

NATIONAL RETAIL PROPERTIES, INC.

Form 10-Q

May 05, 2011

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2011

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 001-11290

**NATIONAL RETAIL PROPERTIES, INC.**

(Exact name of registrant as specified in its charter)

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**Maryland** **56-1431377**  
(State or other jurisdiction of **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**450 South Orange Avenue, Suite 900, Orlando, Florida 32801**  
**(Address of principal executive offices, including zip code)**  
**(407) 265-7348**  
**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) for 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 website, 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, or a non-accelerated filer or smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer

Non-Accelerated Filer  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

85,011,819 shares of common stock, \$0.01 par value, outstanding as of April 28, 2011.

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## PART I. FINANCIAL INFORMATION

**Item 1. Financial Statements**

## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share data)

(Unaudited)

	March 31, 2011	December 31, 2010
<b><u>ASSETS</u></b>		
Real estate, Investment Portfolio:		
Accounted for using the operating method, net of accumulated depreciation and amortization	\$ 2,560,213	\$ 2,519,950
Accounted for using the direct financing method	31,107	29,773
Real estate, Inventory Portfolio, held for sale	31,230	32,076
Investment in unconsolidated affiliate	4,466	4,515
Mortgages, notes and accrued interest receivable, net of allowance	29,905	30,331
Commercial mortgage residual interests	16,402	15,915
Cash and cash equivalents	2,557	2,048
Receivables, net of allowance of \$1,817 and \$1,750, respectively	2,831	3,403
Accrued rental income, net of allowance of \$4,001 and \$3,609, respectively	25,482	25,535
Debt costs, net of accumulated amortization of \$12,372 and \$11,198, respectively	8,192	9,366
Other assets	41,312	40,663
<b>Total assets</b>	<b>\$ 2,753,697</b>	<b>\$ 2,713,575</b>
<b><u>LIABILITIES AND EQUITY</u></b>		
Liabilities:		
Line of credit payable	\$ 184,200	\$ 161,000
Mortgages payable	23,997	24,269
Notes payable convertible, net of unamortized discount of \$10,597 and \$12,201, respectively	351,138	349,534
Notes payable, net of unamortized discount of \$1,068 and \$1,118, respectively	598,932	598,882
Accrued interest payable	19,015	7,342
Other liabilities	39,544	43,774
<b>Total liabilities</b>	<b>1,216,826</b>	<b>1,184,801</b>
Equity:		
Stockholders' equity:		
Preferred stock, \$0.01 par value. Authorized 15,000,000 shares Series C, 3,680,000 depositary shares issued and outstanding, at stated liquidation value of \$25 per share	92,000	92,000
Common stock, \$0.01 par value. Authorized 190,000,000 shares; 84,570,503 and 83,613,289 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively	847	838
Excess stock, \$0.01 par value. Authorized 205,000,000 shares; none issued or outstanding		
Capital in excess of par value	1,448,689	1,429,750
Retained earnings	(9,319)	3,234
Accumulated other comprehensive income	3,322	1,661

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Total stockholders' equity of NNN	1,535,539	1,527,483
Noncontrolling interests	1,332	1,291
Total equity	1,536,871	1,528,774
Total liabilities and equity	\$ 2,753,697	\$ 2,713,575

See accompanying notes to condensed consolidated financial statements

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## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(dollars in thousands, except per share data)

(unaudited)

	Quarter Ended March 31,	
	2011	2010
<b>Revenues:</b>		
Rental income from operating leases	\$ 57,340	\$ 51,919
Earned income from direct financing leases	760	764
Percentage rent	113	54
Real estate expense reimbursement from tenants	2,335	1,758
Interest and other income from real estate transactions	637	950
Interest income on commercial mortgage residual interests	767	1,049
	61,952	56,494
<b>Retail operations:</b>		
Revenues	8,850	6,536
Operating expenses	(8,852)	(6,669)
Net	(2)	(133)
<b>Operating expenses:</b>		
General and administrative	6,657	5,581
Real estate	3,722	3,472
Depreciation and amortization	13,525	11,807
Impairment commercial mortgage residual interests valuation adjustment	129	3,683
	24,033	24,543
<b>Earnings from operations</b>	<b>37,917</b>	<b>31,818</b>
<b>Other expenses (revenues):</b>		
Interest and other income	(342)	(252)
Interest expense	17,662	15,989
	17,320	15,737
<b>Earnings from continuing operations before income tax benefit (expense) and equity in earnings of unconsolidated affiliate</b>	<b>20,597</b>	<b>16,081</b>
Income tax benefit (expense)	19	(104)
Equity in earnings of unconsolidated affiliate	109	105

