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Four Corners Property Trust, Inc.

Form 10-Q

November 03, 2017

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, 2017

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 1-37538

Four Corners Property Trust, Inc.

(Exact name of registrant as specified in its charter)

Maryland 47-4456296
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

591 Redwood Highway, Suite 1150 94941
Mill Valley, California
(Address of principal executive offices) (Zip Code)
(415) 965-8030
(Registrant's telephone number, including area code)
Not applicable
(Former name or former address, if changed since last report)

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 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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act:

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

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

Number of shares of common stock outstanding as of November 2, 2017: 61,196,087

FOUR CORNERS PROPERTY TRUST, INC.
 FORM 10 - Q
 THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2017
 TABLE OF CONTENTS

	Page
Part I FINANCIAL INFORMATION	
Item 1. Financial Statements:	
<u>Consolidated Balance Sheets at September 30, 2017 (unaudited) and December 31, 2016</u>	1
<u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2017 and 2016 (unaudited)</u>	2
<u>Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2017 and 2016 (unaudited)</u>	3
<u>Consolidated Statement of Changes in Equity for the Nine Months Ended September 30, 2017 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2017 and 2016 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	28
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	35
Item 4. <u>Controls and Procedures</u>	35
Part II OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	36
Item 1A. <u>Risk Factors</u>	36
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	36
Item 3. <u>Defaults Upon Senior Securities</u>	36
Item 4. <u>Mine Safety Disclosure</u>	36
Item 5. <u>Other Information</u>	36
Item 6. <u>Exhibits</u>	36
<u>Index to Exhibits</u>	37
<u>Signatures</u>	38

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FOUR CORNERS PROPERTY TRUST, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	September 30, 2017 (Unaudited)	December 31, 2016
ASSETS		
Real estate investments:		
Land	\$441,462	\$421,941
Buildings, equipment and improvements	1,100,430	1,055,624
Total real estate investments	1,541,892	1,477,565
Less: Accumulated depreciation	(593,609)	(583,307)
Total real estate investments, net	948,283	894,258
Real estate held for sale	1,712	—
Cash and cash equivalents	82,865	26,643
Deferred rent	18,877	11,594
Derivative assets	2,296	837
Other assets	7,741	3,819
Total Assets	\$1,061,774	\$937,151
LIABILITIES AND EQUITY		
Liabilities:		
Notes payable, net of deferred financing costs	\$518,353	\$438,895
Dividends payable	14,820	14,519
Deferred rental revenue	7,964	7,974
Derivative liabilities	219	—
Deferred tax liabilities	164	196
Other liabilities	6,571	5,450
Total liabilities	548,091	467,034
Equity:		
Preferred stock, par value \$0.0001 per share; 25,000,000 authorized, zero shares issued and outstanding	—	—
Common stock, par value \$0.0001 per share; 500,000,000 shares authorized, 61,196,087 and 59,923,557 shares issued and outstanding at September 30, 2017 and December 31, 2016, respectively	6	6
Additional paid-in capital	469,571	438,864
Retained earnings	34,811	25,943
Accumulated other comprehensive income	1,545	207
Noncontrolling interest	7,750	5,097
Total equity	513,683	470,117
Total Liabilities and Equity	\$1,061,774	\$937,151

The accompanying notes are an integral part of this financial statement.

