduces some of that risk too.

AMC Restructured in July

AMC has been about 18% of EPR's revenues and pre-COVID, AMC had a Debt to EBITDA figure above 6x. With the theaters closed April – July and capacity restrictions on the openings in August, AMC's debt was a significant problem.

The risks to EPR have been that AMC would need to restructure its debt in bankruptcy. That could mean skipping rent and rejecting its leases with EPR for a new lease deal and walking away from some properties. We would argue that EPR has likely lived through this situation already.

In April, EPR raised \$500 million in new first-lien notes and drew down its credit lines to boost liquidity. As the lockdown continued, AMC sought to exchange other debt on its balance sheet and had to sweeten the deal before getting considerable support in July. The net result is EPR was successful and:

- Reduced its principal debt by \$555 million

- It offered bondholders the ability to exchange/buy more first-lien notes which will add $300 million more in cash.

- Cash interest expense will decline about $120 million through August 2021 as some of the newly exchanged bonds can PIK the interest.

- It also extended the maturity of the bulk of its debt.

Given that AMC's foreign theaters started opening in 2Q and the US properties will be largely open in August (with capacity restrictions), AMC expects that it has the liquidity to handle closed theaters into 2021:

> *"So, from a liquidity point of view, one thing, I'll give you that might be quite helpful. So, we disclosed at the end of June, we had $498 million of cash available to us.* ***Pro forma for the debt exchange transaction that goes up to other $700 million of cash.*** *And when you think about then our run rate* ***assuming that the theatres remained closed right, throughout the remainder of 2020, so, we – in that scenario, we continue to spend roughly $100 million a month. That'll take us into early 2021.****"*

AMC didn't stop there – it has been working to reduce operating costs too with fewer employees, reduced capital spending, and working with landlords to reduce rent during shutdowns and in the years that follow.

It announced that it has agreements on 75% of its leases at this point to defer or abate rent. AMC's deferred rent covers much of 2Q and 3Q. It is projecting that in 2021 – its rent has already been reduced by $35 million annually. It will continue working with the remaining landlords for similar deals.

In our view, AMC has likely improved its cost structure and also gets a year of cash interest expense being $120 million lower. Where we would still have some concern is the debt level remains very high. Plus, the level of debt in December was $4.9 billion with 40% being senior secured bank debt. Talk of the debt level declining is based on the June 30 level of $5.7 billion. Bank debt increased, and there are now first lien notes that didn't exist in December. This is an estimate, but we believe debt may be about $5.1-$5.2 billion with about 60% being senior secured bank debt and first-lien notes. Thus, other creditors moved up in the pecking order.

Net of cash, AMC may be around $4.5 billion in net debt when this is all done. Based on 2019 EBITDA of $771 million and the cost savings – EBITDA could proforma out to $825 million. That seems like an unrealistic best-case scenario in the near future, but debt would still be 5.5x EBITDA. More realistically, AMC may be looking at a ratio closer to 6x for 2021. Capital spending should come in lower than in past years, but AMC's cash flow may still be impaired in 2021 and not allow for meaningful debt reduction. Also, if you are looking at pre-2019 EBITDA figures for AMC and estimating it could do materially better – remember that it was using a large number of capital leases which inflate operating income and operating cash flow. When we adjusted for that in 2018 – results are much closer to 2019.

EPR and AMC Reworked Their Deal

As we have noted before, EPR now records revenue from AMC when cash is received. Very little would have come in from April-July. Under the terms of the new lease:

- Fixed rent was cut by 21%, which is a $25.6 million reduction.
- The fixed rent will increase by 7.5% every 5-years.
- April, May, and June deferred rent will now be added to the base rent and amortized over as long as 14 years.
- For the period July 1-Dec 31, 2020, AMC's rent will be 15% of gross revenues.
- The difference between the new level of fixed rent vs. what AMC pays under the 15% of sales will be deferred also.
- Any deferred rent for the 2H of 2020, will be added to the amortized over 14 years and added to the fixed rent starting in February 2021.
- This deal extends the term on 46 properties in a new Master Lease by 9 years.
- It allows for 7 properties to be sold by EPR or transitioned over time to a new tenant.

The net impact is EPR should start seeing revenue from AMC in 3Q and since it did not recognize any of the previously deferred rent in 2Q and reversed previously recognized revenue in 1Q by writing off some AMC receivables – this should produce a benefit for EPR revenues.

Given that recent years have seen lease renewals come with rent reductions – extending the term of AMC leases by nearly a decade with built-in rent escalations is plus in our view as well.

EPR has further stipulated that this agreement may improve its position in a bankruptcy. There are reasons to think that in our view – but not in the way of arguing EPR is a more senior creditor now. In a bankruptcy, the debtor has the ability to reject contracts including leases. EPR as a landlord has the ability to essentially kick AMC out of the property if AMC rejects the lease – and look for a new tenant. AMC would essentially lose the ability to earn revenue and cash flow under that event. We think the reasons to believe this lease would largely survive an AMC bankruptcy are the following:

- It is cobbled together into one Master Lease for 46 properties – AMC has to assume or reject the whole thing. It cannot choose to keep the top 20 properties and kick out the other 26.