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Earnings from continuing operations	20,725	16,082
Earnings (loss) from discontinued operations (Note 7):		
Real estate, Investment Portfolio, net of income tax benefit (expense)	(4)	75
Real estate, Inventory Portfolio, net of income tax expense	132	141
	128	216

See accompanying notes to condensed consolidated financial statements

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## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS CONTINUED

(dollars in thousands, except per share data)

(unaudited)

	Quarter Ended	
	2011	2010
	March 31,	March 31,
Earnings including noncontrolling interests	\$ 20,853	\$ 16,298
Loss (earnings) attributable to noncontrolling interests:		
Continuing operations	26	143
Discontinued operations	(59)	(76)
	(33)	67
Net earnings attributable to NNN	\$ 20,820	\$ 16,365
Net earnings attributable to NNN	\$ 20,820	\$ 16,365
Series C preferred stock dividends	(1,696)	(1,696)
Net earnings available to common stockholders	\$ 19,124	\$ 14,669
Net earnings per share of common stock:		
Basic:		
Continuing operations	\$ 0.23	\$ 0.18
Discontinued operations	0.00	0.00
Net earnings	\$ 0.23	\$ 0.18
Diluted:		
Continuing operations	\$ 0.23	\$ 0.18
Discontinued operations	0.00	0.00
Net earnings	\$ 0.23	\$ 0.18
Weighted average number of common shares outstanding:		
Basic	83,122,731	82,320,772
Diluted	83,570,438	82,446,011

See accompanying notes to condensed consolidated financial statements





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## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(unaudited)

	Quarter Ended	
	March 31, 2011	2010
Cash flows from operating activities:		
Earnings including noncontrolling interests	\$ 20,853	\$ 16,298
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Performance incentive plan expense	1,739	1,113
Stock option expense tax effect		122
Depreciation and amortization	13,670	12,045
Impairment commercial mortgage residual interests valuation	129	3,683
Amortization of notes payable discount	1,654	1,552
Amortization of deferred interest rate hedges	(43)	(42)
Equity in earnings of unconsolidated affiliate	(109)	(105)
Distributions received from unconsolidated affiliate	149	143
Gain on disposition of real estate, Investment Portfolio	(30)	(22)
Gain on note receivable and property foreclosures		(16)
Gain on disposition of real estate, Inventory Portfolio	(102)	(87)
Change in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Additions to real estate, Inventory Portfolio	(92)	(8)
Proceeds from disposition of real estate, Inventory Portfolio	1,058	775
Decrease in real estate leased to others using the direct financing method	413	372
Increase in work in process	(322)	(152)
Decrease (increase) in mortgages, notes and accrued interest receivable	209	(153)
Decrease in receivables	581	766
Increase in commercial mortgage residual interests	(556)	(15)
Decrease (increase) accrued rental income	53	(270)
Decrease in other assets	502	236
Increase in accrued interest payable	11,673	11,015
Decrease in other liabilities	(3,132)	(734)
Increase (decrease) in tax liability	569	(70)
Net cash provided by operating activities	48,866	46,446
Cash flows from investing activities:		
Proceeds from the disposition of real estate, Investment Portfolio	773	1,419
Additions to real estate, Investment Portfolio:		
Accounted for using the operating method	(57,512)	(6,491)
Accounted for using the direct financing method	(1,747)	
Increase in mortgages and notes receivable	(1,245)	
Principal payments on mortgages and notes	1,462	291
Payment of lease costs	(138)	(269)
Other	463	(750)

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Net cash used in investing activities

\$ (57,944)    \$ (5,800)

