Seritage Growth Properties
Form 10-Q
November 04, 2016

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 SEPTEMBER 30, 2016
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.)

489 Fifth Avenue, 18th Floor, New York, New York	10017
(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 or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting 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

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 October 31, 2016, the registrant had the following common shares outstanding:

Class	Shares Outstanding
Class A common shares of beneficial interest, par value $0.01 per share	25,825,651
Class B common shares of beneficial interest, par value $0.01 per share	1,589,020
Class C common shares of beneficial interest, par value $0.01 per share	5,772,285

SERITAGE GROWTH PROPERTIES

QUARTERLY REPORT ON FORM 10-Q

QUARTER ENDED SEPTEMBER 30, 2016

TABLE OF CONTENTS

		Page
PART I.	FINANCIAL INFORMATION	
Item 1.	Condensed Consolidated Financial Statements (unaudited)	
	Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015	3
	Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2016 and the Period from July 7, 2015 (Date Operations Commenced) to September 30, 2015	4
	Condensed Consolidated Statements of Equity for the Nine Months Ended September 30, 2016 and the Period from July 7, 2015 (Date Operations Commenced) to September 30, 2015	5
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2016 and the Period from July 7, 2015 (Date Operations Commenced) to September 30, 2015	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	26
Item 3.	Quantitative and Qualitative Disclosure about Market Risk	38
Item 4.	Controls and Procedures	38
PART II.	OTHER INFORMATION	
Item 1.	Legal Proceedings	39
Item 1A.	Risk Factors	39
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	40
Item 3.	Defaults upon Senior Securities	40
Item 4.	Mine Safety Disclosures	40
Item 5.	Other Information	40
Item 6.	Exhibits	41
SIGNATURES		42

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)

	September 30, 2016	December 31, 2015
ASSETS		
Investment in real estate		
Land	$840,021	$840,563
Buildings and improvements	831,269	814,652
Accumulated depreciation	(78,025)	(29,076)
	1,593,265	1,626,139
Construction in progress	44,172	13,136
Net investment in real estate	1,637,437	1,639,275
Investment in unconsolidated joint ventures	419,675	427,052
Cash and cash equivalents	90,029	62,867
Restricted cash	81,790	92,475
Tenant and other receivables, net	13,477	9,772
Lease intangible assets, net	505,564	578,795
Prepaid expenses, deferred expenses and other assets, net	12,466	23,123
Total assets	$2,760,438	$2,833,359
LIABILITIES AND EQUITY		
Liabilities		
Mortgage loans payable, net	$1,165,675	$1,142,422
Accounts payable, accrued expenses and other liabilities	130,283	120,860
Total liabilities	1,295,958	1,263,282
Commitments and contingencies (Note 10)		
Shareholders' Equity		
Class A shares $0.01 par value; 100,000,000 shares authorized; 25,822,201 and 24,817,842 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	258	248
Class B shares $0.01 par value; 5,000,000 shares authorized; 1,589,020 shares issued and outstanding as of September 30, 2016 and December 31, 2015	16	16
Class C shares $0.01 par value; 50,000,000 shares authorized; 5,775,735 and 6,773,185 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	58	68
Additional paid-in capital	925,296	924,508

Accumulated deficit	(98,425)	(38,145)
Total shareholders' equity	827,203	886,695
Non-controlling interests	637,277	683,382
Total equity	1,464,480	1,570,077
Total liabilities and equity	$2,760,438	$2,833,359

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 September 30, 2016	July 7, 2015 (date operations commenced) to September 30, 2015	Nine Months Ended September 30, 2016
REVENUE			
Rental income	$ 45,584	$ 41,389	$ 136,737
Tenant reimbursements	12,023	12,674	45,741
Total revenue	57,607	54,063	182,478
EXPENSES			
Property operating	4,505	2,815	17,176
Real estate taxes	7,965	10,741	31,101
Depreciation and amortization	44,532	32,935	121,365
General and administrative	4,252	5,782	13,104
Litigation charge	19,000	-	19,000
Allowance for doubtful accounts	124	-	269
Acquisition-related expenses	-	18,340	73
Total expenses	80,378	70,613	202,088
Operating income	(22,771)	(16,550)	(19,610)
Equity in income of unconsolidated joint ventures	1,497	2,720	4,495
Interest and other income	77	38	196
Interest expense	(15,931)	(14,796)	(47,297)
Unrealized loss on interest rate cap	(47)	(2,814)	(1,898)
Loss before income taxes	(37,175)	(31,402)	(64,114)
Provision for income taxes	(72)	(451)	(412)
Net loss	(37,247)	(31,853)	(64,526)
Net loss attributable to non-controlling interests	16,145	13,552	27,972
Net loss attributable to common shareholders	$ (21,102)	$ (18,301)	$ (36,554)
Net loss per share attributable to Class A and Class C common shareholders - Basic and diluted	$ (0.67)	$ (0.58)	$ (1.16)
Weighted average Class A and Class C common shares outstanding - Basic and diluted	31,419	31,384	31,414

