REIT: Equity Residential (EQR) Suspended Rating

New Constructs has suspended the rating for Equity Residential (EQR) due to an abnormally large gain on the sale of real estate properties. The $3.7 billion gain is comprised of $3.2 billion net gain on the sale of the Starwood portfolio as well as roughly $500 million in other undisclosed gains. Normally, property sales are treated as a recurring component of operations for this type of REIT, which we call "Equity REIT". However, the low likelihood of EQR realizing consistent gains of this magnitude in the future has influenced our decision to remove the bulk of the gain from Net Operating Profit After Taxes (NOPAT).

While we are able to remove the net gain on the sale of the Starwood portfolio ($3.2 billion) from NOPAT, the rest ($500 million) remains because the lack of additional disclosure regarding which parts are not normal requires treating the gain as operating. Without knowing exactly of the $500 million is (operating/non-operating), we cannot be sure what the exact right number is. Rather than remove the entire amount and show an overly negative view of the business, we leave the $500 in NOPAT and provide this additional disclosure for clients.

Removing the remaining $500 million would bring EQR's NOPAT down from $1.8 billion to $1.3 billion, a 27% drop. NOPAT growth, the numerator of Return On Invested Capital (ROIC), is driven primarily by this undisclosed gain. Additionally, the disposition of Starwood assets has marginally reduced Invested Capital, the denominator of ROIC, resulting in an inflated ROIC metric. Because of these factors, we have opted to suspend our rating for this quarter.

Disclosure: David Trainer, Lindsay Bohannon, and Kyle Martone receive no compensation to write about any specific stock, sector, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

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