FOUR CORNERS PROPERTY TRUST, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except share and per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenues:				
Rental revenue	\$28,835	\$ 26,363	\$84,926	\$ 78,748
Restaurant revenues	4,676	4,443	14,445	14,003
Total revenues	33,511	30,806	99,371	92,751
Operating expenses:				
General and administrative	2,899	2,608	9,215	8,434
Depreciation and amortization	5,425	5,059	16,254	15,347
Restaurant expenses	4,571	4,308	13,823	13,600
Interest expense	5,463	3,549	14,066	11,588
Total expenses	18,358	15,524	53,358	48,969
Other income	172	10	211	88
Realized gain on sale, net	4,042	—	7,333	—
Income before income taxes	19,367	15,292	53,557	43,870
Income tax (expense) benefit	(33)	(52)	(139)	80,455
Net income	19,334	15,240	53,418	124,325
Net income attributable to noncontrolling interest	(129)	—	(374)	—
Net Income Available to Common Shareholders	\$19,205	\$ 15,240	\$53,044	\$ 124,325
Basic net income per share:	\$0.31	\$ 0.25	\$0.88	\$ 2.22
Diluted net income per share:	\$0.31	\$ 0.25	\$0.88	\$ 2.09
Weighted average number of common shares outstanding:				
Basic	61,112,055	59,832,824	60,457,945	56,026,594
Diluted ⁽¹⁾	61,256,145	59,863,109	60,567,155	59,469,008
Dividends declared per common share	\$0.2425	\$ 0.2425	\$0.7275	\$ 0.7275

(1) Includes 17,085,566 shares issued on March 2, 2016 as part of our purging distribution to satisfy certain REIT requirements. For financial reporting purposes, these shares were assumed to have been issued on January 7, 2016.

The accompanying notes are an integral part of this financial statement.

FOUR CORNERS PROPERTY TRUST, INC.
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (In thousands, except for share and per share data)
 (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	\$19,334	\$15,240	\$53,418	\$124,325
Other comprehensive income (loss):				
Effective portion of change in fair value of derivative instruments:				
Effective portion of change in fair value of derivative instruments	293	1,469	115	(9,042)
Reclassification adjustment of derivative instruments included in net income	196	935	1,230	2,900
Other comprehensive income (loss):	489	2,404	1,345	(6,142)
Comprehensive income	19,823	17,644	54,763	118,183
Less: comprehensive income attributable to noncontrolling interest				
Net income attributable to noncontrolling interest	129	—	374	—
Other comprehensive income attributable to noncontrolling interest	4	—	7	—
Comprehensive income attributable to noncontrolling interest	133	—	381	—
Comprehensive Income Attributable to Common Shareholders	\$19,690	\$17,644	\$54,382	\$118,183

The accompanying notes are an integral part of this financial statement.

FOUR CORNERS PROPERTY TRUST, INC.
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(In thousands, except share data)

(Unaudited)

	Common Stock		Additional	Retained	Accumulated	Noncontrolling	Total
	Shares	Par Value	Paid-in Capital	Earnings	Other Comprehensive Income	Interest	
Balance at December 31, 2016	59,923,557	\$ 6	\$438,864	\$25,943	\$ 207	\$ 5,097	\$470,117
Net income	—	—	—	53,044	—	374	53,418
Other comprehensive income	—	—	—	—	1,338	7	1,345
Issuance of OP units, net	—	—	—	—	—	2,620	2,620
ATM proceeds, net of issuance costs	1,216,992	—	28,787	—	—	—	28,787
Dividends and distributions to equity holders	—	—	—	(44,176)	—	(348)	(44,524)
Stock-based compensation, net	55,538	—	1,920	—	—	—	1,920
Balance at September 30, 2017	61,196,087	\$ 6	\$469,571	\$34,811	\$ 1,545	\$ 7,750	\$513,683

The accompanying notes are an integral part of this financial statement.