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 Shares	Amount	Class B Shares	Amount	Class C Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Non-Controlling Interests	Total Equity
Balance at July 7, 2015 (date operations commenced)	25,584	$ 246	1,589	$ 16	6,790	$ 68	$ 923,636	$ -	$ 711,991	$ 1,635,957
Net loss	-	-	-	-	-	-	-	(18,301)	(13,552)	(31,853)
Dividends and distributions declared ($0.00 per share and unit)	-	-	-	-	-	-	-	-	-	-
Issuance of restricted shares	217	2	-	-	-	-	(2)	-	-	-
Vesting of restricted share units	-	-	-	-	-	-	-	-	-	-
Stock-based compensation	-	-	-	-	-	-	716	-	-	716
Share class exchanges, net (132,450 common shares)	132	1	-	-	(132)	(1)	-	-	-	-
Balance at September 30, 2015	25,933	$ 249	1,589	$ 16	6,658	$ 67	$ 924,350	$ (18,301)	$ 698,439	$ 1,604,820
Balance at December 31, 2015	24,818	$ 248	1,589	$ 16	6,773	$ 68	$ 924,508	$ (38,145)	$ 683,382	$ 1,570,077
Net loss	-	-	-	-	-	-	-	(36,554)	(27,972)	(64,526)
Dividends and	-	-	-	-	-	-	-	(23,726)	(18,133)	(41,859)

distributions declared ($0.75 per share and unit)										
Issuance of restricted shares	-	-	-	-	-	-	-	-	-	-
Vesting of restricted share units	7	0	-	-	-	-	(13)	-	-	(13)
Stock-based compensation	-	-	-	-	-	-	801	-	-	801
Share class exchanges, net (997,450 common shares)	997	10	-	-	(997)	(10)	-	-	-	-
Balance at September 30, 2016	25,822	$ 258	1,589	$ 16	5,776	$ 58	$ 925,296	$ (98,425)	$ 637,277	$ 1,464,480

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)

	Nine Months Ended September 30, 2016	July 7, 2015 (date operations commenced) to September 30, 2015
CASH FLOW FROM OPERATING ACTIVITIES		
Net loss	$ (64,526)	$ (31,853)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Equity in income of unconsolidated joint ventures	(4,495)	(2,720)
Distributions from unconsolidated joint ventures	11,872	2,598
Unrealized loss on interest rate cap	1,898	2,814
Stock-based compensation	801	716
Depreciation and amortization	121,365	32,935
Amortization of deferred financing costs	4,021	1,324
Amortization of above and below market leases, net	(520)	(194)
Straight-line rent adjustment	(11,242)	(3,923)
Change in operating assets and liabilities		
Tenants and other receivables	8,425	(662)
Prepaid expenses, deferred expenses and other assets	8,496	(12,939)
Restricted cash	(1,047)	(2,856)
Accounts payable, accrued expenses and other liabilities	24,043	22,292
Net cash provided by operating activities	99,091	7,532
CASH FLOW FROM INVESTING ACTIVITIES		
Acquisition of real estate and unconsolidated joint ventures	-	(2,653,019)
Development of real estate	(47,236)	(3,896)
Decrease (increase) in restricted cash	11,732	(74,830)
Net cash used in investing activities	(35,504)	(2,731,745)
CASH FLOW FROM FINANCING ACTIVITIES		
Proceeds from issuance of mortgage loans payable, net	-	1,161,196
Proceeds from Future Funding Facility	19,239	-
Payment of deferred financing costs	(6)	(21,431)
Proceeds from issuance of common stock and non-controlling interest	-	1,644,042
Offering related costs	-	(8,086)
Common dividends paid	(31,482)	-
Non-controlling interests distributions paid	(24,176)	-
Net cash used by financing activities	(36,425)	2,775,721
Net increase in cash and cash equivalents	27,162	51,508
Cash and cash equivalents, beginning of period	62,867	-
Cash and cash equivalents, end of period	$ 90,029	$ 51,508