See accompanying notes to condensed consolidated financial statements

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## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS CONTINUED

(dollars in thousands)

(unaudited)

	Quarter Ended	
	March 31, 2011	2010
Cash flows from financing activities:		
Proceeds from line of credit payable	\$ 129,500	\$
Repayment of line of credit payable	(106,300)	
Repayment of mortgages payable	(272)	(253)
Proceeds from issuance of common stock	20,025	8,357
Payment of Series C preferred stock dividends	(1,696)	(1,696)
Payment of common stock dividends	(31,678)	(31,026)
Noncontrolling interest contributions	41	
Noncontrolling interest distributions	(33)	(10)
Net cash provided by (used in) financing activities	9,587	(24,628)
Net increase in cash and cash equivalents	509	16,018
Cash and cash equivalents at beginning of period	2,048	15,225
Cash and cash equivalents at end of period	\$ 2,557	\$ 31,243
Supplemental disclosure of cash flow information:		
Interest paid, net of amount capitalized	\$ 5,040	\$ 4,460
Taxes paid (received)	\$ (541)	\$ 88
Supplemental disclosure of non-cash investing and financing activities:		
Issued 139,351 and 392,474 shares of restricted and unrestricted common stock in 2011 and 2010, respectively, pursuant to NNN's performance incentive plan	\$ 3,407	\$ 8,392
Issued 2,391 and 2,949 shares of common stock in 2011 and 2010, respectively, to directors pursuant to NNN's performance incentive plan	\$ 59	\$ 59
Issued 7,115 and 6,823 shares of common stock in 2011 and 2010, respectively, pursuant to NNN's Deferred Director Fee Plan	\$ 122	\$ 93
Change in other comprehensive income	\$ 1,661	149
Mortgage receivable accepted in connection with real estate transactions	\$	\$ 5,500

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Mortgages payable assumed in connection with real estate transactions	\$	\$ 5,432
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See accompanying notes to condensed consolidated financial statements

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## NATIONAL RETAIL PROPERTIES, INC.

## and SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(unaudited)

**Note 1 Organization and Summary of Significant Accounting Policies:**

**Organization and Nature of Business** National Retail Properties, Inc., a Maryland corporation, is a fully integrated real estate investment trust ( REIT ) formed in 1984. The term NNN or the Company refers to National Retail Properties, Inc. and all of its consolidated subsidiaries. NNN has elected to treat certain subsidiaries as taxable REIT subsidiaries. These taxable subsidiaries and their majority owned and controlled subsidiaries are collectively referred to as the TRS.

NNN's operations are divided into two primary business segments: (i) investment assets, including real estate assets, mortgages and notes receivable and commercial mortgage residual interests (collectively, Investment Assets ), and (ii) inventory real estate assets ( Inventory Assets ). NNN acquires, owns, invests in, and develops properties that are leased primarily to retail tenants under long-term net leases and primarily held for investment ( Investment Properties or Investment Portfolio ). NNN's Investment Portfolio consisted of the following:

	March 31, 2011
<b>Investment Portfolio:</b>	
Total properties (including retail operations)	1,223
Gross leasable area (square feet)	13,320,000
States	46

The Inventory Assets typically represent direct and indirect investment interests in real estate assets acquired or developed primarily for the purpose of selling the real estate ( Inventory Properties or Inventory Portfolio ). NNN owned 16 Inventory Properties at March 31, 2011.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by accounting principles generally accepted in the United States of America. The unaudited condensed consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. Operating results for the quarter ended March 31, 2011, may not be indicative of the results that may be expected for the year ending December 31, 2011. Amounts as of December 31, 2010, included in the condensed consolidated financial statements have been derived from the audited consolidated financial statements as of that date. The unaudited condensed consolidated financial statements, included herein, should be read in conjunction with the consolidated financial statements and notes thereto as well as Management's Discussion and Analysis of Financial Condition and Results of Operations in NNN's Form 10-K for the year ended December 31, 2010.