FOUR CORNERS PROPERTY TRUST, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2017	2016
Cash flows - operating activities		
Net income	\$53,418	\$124,325
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	16,254	15,347
Gain on disposal of land, building, and equipment	(7,333)	—
Amortization of financing costs	1,265	1,194
Stock-based compensation expense	1,920	1,158
Deferred income taxes	(32)	(80,685)
Changes in assets and liabilities:		
Derivative assets and liabilities	105	140
Deferred rental asset	(7,323)	(7,799)
Deferred rental revenue	(10)	(55)
Other assets and liabilities	1,915	(1,992)
Net cash provided by operating activities	60,179	51,633
Cash flows - investing activities		
Purchases of real estate investments	(70,366)	(23,742)
Net proceeds from sale of real estate investments	10,734	—
Restricted escrow deposits for pending Section 1031 tax-deferred exchanges	(3,030)	—
Advance deposits on acquisition of operating real estate	(757)	—
Cash used in investing activities	(63,419)	(23,742)
Cash flows - financing activities		
Net proceeds from equity issuance	28,787	—
Proceeds from issuance of senior notes	125,000	—
Payment of deferred financing costs	(1,809)	—
Proceeds from revolving credit facility	36,000	—
Repayment of revolving credit facility	(81,000)	—
Payment of dividend to shareholders	(43,875)	(107,094)
Distribution to non-controlling interests	(348)	—
Redemption of non-controlling interests	(988)	—
Repayment of debt assumed in purchase of real estate investments	(2,305)	—
Net cash provided by (used in) financing activities	59,462	(107,094)
Net increase (decrease) in cash and cash equivalents	56,222	(79,203)
Cash and cash equivalents, beginning of period	26,643	98,073
Cash and cash equivalents, end of period	\$82,865	\$18,870
Supplemental disclosures:		
Dividends declared but not paid	\$14,820	\$14,510
Interest paid	\$10,945	\$6,554
Taxes paid	\$522	\$2,369
Non-cash investing and financing activities:		
Debt assumed in acquisition of real estate investments	\$2,305	\$—
Change in fair value of derivative instruments	\$1,240	\$—
Operating partnership units issued in exchange for real estate investments	\$3,609	\$—

The accompanying notes are an integral part of this financial statement.

5

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION

Four Corners Property Trust, Inc. (together with its consolidated subsidiaries, “FCPT”) is an independent, publicly traded, self-administered company, primarily engaged in the ownership, acquisition and leasing of restaurant properties. Substantially all of our business is conducted through Four Corners Operating Partnership, LP (“FCPT OP”), a Delaware limited partnership of which we are the initial and substantial limited partner. Our wholly owned subsidiary, Four Corners GP, LLC (“FCPT GP”), is its sole general partner.

FCPT was incorporated as a Maryland corporation on July 2, 2015 as a wholly owned indirect subsidiary of Darden Restaurants, Inc., (together with its consolidated subsidiaries, “Darden”), for the purpose of owning, acquiring and leasing properties on a triple-net basis, for use in the restaurant and related food service industries. On November 9, 2015, Darden completed a spin-off of FCPT whereby Darden contributed to us 100% of the equity interest in entities that own 418 properties in which Darden operates restaurants, representing five of their brands, and six LongHorn Steakhouse® restaurants located in the San Antonio, Texas area (the “Kerrow Restaurant Operating Business”) along with the underlying properties or interests therein associated with the Kerrow Restaurant Operating Business. In exchange, we issued to Darden all of our common stock and paid to Darden \$315.0 million in cash. Subsequently, Darden distributed all of our outstanding shares of common stock pro rata to holders of Darden common stock whereby each Darden shareholder received one share of our common stock for every three shares of Darden common stock held at the close of business on the record date as well as cash in lieu of any fractional shares of our common stock which they would have otherwise received (the “Spin-Off”). The Spin-Off is intended to qualify as tax-free to Darden shareholders for U.S. federal income tax purposes, except for cash paid in lieu of fractional shares.

We believe that we have been organized and have operated in conformity with the requirements for qualification and taxation as a real estate investment trust (a “REIT”) for U.S. federal income tax purposes commencing with our taxable year ended December 31, 2016, and we intend to continue to operate in a manner that will enable us to maintain our qualification as a REIT. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement that we distribute at least 90% of our adjusted taxable income to our shareholders, subject to certain adjustments and excluding any net capital gain. As a REIT, we will not be subject to federal corporate income tax on that portion of net income that is distributed to our shareholders. However, FCPT’s taxable REIT subsidiaries (“TRS”) will generally be subject to federal, state, and local income taxes. We made our REIT election upon the filing of our 2016 tax return.

Any references to “the Company,” “we,” “us,” or “our” refer to FCPT as an independent, publicly traded, self-administered company.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of Four Corners Property Trust, Inc. and its consolidated subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary to a fair presentation of the results for the interim periods presented. These adjustments are considered to be of a normal, recurring nature.