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash payments for interest	$ 45,495	$ 11,001
Capitalized interest	2,198	-
Income taxes paid	412	451
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES		
Development of real estate financed with accounts payable	3,442	6,214
Dividends and distribution declared and unpaid	13,954	-

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 234 of Sears Holdings' owned properties and one of its ground leased properties (the "Wholly Owned Properties"), and its 50% interests in three joint ventures (such joint ventures, the "JVs," and such 50% joint venture interests, the "JV Interests") that collectively own 28 properties, ground lease one property and lease two properties (collectively, the "JV Properties") (collectively, 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 September 30, 2016, subsidiaries of the Operating Partnership lease a substantial majority of the space at all but 14 of the Wholly Owned Properties back to Sears Holdings under a master lease agreement (the "Master Lease"), with the remainder of such space leased to third-party tenants. A substantial majority of the space at the JV Properties is also leased (or subleased) by the JVs to Sears Holdings under master lease agreements (collectively, the "JV Master Leases"). 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 period from July 7, 2015 (Date Operations Commenced) to December 31, 2015. 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. Capitalized terms used, but not defined in this quarterly report, have the same meanings as set forth in our Annual Report.

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The 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. The Company holds a 56.7% 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 new 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 reviews operating and financial information for each property on an individual basis, and therefore, each property represents an individual operating segment. The Company does not distinguish or group consolidated operations based on geography, size, or type. The Company 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.

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 September 30, 2016 or the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. No such impairment losses were recognized for the nine months ended September 30, 2016.

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 September 30, 2016 or the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. No such impairment losses were recognized for nine months ended September 30, 2016.

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 September 30, 2016, the Company had approximately $81.8 million of restricted cash, including $35.8 million related to future capital investments such as unfunded construction commitments, deferred maintenance and environmental reserves, $31.4 million related to basic property carrying costs such as real estate taxes, insurance and ground rent, and $14.6 million 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 that 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.

- 10 -

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 is deemed uncollectable as result of the lease modification is amortized over the remaining shortened life of the lease from the date of notice to the date of termination.
- 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 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 is subject to the lease modification is amortized over the remaining shortened life of the lease from the date of notice to the date of termination. 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 are deemed to be impacted by the lease modification is amortized over the shorter of the shortened lease term 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 is subject to the termination is amortized over the remaining shortened life of the lease from the date of notice to the date of termination.
- Intangible lease assets and liabilities that are deemed to be impacted by the termination are amortized over the shorter of the shortened lease term 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 termination.
  - 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, the Company purchased for $5.0 million an interest rate cap with a term of four years, a notional amount of $1.26 billion 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 consolidated statements of operations. For the three months ended September 30, 2016, the Company recorded a loss of $47 thousand related to the change in fair value of the interest rate cap compared to a loss of $2.8 million during the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. For the nine months ended September 30, 2016, the Company recorded a loss of $1.9 million related to the change in fair value of the interest rate cap.

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 September 30, 2016, substantially all 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 6). 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 September 30, 2016, the Company's portfolio of 235 Wholly Owned 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 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 August 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,” which is intended to address diversity in practice related to how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in ASU 2016-15 address eight specific cash flow issues as well as application of the predominance principle (dependence on predominant source or use of receipt or payment) and are effective for public business entities for fiscal years beginning after December 15, 2017 and interim periods