- The deal already isolated 7 properties for independent treatment so AMC and EPR have already made a provision for culling potentially weaker locations.

- EPR has helped movie tenants upgrade facilities with reclining seats, better sound, more food/beverage concessions. Many of the EPR properties are likely more desirable to AMC at this point.

- EPR has already given a sizeable level of rent reduction. EPR thinks it will see less than $40 million in total rent cuts – it gave $25.6 million to AMC. AMC is crowing about $35 million in rent cuts – in its mind, it received quite a bit from EPR.

- Conceptually, AMC has a cluster or more updated/desirable locations at a lower rent from EPR. Rather than reject that lease, it would make more sense to close a higher cost location nearby and try to drive that traffic to the EPR location. That’s why we would consider this to be a more secure lease in a bankruptcy situation.

- Also, there can be a look-back period of major deals in a bankruptcy to examine if things were done in at arms-length and make financial sense. This is to prevent someone from essentially selling valuable assets in a fire-sale before bankruptcy and keeping them away from creditors in court.

- In this case, EPR made the concessions and arguably became a larger creditor by extending the terms of the lease by nine years.

- Should it be challenged, we think the issue would focus on the roll-up of these properties into one large master lease that requires AMC to keep all or reject all properties as one decision. The singling out of the 7 properties probably helps support the new structure in our view.

- Also, the creditors would have an incentive to keep AMC operating to focus on recoveries of their debt. That's not going to happen without theaters. The other creditors have little incentive to push AMC and the court to reject the EPR lease.

- By our speculation, creditors and AMC would be more likely to embrace the EPR deal and push other landlords to accept similar deals with lower rent and longer terms and be able to project lower operating costs and higher cashflows for a longer period.

Given that EPR already has deferral agreements with 86% of its tenants on rent deferral, it too has a blueprint to point to for the remaining 14% to largely match what has already been achieved with others. Our conclusion is EPR has addressed its largest risk factor in AMC. It will definitely see lower rental revenue as a result, but the problem has been dealt with and both companies should have the liquidity to watch how the recovery proceeds.

EPR's Credit Line Terms and the Impacts on the Dividend

EPR amended its credit agreement on June 29, 2020. EPR has $750 million drawn on the facility to bolster its liquidity. Total cash was just over $1 billion on June 30. The company only burned $38 million in cash in 2Q, which should improve as theaters open and 88% of non-theater businesses were open on August 4.

The amendment provides for a covenant relief period through April 1, 2021. It can be ended sooner at EPR's option provided it proves it is in compliance with the financial ratios at that earlier date. The covenant does three things:

- It prevents the company from paying dividends on the common stock. It can continue to pay the preferred stocks quarterly dividend of about $6.1 million/Q. There are two exceptions on the common stock dividend. It can pay a minimum distribution to maintain REIT status with the IRS or to avoid incurring income taxes.

- It limits capital spending to $125 million in the 2H of 2020 and $50 million for the 1Q21.

- It also raises the interest rate paid on credit line borrowings during the relief period, but those will revert to normal levels after this is complete.

In our view, a dividend is unlikely to return in 2020 based on a required payment. Through the first half of 2020, EPR had a loss of -$38 million for income. It had already paid $160 million in dividends (which would include the preferred dividends). EPR would need to post income in excess of $200 million in the second half of 2020 to start reaching that threshold. For a full normal year, EPR normally earns just over $200 million, which makes it unlikely would need to pay additional common dividends in 2020. The month of July would not have been typical to begin the second half of 2020. Plus, the change to recognizing many tenants rent income as it is received in cash would create a lag impact and lower current income.

We still believe EPR will begin paying a dividend again next year. We also do not believe it will have much difficulty meeting covenants to repeal the relief period and end the restrictions:

- Property Income needs to exceed Interest expense by 1.75x. Total interest expense should be about $155 million annualized. So, property income needs to be above $270 million. EPR's annualized rent is about $625 million and property costs are about 10% of that. Even with rent concessions and recognizing AMC on a cash basis – EPR should be able to clear that test. It does get to include rent that has been recognized as revenue but deferred in this test.

- Also, Adjusted EBITDA needs to be greater than 1.5x the sum of scheduled debt maturities, interest expense and preferred dividends. That requires annualized Adjusted EBITDA to exceed about $270 million. Even in 2Q, EBITDA would annualize to $311 million. EPR should be able to clear that test. It also can include rent that has been recognized but deferred as part of EBITDA in this test.

- Minimum liquidity of cash on hand plus cash left on the credit line needs to exceed $250 million – EPR has $250 million it can still draw and $1 billion in cash on hand with a minimal burn rate.

- The maximum of unsecured debt to unencumbered assets cannot exceed 60% and it is adjusted for cash. The ratio adjusted for cash was 41% at the end of 2Q.

Our view is as more properties open, EPR should be able to maintain its strong liquidity position and meet its covenants. That could allow it to end the relief period, which would end the dividend restrictions.

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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