Reclassifications

Certain amounts previously reported under specific financial statement captions have been reclassified to be consistent with the current period presentation. The Company reclassified 2016 interest income earned on its cash and marketable securities from rental income to other income. The reclassification totaled \$10 thousand and \$88 thousand for the three and nine months ended September 30, 2016, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Use of Estimates

The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of sales and expenses during the reporting period. The estimates and assumptions used in the accompanying consolidated financial statements are based on management's evaluation of the relevant facts and circumstances as of the date of the combination. Actual results may differ from the estimates and assumptions used in preparing the accompanying consolidated financial statements, and such differences could be material.

Real Estate Investments, Net

Real estate investments, net are recorded at cost less accumulated depreciation. Building components are depreciated over estimated useful lives ranging from seven to fifty-five years using the straight-line method. Leasehold improvements, which are reflected on our balance sheets as a component of buildings, equipment and improvements are amortized over the lesser of the non-cancelable lease term or the estimated useful lives of the related assets using the straight-line method. Other equipment is generally depreciated over estimated useful lives ranging from two to fifteen years also using the straight-line method. Real estate development and construction costs for newly constructed restaurants are capitalized in the period in which they are incurred. Gains and losses on the disposal of land, buildings and equipment are included in our accompanying consolidated statements of comprehensive income.

Our accounting policies regarding land, buildings and equipment, including leasehold improvements, include our judgments regarding the estimated useful lives of these assets, the residual values to which the assets are depreciated or amortized, the determination of what constitutes a reasonably assured lease term, and the determination as to what constitutes enhancing the value of or increasing the life of existing assets. These judgments and estimates may produce materially different amounts of reported depreciation and amortization expense if different assumptions were used. As discussed further below, these judgments may also impact our need to recognize an impairment charge on the carrying amount of these assets as the cash flows associated with the assets are realized, or as our expectations of estimated future cash flows change.

Acquisition of Real Estate

The Company evaluated the acquisitions and concluded that the land, building, site improvements, and in-place leases (if any) were a single asset. The building and property improvements are attached to the land and cannot be physically removed and used separately from the land without incurring significant costs or reducing their fair value. As substantially all of the fair value of the gross assets acquired are concentrated in a single identifiable asset, the acquisitions do not qualify as a business and are accounted for as asset acquisitions. Related transaction costs are generally capitalized into the basis of the acquired assets and depreciated over the useful life of those acquired assets. Goodwill is not recognized in the acquisition of assets.

The Company allocates the purchase price (including acquisition and closing costs) of real estate acquisitions to land, building, site improvements, and lease intangibles based on their relative fair values. In making estimates of fair values for this purpose, the Company uses a third-party specialist that obtains various information about each property, including the pre-acquisition due diligence and leasing activities of the Company.

Lease Intangibles

Lease intangibles, if any, acquired in conjunction with the purchase of real estate represent the value of in-place leases and above- or below-market leases. For real estate acquired subject to existing lease agreements, in-place lease intangibles are valued based on the Company's estimates of costs related to tenant acquisition and the asset carrying costs that would be incurred during the time it would take to locate a tenant if the property were vacant, considering current market conditions and costs to execute similar leases at the time of the acquisition. Above-market and below-market lease intangibles are recorded based on the present value of the difference between the contractual amounts to be paid pursuant to the leases at the time of acquisition of the real estate and the Company's estimate of current market lease rates for the property, measured over a period equal to the remaining initial term of the lease. In-place lease intangibles are amortized on a straight-line basis over the remaining initial term of the related lease and included in depreciation and amortization expense. Above-market lease intangibles are amortized over the remaining initial terms of the respective leases as a decrease in rental revenue. Below market lease intangibles are amortized as

an increase to rental revenue

7

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

over the remaining initial term of the respective leases, including renewal options. Should a lease terminate early, the unamortized portion of any related lease intangible is immediately recognized in impairment loss in the Company's consolidated statements of operations.