within those fiscal years with early adoption permitted. The Company is currently evaluating the impact this amendment will have on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting,” which amends accounting for income taxes related to share-based compensation, the related classification in the statement of cash flows, and share award forfeiture accounting. The new guidance is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-07, “Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting,” which eliminates the requirement to retroactively adjust an investment that subsequently qualifies for equity method accounting (as a result of an increase in level of ownership interest or degree of influence) as if the equity method of accounting had been applied during all prior periods that the investment was held. The new standard requires that the investor add the cost of acquiring additional ownership interest in the investee to its current basis and prospectively adopt the equity method of accounting. Any unrealized gains or losses in an available-for-sale investment that subsequently qualifies as an equity method investment should be recognized in earnings at the date the investment qualifies as an equity method investment. The new guidance is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods and requires prospective adoption. Early adoption is permitted. The Company has evaluated the impact of this standard, and has concluded that it has no material impact on its consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Codification (“ASC”) 842 (“ASC 842”), “Leases” which replaces the existing guidance in ASC 840, Leases. ASC 842 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. ASC 842 requires a dual approach for lessee accounting under which a lessee would account for leases as finance leases or operating leases. Both finance leases and operating leases will result in the lessee recognizing a right-of-use (ROU) asset and a corresponding lease liability. For finance leases, the lessee would recognize interest expense and amortization of the ROU asset and for operating leases, the lessee would recognize a straight-line total lease expense. The Company is currently assessing the impact that adoption of this guidance will have on its consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, “Amendments to the Consolidation Analysis,” which makes certain changes to both the variable interest model and the voting model, including changes to (1) the identification of variable interests (fees paid to a decision maker or service provider), (2) the variable interest entity characteristics for a limited partnership or similar entity and (3) the primary beneficiary determination. The Company adopted ASU 2015-02 on January 1, 2016. The adoption of this standard did not have a material impact on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers,” which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 states that “an entity recognizes 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.” While ASU 2014-09 specifically references contracts with customers, it may apply to certain other transactions such as the sale of real estate or equipment. In July 2015, the FASB voted to defer the effective date of ASU 2014-09 by one year. Accordingly, ASU 2014-09 is effective for annual periods beginning after December 15, 2017, with early adoption permitted for annual periods beginning after December 15, 2016. The standard can be applied either retrospectively to each prior reporting period presented or as a cumulative-effect adjustment recognized as of the date of initial application. The FASB has also issued the following standards which clarify ASU 2014-09 and have the same effective date as the original standard: ASU 2016-12, “Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients,” and ASU 2016-10, “Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing,” and ASU 2016-08, “Revenue from Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net).” The Company is evaluating the impact of adopting these new accounting standards on its consolidated financial statements.

Note 3 – Acquisitions

On July 7, 2015, the Company purchased the Wholly Owned Properties and JV Interests at their fair value for $2.7 billion, with the substantial majority of such properties being leased back to Sears Holdings.

The following table summarizes the final purchase price and fair values of the net assets acquired in the Transaction (in thousands):

Proceeds from issuance of common stock and non-controlling interest		$1,644,042
Less: Offering related costs		(8,212)
Proceeds from issuance of mortgage loans payable		1,161,196
Less: Deferred financing costs		(21,446)
Total sources of funds net of offering and financing costs		2,775,580
Real estate assets acquired		
Land	840,563	
Buildings and improvements	810,499	
Lease intangibles		
In-place leases	595,443	
Below-market ground lease	11,766	
Above-market leases	9,058	
Below-market leases	(20,045)	
Investments in unconsolidated joint ventures	429,012	
Total fair value of real estate assets acquired		2,676,296
Plus: Restricted cash		
Environmental expenses reserve	12,034	
Deferred maintenance reserve	10,575	
Total restricted cash		22,609
Less: Assumed liabilities		
Real estate taxes payable	(23,277)	
Environmental expenses	(12,034)	
Deferred maintenance	(10,575)	
Total assumed liabilities		(45,886)
Net cash paid for acquisition of real estate and unconsolidated joint ventures		2,653,019
Additional (sources) / uses of cash		
Prepaid rent	(26,855)	
Initial funding of unfunded construction commitments reserve (restricted cash)	42,470	
Initial funding of property carry costs reserve (restricted cash)	32,482	
Initial funding of interest expense reserve (restricted cash)	4,924	
Acquisition related expenses	18,340	
Prepaid interest expense	1,249	
Total additional (sources) uses of cash, net		72,610
Remaining excess cash from transaction		$49,951

Note 4 – Lease Intangible Assets and Liabilities

As of September 30, 2016, 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 $505.6 million and $17.4 million, respectively. The following table summarizes the Company's lease intangible assets and liabilities as of September 30, 2016 (in thousands):

Lease Intangible Assets	Gross Asset	Accumulated Amortization	Balance
In-place leases, net	$595,350	$ (108,614)	$486,736
Below-market ground leases, net	11,766	(254)	11,512
Above-market leases, net	8,964	(1,648)	7,316
Total	$616,080	$ (110,516)	$505,564

Lease Intangible Liabilities	Gross Liability	Accumulated Amortization	Balance
Below-market leases, net	$20,045	$ (2,687)	$17,358
Total	$20,045	$ (2,687)	$17,358