**Principles of Consolidation** NNN's condensed consolidated financial statements include the accounts of each of the respective majority owned and controlled affiliates, including transactions whereby NNN has been determined to be the primary beneficiary in accordance with the Financial Accounting Standards Board ( FASB ) guidance included in *Consolidation*. All significant intercompany account balances and transactions have been eliminated.

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**Investment in an Unconsolidated Affiliate** NNN accounts for its investment in an unconsolidated affiliate under the equity method of accounting.

**Cash and Cash Equivalents** NNN considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents consist of cash and money market accounts. Cash equivalents are stated at cost plus accrued interest, which approximates fair value.

Cash accounts maintained on behalf of NNN in demand deposits at commercial banks and money market funds may exceed federally insured levels; however, NNN has not experienced any losses in such accounts.

**Valuation of Receivables** NNN estimates the collectability of its accounts receivable related to rents, expense reimbursements and other revenues. NNN analyzes accounts receivable and historical bad debt levels, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. In addition, tenants in bankruptcy are analyzed and estimates are made in connection with the expected recovery of pre-petition and post-petition claims.

**Goodwill** Goodwill arises from business combinations and represents the excess of the cost of an acquired entity over the net fair value amounts that were assigned to the assets acquired and the liabilities assumed. In accordance with the FASB guidance included in *Goodwill*, NNN performs impairment testing on goodwill by comparing fair value to carrying amount annually.

**Other Comprehensive Income** The components for the change in other comprehensive income consisted of the following (dollars in thousands):

	Quarter Ended March 31, 2011
Balance at beginning of period	\$ 1,661
Amortization of interest rate hedges	(43)
Fair value treasury locks	1,663
Unrealized gain commercial mortgage residual interests	60
Stock value adjustment	(19)
Balance at end of period	\$ 3,322

NNN's total comprehensive income consisted of the following (dollars in thousands):

	Quarter Ended	
	March 31, 2011	2010
Net earnings	\$ 20,820	\$ 16,365
Other comprehensive income	1,661	50
Comprehensive income including noncontrolling interests	22,481	16,415
Comprehensive loss attributable to noncontrolling interests		99
Comprehensive income attributable to NNN	\$ 22,481	\$ 16,514

**Earnings Per Share** Earnings per share have been computed pursuant to the FASB guidance included in *Earnings Per Share*. Effective January 1, 2009, the guidance requires classification of the Company's unvested restricted share units which contain rights to receive nonforfeitable dividends, as participating securities requiring the two-class method of computing earnings per share. Under the two-class method, earnings per common share are computed by dividing the sum of distributed earnings to common stockholders and undistributed earnings allocated to common stockholders by the weighted average number of common shares outstanding for the period. In





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applying the two-class method, undistributed earnings are allocated to both common shares and participating securities based on the weighted average shares outstanding during the period.

The following table is a reconciliation of the numerator and denominator used in the computation of basic and diluted earnings per common share using the two-class method (dollars in thousands):

	Quarter Ended	
	2011	March 31, 2010
<b>Basic and Diluted Earnings:</b>		
Net earnings attributable to NNN	\$ 20,820	\$ 16,365
Less: Series C preferred stock dividends	(1,696)	(1,696)
Net earnings available to the Company's common stockholders	19,124	14,669
Less: Earnings attributable to unvested restricted shares	(134)	(84)
Net earnings used in basic earnings per share	18,990	14,585
Reallocated undistributed income		
Net earnings used in diluted earnings per share	\$ 18,990	\$ 14,585
<b>Basic and Diluted Weighted Average Shares Outstanding:</b>		
Weighted average number of shares outstanding	83,955,295	82,953,206
Less: unvested restricted stock	(832,564)	(632,434)
Weighted average number of shares outstanding used in basic earnings per share	83,122,731	82,320,772
<b>Effects of dilutive securities:</b>		
Common stock options	3,276	4,392
Convertible debt	298,241	
Directors' deferred fee plan	146,190	120,847
Weighted average number of shares outstanding used in diluted earnings per share	83,570,438	82,446,011

The potential dilutive shares related to certain convertible notes payable were not included in computing earnings per common share for March 31, 2010 because their effects would be antidilutive.