Impairment of Long-Lived Assets

Land, buildings and equipment and certain other assets, including definite-lived intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted net cash flows expected to be generated by the assets. Identifiable cash flows are measured at the lowest level for which they are largely independent of the cash flows of other groups of assets and liabilities, generally at the restaurant level. If these assets are determined to be impaired, the amount of impairment recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Fair value is generally determined by appraisals or sales prices of comparable assets.

The judgments we make related to the expected useful lives of long-lived assets and our ability to realize undiscounted cash flows in excess of the carrying amounts of these assets are affected by factors such as the ongoing maintenance and improvements of the assets, changes in economic conditions, changes in usage or operating performance, desirability of the restaurant sites and other factors, such as our ability to sell or lease our assets. As we assess the ongoing expected cash flows and carrying amounts of our long-lived assets, significant adverse changes in these factors could cause us to realize a material impairment loss.

Real Estate Held for Sale

Real estate is classified as held for sale when the sale is probable, will be completed within one year, purchase agreements are executed, the buyer has a significant deposit at risk, and no financing contingencies exist which could prevent the transaction from being completed in a timely manner. Restaurant sites and certain other assets to be disposed of are included in assets held for sale when the likelihood of disposing of these assets within one year is probable. Assets whose disposal is not probable within one year remain in land, buildings, equipment and improvements until their disposal within one year is probable. Disposals of assets that have a major effect on our operations and financial results or that represent a strategic shift in our operating businesses meet the requirements to be reported as discontinued operations. Real estate held for sale is reported at the lower of carrying amount or fair value, less estimated costs to sell.

During the nine months ended September 30, 2017, the Company sold two properties leased to Darden for total consideration of \$11.1 million, exclusive of \$0.4 million of selling costs. The sales were the result of unsolicited offers and resulted in a net gain of \$7.3 million after costs to sell. Additionally, the Company expects to finalize the sale of one property leased to Darden for approximately \$5.1 million in the fourth quarter of 2017. This prospective sale is from an unsolicited offer and would result in a gain of approximately \$3.3 million.

Cash and Cash Equivalents

We consider all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents can consist of cash and money market accounts.

Derivative Instruments and Hedging Activities

We enter into derivative instruments for risk management purposes only, including derivatives designated as hedging instruments as required by Financial Accounting Standards Board ("FASB") ASC Topic 815, Derivatives and Hedging, and those utilized as economic hedges. Our use of derivative instruments is currently limited to interest rate hedges. These instruments are generally structured as hedges of the variability of cash flows related to forecasted transactions (cash flow hedges). We do not enter into derivative instruments for trading or speculative purposes, where changes in the cash flows of the derivative are not expected to offset changes in cash flows of the hedged item. All derivatives are recognized on the balance sheet at fair value. For those derivative instruments for which we intend to elect hedge accounting, at the time the derivative contract is entered into, we document all relationships between hedging instruments and hedged items, as well as our risk-management objective and strategy for undertaking the various hedge transactions. This process includes linking all derivatives designated as cash flow hedges to specific assets and liabilities on the consolidated balance sheet or to specific forecasted transactions. We also formally assess, both

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items.

To the extent our derivatives are effective in offsetting the variability of the hedged cash flows, and otherwise meet the cash flow hedge accounting criteria in accordance with United States generally accepted accounting principals ("U.S. GAAP"), changes in the derivatives' fair value are not included in current earnings but are included in accumulated other comprehensive income (loss), net of tax. These changes in fair value will be reclassified into earnings at the time of the forecasted transaction. Ineffectiveness measured in the hedging relationship is recorded in earnings in the period in which it occurs.

See Note 7 - Derivative Financial Instruments for additional information.

Other Assets and Liabilities

Other assets primarily consist of intangible lease assets described above, pre-acquisition costs, prepaid assets, food and beverage inventories, escrow deposits, lease origination fees, and accounts receivable. Other liabilities primarily consist of accrued compensation, accrued interest, accrued operating expenses, and deferred rent obligations on certain operating leases.