As of December 31, 2015, 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 $578.8 million and $19.0 million, respectively. The following table summarizes the Company's lease intangible assets and liabilities as of December 31, 2015 (in thousands):

Lease Intangible Assets	Gross Asset	Accumulated Amortization	Balance
In-place leases, net	$595,443	$ (36,800)	$558,643
Below-market ground leases, net	11,766	(102)	11,664
Above-market leases, net	9,058	(570)	8,488
Total	$616,267	$ (37,472)	$578,795

Lease Intangible Liabilities	Gross Liability	Accumulated Amortization	Balance
Below-market leases, net	$20,045	$ (1,059)	$18,986
Total	$20,045	$ (1,059)	$18,986

Amortization of acquired below-market leases, net of acquired above-market leases, resulted in additional rental income of $0.3 million for the three months ended September 30, 2016 and $0.2 million for the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. For the nine months ended September 30, 2016, amortization of acquired below-market leases, net of acquired above-market leases, resulted in additional rental income of $0.9 million. Future amortization of these intangibles is estimated to increase rental income as set forth below (in thousands):

Remainder of 2016	$(248)
2017	(991)
2018	(991)
2019	(964)
2020	(830)
2021	(817)

Amortization of acquired below-market ground leases resulted in additional property expense of $50 thousand for the three months ended September 30, 2016 and $50 thousand for the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. For the nine months ended September 30, 2016, amortization of acquired below-market ground leases resulted in additional property expense of $150 thousand. Future amortization of below-market ground leases is estimated to increase property expenses as set forth below (in thousands):

Remainder of 2016	$51
2017	203
2018	203
2019	203
2020	203
2021	203

Amortization of acquired in-place leases resulted in additional depreciation and amortization expense of $27.4 million for the three months ended September 30, 2016 and $18.4 million for the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. For the nine months ended September 30, 2016, amortization of acquired in-place leases resulted in additional depreciation and amortization expense of $72.1 million. Future estimated amortization of acquired in-place leases is set forth below (in thousands):

Remainder of 2016	$37,422
2017	69,997
2018	68,021
2019	65,617
2020	63,290
2021	55,697

Note 5 – Investments in Unconsolidated Joint Ventures

The Company conducts a portion of its property rental activities through investments in unconsolidated joint ventures for which the Company holds less than a controlling interest. The Company's partners in these unconsolidated joint ventures are unrelated real estate entities or commercial enterprises. The Company and its unconsolidated joint venture partners make initial and/or ongoing capital contributions to these unconsolidated joint ventures. The obligations to make capital contributions are governed by each unconsolidated joint venture's respective operating agreement and related governing documents.

The Company currently has investments in three unconsolidated entities: GS Portfolio Holdings LLC (the "GGP JV"), a joint venture between Seritage and a subsidiary of General Growth Properties, Inc. (together with its subsidiaries, "GGP"), SPS Portfolio Holdings LLC (the "Simon JV"), a joint venture between Seritage and a subsidiary of Simon Property Group, Inc. (together with its subsidiaries, "Simon"), and MS Portfolio LLC (the "Macerich JV"), a joint venture between Seritage and a subsidiary of The Macerich Company (together with its subsidiaries, "Macerich"). A substantial majority of the space at the JV Properties is leased to Sears Holdings under the JV Master Leases which include recapture rights and termination rights with similar terms as those described under the Master Lease.

As of September 30, 2016, the GGP JV had submitted recapture notices related to Pembroke Lakes Mall in Pembroke Pines, FL, Valley Plaza Mall in Bakersfield, CA, Staten Island Mall in Staten Island, NY and Coronado Mall in Albuquerque, NM. Subsequent to September 30, 2016, the GGP JV announced plans to recapture space at five additional locations according to a specific schedule, including Oakbrook Center in Oak Brook, IL, The Mall at Columbia in Columbia, MD, Natick Collection in Natick, MA, Paramus Park in Paramus, NJ and Alderwood in Lynnwood, WA. The GGP JV will recapture 100% of the space currently occupied by Sears Holdings at Alderwood and Paramus Park, while Sears Holdings will continue to occupy a downsized space at the other locations.

No recaptures notices have been submitted related to properties in the Macerich JV or the Simon JV.