**Fair Value Measurement** NNN's estimates of fair value of certain financial and non-financial assets and liabilities are based on the framework established in the fair value accounting guidance. The framework specifies a hierarchy of valuation inputs which was established to increase consistency, clarity and comparability in fair value measurements and related disclosures. The guidance describes a fair value hierarchy based upon three levels of inputs that may be used to measure fair value, two of which are considered observable and one that is considered unobservable. The following describes the three levels:

Level 1 Valuation is based upon quoted prices in active markets for identical assets or liabilities.

Level 2 Valuation is based upon inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by

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observable market data for substantially the full term of the assets or liabilities.

Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include option pricing models, discounted cash flow models and similar techniques.

Use of Estimates Management of NNN has made a number of estimates and assumptions relating to the reporting of assets and liabilities, revenues and expenses and the disclosure of

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contingent assets and liabilities to prepare these condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Significant estimates include provision for impairment and allowances for certain assets, accruals, useful lives of assets and capitalization of costs. Actual results could differ from those estimates.

**Reclassification** Certain items in the prior year's consolidated financial statements and notes to consolidated financial statements have been reclassified to conform to the 2011 presentation.

**Note 2 Real Estate - Investment Portfolio:**

**Leases** The following outlines key information for NNN's Investment Property leases:

	March 31, 2011
Lease classification:	
Operating	1,185
Direct financing	16
Building portion direct financing / land portion operating	8
Weighted average remaining lease term	12 Years

The leases generally provide for limited increases in rent as a result of fixed increases, increases in the consumer price index, and/or increases in the tenant's sales volume. Generally, the tenant is also required to pay all property taxes and assessments, substantially maintain the interior and exterior of the building and carry property and liability insurance coverage. Certain of NNN's Investment Properties are subject to leases under which NNN retains responsibility for certain costs and expenses of the property. Generally, the leases of the Investment Properties provide the tenants with one or more multi-year renewal options subject to generally the same terms and conditions, including rent increases, consistent with the initial lease term.

**Investment Portfolio Accounted for Using the Operating Method** Real estate subject to operating leases consisted of the following (dollars in thousands):

	March 31, 2011	December 31, 2010
Land and improvements	\$ 1,136,183	\$ 1,122,243
Buildings and improvements	1,632,909	1,592,752
Leasehold interests	1,290	1,290
	2,770,382	2,716,285
Less accumulated depreciation and amortization	(234,461)	(222,921)
	2,535,921	2,493,364
Work in process	24,292	26,586
	\$ 2,560,213	\$ 2,519,950

NNN has remaining funding commitments as follows (dollars in thousands):

		March 31, 2011		
	# of Properties	Total Commitment <sup>(1)</sup>	Amount Funded	Remaining Commitment
Investment Portfolio	26	\$ 67,585	\$ 48,498	\$ 19,087

<sup>(1)</sup> Includes land and construction costs.

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In May 2010 and July 2010, NNN acquired the 21.1% non-controlling interest in its majority owned and controlled subsidiary, Orange Avenue Mortgage Investments, Inc. ( OAMI ), for \$1,603,000, and OAMI became a wholly owned subsidiary of NNN. NNN accounted for the transaction as an equity transaction in accordance with the FASB guidance on consolidation. OAMI holds the commercial mortgage residual interests ( Residuals ) from seven securitizations. Each of the Residuals is recorded at fair value based upon an independent valuation. Unrealized gains and losses are reported as other comprehensive income in stockholders' equity and other than temporary losses as a result of a change in the timing or amount of estimated cash flows are recorded as an other than temporary valuation impairment.

Due to changes in loan performance relating to the Residuals, the independent valuation adjusted certain of the valuation assumptions. The following table summarizes the key assumptions used in determining the value of the Residuals as of:

	March 31, 2011	December 31, 2010
Discount rate	25%	25%
Average life equivalent CPR speeds range	3.26% to 20.13% CPR	4.35% to 20.37% CPR
Foreclosures:		
Frequency curve default model	0.1% - 14.0% range	0.1% - 15.0% range
Loss severity of loans in foreclosure	20%	20%
Yield:		
LIBOR	Forward 3-month curve	