Notes Payable

Notes payable are carried at their unpaid principal balance, net of deferred financing costs. This long-term debt is unsecured and interest is paid monthly on our non-amortizing term loan and revolving credit facility and semi-annually on our senior fixed rate notes until the principal is paid in whole or matures at a future date.

See Note 6 - Notes Payable, Net of Deferred Financing Costs for additional information.

Deferred Financing Costs

Financing costs related to long-term debt are deferred and amortized over the remaining life of the debt using the effective interest method. These costs are presented as a deduction from the carrying value of the related liabilities on the consolidated balance sheets.

Revenue Recognition

Rental Revenue

For those net leases that provide for periodic and determinable increases in base rent, base rental revenue is recognized on a straight-line basis over the applicable lease term when collectability is reasonably assured.

Recognizing rental income on a straight-line basis generally results in recognized revenues during the first half of a lease term exceeding the cash amounts contractually due from our tenants, creating a deferred rent receivable. Lease origination fees are deferred and amortized over the related lease term as an adjustment to rental revenue. Taxes collected from lessees and remitted to governmental authorities are presented on a net basis within rental revenue in our consolidated statements of income and comprehensive income.

For those leases that provide for periodic increases in base rent only if certain revenue parameters or other substantive contingencies are met, the increased rental revenue is recognized as the related parameters or contingencies are met, rather than on a straight-line basis over the applicable lease term.

Income from rent, lease termination fees and all other income is recognized when all of the following criteria are met in accordance with Securities and Exchange Commissions ("SEC") Staff Accounting Bulletin 104: (i) the applicable agreement has been fully executed and delivered; (ii) services have been rendered; (iii) the amount is fixed or determinable; and (iv) collectability is reasonably assured.

We assess the collectability of our lease receivables, including deferred rent receivables. We base our assessment of the collectability of rent receivables (other than deferred rent receivables) on several factors, including payment history, the financial strength of the tenant and any guarantors, the value of the underlying collateral, if any, and current economic conditions. If our evaluation of these factors indicates it is probable that we will be unable to recover the full value of the receivable, we provide a reserve against the portion of the receivable that we estimate may not be recovered. We also base our assessment of the collectability of deferred rent receivables on several factors, including among other things, the financial strength of the tenant and any guarantors,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

the historical operations and operating trends of the property, the historical payment pattern of the tenant and the type of property. If our evaluation of these factors indicates it is probable that we will be unable to receive the rent payments due in the future, we provide a reserve against the recognized deferred rent receivable asset for the portion, up to its full value, that we estimate may not be recovered. If we change our assumptions or estimates regarding the collectability of future rent payments required by a lease, we may adjust our reserve or reduce the rental revenue recognized in the period we make such change in our assumptions or estimates.

Restaurant Revenue

Restaurant revenue represents food, beverage, and other products sold and is presented net of the following discounts: coupons, employee meals, complimentary meals and gift cards. Revenue from restaurant sales is recognized when food and beverage products are sold. We recognize sales from our gift cards when the gift card is redeemed by the customer. Sales taxes collected from customers and remitted to governmental authorities are presented on a net basis within restaurant revenue on our consolidated statements of income.

On January 1, 2017, the Company adopted ASU No. 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory," which applies to inventory that is measured using first-in, first-out or average cost. Under the updated guidance, an entity should measure inventory that is within scope at the lower of cost and net realizable value, which is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. Subsequent measurement is unchanged for inventory that is measured using last-in, first-out. Adoption of this guidance did not have a material impact on our consolidated financial statements or related disclosures.

Restaurant Expenses

Restaurant expenses include restaurant labor, general and administrative expenses, and food and beverage costs. Food and beverage costs include inventory, warehousing, related purchasing and distribution costs. Vendor allowances received in connection with the purchase of a vendor's products are recognized as a reduction of the related food and beverage costs as earned.