The Company's investments in unconsolidated joint ventures at September 30, 2016, consisted of (in thousands, except for number of properties):

Joint Venture	# of Properties	Total GLA	Initial Investment	Seritage % Ownership
GGP JV	12	2,162	$ 165,000	50%
Macerich JV	9	1,574	150,000	50%
Simon JV	10	1,714	114,012	50%
Total	31	5,450	$ 429,012	

Each unconsolidated joint venture is obligated to maintain financial statements in accordance with GAAP. The Company shares in the profits and losses of these unconsolidated joint ventures generally in accordance with the Company's respective equity interests. In some instances, the Company may recognize profits and losses related to investment in an unconsolidated joint venture that differ from the Company's equity interest in the unconsolidated joint venture. This may arise from impairments that the Company recognizes related to its investment that differ from the impairments the unconsolidated joint venture recognizes with respect to its assets; differences between the Company's basis in assets it has transferred to the unconsolidated joint venture and the unconsolidated joint venture's basis in those assets; the Company's deferral of the unconsolidated joint venture's profits from land sales to the Company; or other items. There were no joint venture impairment charges during the three months ended September 30, 2016 or the period from July 7, 2015 (Date Operations Commenced) to September 30, 2015. There were no joint venture impairment charges during the nine months ended September 30, 2016.

The following table presents combined condensed financial data for all of the Company's unconsolidated joint ventures as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
ASSETS		
Investment in real estate		
Land	$ 214,109	$ 214,726
Buildings and improvements	600,642	603,265
Accumulated depreciation	(48,256)	(24,111)
	766,495	793,880
Construction in progress	6,740	1,481
Net investment in real estate	773,235	795,361
Cash and cash equivalents	22,743	19,903
Tenant and other receivables, net	5,088	4,990
Other assets, net	16,019	30,506
Total assets	$ 817,085	$ 850,760
LIABILITIES AND EQUITY		
Liabilities		
Accounts payable, accrued expenses and other liabilities	$ 11,761	$ 13,973
Total liabilities	11,761	13,973
Equity		
Additional paid in capital	796,334	823,923
Retained earnings	8,990	12,864
Total equity	805,324	836,787
Total liabilities and equity	$ 817,085	$ 850,760

	Three Months Ended September 30, 2016	July 7, 2015 (date operations commenced) to September 30, 2015	Nine Months Ended September 30, 2016
EQUITY IN INCOME OF UNCONSOLIDATED JOINT VENTURES			
Total revenue	$ 16,266	$ 16,932	$ 50,113
Property operating expenses	(3,103)	(4,208)	(9,703)
Depreciation and amortization	(10,382)	(7,133)	(31,304)
Operating income	2,781	5,591	9,106
Other expenses	212	(151)	(117)
Net income	$ 2,993	$ 5,440	$ 8,989
Equity in income of unconsolidated joint ventures	$ 1,497	$ 2,720	$ 4,495

Note 6 – Leases

Master Lease

On July 7, 2015, subsidiaries of Seritage and subsidiaries of Sears Holdings entered into the Master Lease. The Master Lease generally is a triple net lease with respect to all space which is leased thereunder to Sears Holdings, subject to proportional sharing by Sears Holdings for repair and maintenance charges, real property taxes, insurance and other costs and expenses which are common to both the space leased by Sears Holdings and other space occupied by unrelated third-party tenants in the same or other buildings pursuant to third-party leases, space which is recaptured pursuant to the Company recapture rights described below and all other space which is constructed on the properties. Under the Master Lease, Sears Holdings and/or one or more of its subsidiaries will be required to make all expenditures reasonably necessary to maintain the premises in good appearance, repair and condition for as long as they are in occupancy.

The Master Lease has an initial term of 10 years and contains three options for five-year renewals of the term and a final option for a four-year renewal. As of September 30, 2016, the annual base rent paid directly by Sears Holdings and its subsidiaries under the Master Lease was approximately $134.2 million. In each of the initial and first two renewal terms, annual base rent will be increased by 2.0% per annum for each lease year over the rent for the immediately preceding lease year. For subsequent renewal terms, rent will be set at the commencement of the renewal term at a fair market rent based on a customary third-party appraisal process, taking into account all the terms of the Master Lease and other relevant factors, but in no event will the renewal rent be less than the rent payable in the immediately preceding lease year.

Revenues from the Master Lease for the three and nine months ended September 30, 2016 are as follows (in thousands and excluding the effect of straight-line rent):

	Three Months Ended September 30, 2016	July 7, 2015 (date operations commenced) to September 30, 2015	Nine Months Ended September 30, 2016
Rental income	$ 33,378	$ 31,339	$ 99,846
Tenant reimbursements			