Income Taxes

We believe that we have been organized and have operated in conformity with the requirements for qualification and taxation as a REIT commencing with our taxable year ended December 31, 2016, and we intend to continue to operate in a manner that will enable us to maintain our qualification as a REIT. So long as we qualify as a REIT, we generally will not be subject to U.S. federal income tax on our net income that we distribute currently to our shareholders. To maintain our qualification as a REIT, we are required under the Code to distribute at least 90% of our REIT taxable income (without regard to the deduction for dividends paid and excluding net capital gains) to our shareholders and meet certain other requirements. If we fail to qualify as a REIT in any taxable year, we will be subject to U.S. federal income tax on our taxable income at regular corporate rates. Even if we qualify as a REIT, we may also be subject to certain state, local and franchise taxes. Under certain circumstances, U.S. federal income and excise taxes may be due on our undistributed taxable income.

The Kerrow Restaurant Operating Business is a TRS and is taxed as a C corporation.

We provide for federal and state income taxes currently payable as well as for those deferred because of temporary differences between reporting income and expenses for financial statement purposes versus tax purposes. Federal income tax credits are recorded as a reduction of income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Interest recognized on reserves for uncertain tax positions is included in interest, net in our consolidated statements of comprehensive income. A corresponding liability for accrued interest is included as a component of other liabilities on our consolidated balance sheets. Penalties, when incurred, are recognized in general and administrative expenses.

We estimate certain components of our provision for income taxes. These estimates include, among other items, depreciation and amortization expense allowable for tax purposes, allowable tax credits for items such as taxes paid

on reported employee tip

10

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

income, effective rates for state and local income taxes and the valuation and tax deductibility of certain other items. We adjust our annual effective income tax rate as additional information on outcomes or events becomes available. We base our estimates on the best available information at the time that we prepare the provision. We will generally file our annual income tax returns several months after our year end. Income tax returns are subject to audit by state and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws. The major jurisdictions in which we will file income tax returns are the U.S. federal jurisdiction and all states in the U.S. in which we own properties that have an income tax. Tax accounting guidance requires that a position taken or expected to be taken in a tax return be recognized (or derecognized) in the financial statements when it is more likely than not (i.e., a likelihood of more than 50 percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. We include within our current tax provision the balance of unrecognized tax benefits related to tax positions for which it is reasonably possible that the total amounts could change during the next 12 months based on the outcome of examinations.

See Note 8 - Income Taxes for additional information.

Earnings Per Share

Basic earnings per share (“EPS”) are computed by dividing net income allocated to common shareholders by the weighted-average number of common shares outstanding for the reporting period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. No effect is shown for any securities that are anti-dilutive. Net income allocated to common shareholders represents net income less income allocated to participating securities and non-controlling interests.

None of the Company’s equity awards are participating securities.

See Note 9 - Stockholders’ Equity for additional information.

Stock-Based Compensation

The Company’s stock-based compensation plan provides for the grant of restricted stock awards (“RSAs”), deferred stock units (“DSUs”), performance-based awards (including performance stock units, “PSUs”), forfeitable dividend equivalent units (“DEUs”), restricted stock units (“RSUs”), and other types of awards to eligible participants. DEUs are earned during the vesting period and received upon vesting of award. Upon forfeiture of an award, DEUs earned during the vesting period are also forfeited. We classify stock-based payment awards either as equity awards or liability awards based upon cash settlement options. Equity classified awards are measured based on the fair value on the date of grant. Liability classified awards are remeasured to fair value each reporting period. We recognize costs resulting from the Company’s stock-based compensation awards on a straight-line basis over their vesting periods, which range between one and three years, less estimated forfeitures. No compensation cost is recognized for awards for which employees do not render the requisite services.

Effective January 1, 2017, the Company adopted ASU No. 2016-09, “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting,” which amends how companies account for certain aspects of share-based payments to employees. The new guidance required all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allowed an employer to repurchase more of an employee’s shares than it could prior to adoption for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The Company’s adoption of this guidance did not have a material impact on our consolidated financial statements or related disclosures.

See Note 10 - Stock-Based Compensation for additional information.