APARTMENT INVESTMENT & MANAGEMENT CO
Form 10-Q
August 01, 2008

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**Form 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2008**

**OR**

o **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 1-13232**

**Apartment Investment and Management Company**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Maryland** | **84-1259577** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **4582 South Ulster Street Parkway, Suite 1100 Denver, Colorado** | **80237** |
| (Address of principal executive offices) | (Zip Code) |

**(303) 757-8101**
(Registrant s telephone number, including area code)

**Not Applicable**
(Former name, former address, and former fiscal year, 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 þ No o

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large accelerated filer þ | Accelerated filer o | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

The number of shares of Class A Common Stock outstanding as of July 28, 2008: 85,619,144

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## PART I. FINANCIAL INFORMATION

### ITEM 1. Financial Statements

### APARTMENT INVESTMENT AND MANAGEMENT COMPANY
### CONDENSED CONSOLIDATED BALANCE SHEETS
**(In thousands, except share data)**
**(Unaudited)**

| | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| Real estate: | | |
| Buildings and improvements | $ 9,275,563 | $ 8,944,353 |
| Land | 2,551,108 | 2,542,322 |
| Total real estate | 11,826,671 | 11,486,675 |
| Less accumulated depreciation | (2,962,147) | (2,747,403) |
| Net real estate | 8,864,524 | 8,739,272 |
| Cash and cash equivalents | 330,163 | 210,461 |
| Restricted cash | 316,892 | 316,233 |
| Accounts receivable, net | 78,439 | 71,463 |
| Accounts receivable from affiliates, net | 32,420 | 34,958 |
| Deferred financing costs, net | 68,768 | 74,166 |
| Notes receivable from unconsolidated real estate partnerships, net | 31,869 | 35,186 |
| Notes receivable from non-affiliates, net | 147,635 | 143,054 |
| Investment in unconsolidated real estate partnerships | 106,388 | 117,217 |
| Other assets | 192,851 | 207,857 |
| Deferred income tax assets, net | 11,059 | 14,426 |
| Assets held for sale | 145,670 | 642,239 |
| Total assets | $ 10,326,678 | $ 10,606,532 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Property tax-exempt bond financing | $ 910,300 | $ 901,985 |
| Property loans payable | 5,809,951 | 5,563,703 |
| Term loans | 475,000 | 475,000 |
| Credit facility | 145,000 | |
| Other borrowings | 87,839 | 75,057 |
| Total indebtedness | 7,428,090 | 7,015,745 |
| Accounts payable | 30,931 | 56,792 |
| Accrued liabilities and other | 366,197 | 449,485 |
| Deferred income | 205,494 | 201,498 |
| Security deposits | 48,450 | 45,622 |
| Liabilities related to assets held for sale | 113,723 | 532,645 |
| Total liabilities | 8,192,885 | 8,301,787 |

| | | |
|---|---|---|
| Minority interest in consolidated real estate partnerships | 415,835 | 441,778 |
| Minority interest in Aimco Operating Partnership | 124,337 | 113,263 |
| Commitments and contingencies (Note 5) | | |
| Stockholders equity: | | |
| Preferred Stock, perpetual | 723,500 | 723,500 |
| Class A Common Stock, $0.01 par value, 426,157,736 shares authorized, 87,431,180 and 96,130,586 shares issued and outstanding, at June 30, 2008 and December 31, 2007, respectively | 874 | 961 |
| Additional paid-in capital | 2,740,890 | 3,049,417 |
| Notes due on common stock purchases | (4,125) | (5,441) |
| Distributions in excess of earnings | (1,867,518) | (2,018,733) |
| Total stockholders equity | 1,593,621 | 1,749,704 |
| Total liabilities and stockholders equity | $ 10,326,678 | $ 10,606,532 |

See notes to condensed consolidated financial statements.

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**APARTMENT INVESTMENT AND MANAGEMENT COMPANY**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
**(In thousands, except per share data)**
**(Unaudited)**

| | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|---|---|
| **REVENUES:** | | | | |
| Rental and other property revenues | $ 384,191 | $ 372,289 | $ 768,354 | $ 734,645 |
| Property management revenues, primarily from affiliates | 1,415 | 1,271 | 3,519 | 3,367 |
| Asset management and tax credit revenues | 38,175 | 15,178 | 51,027 | 26,808 |
| Total revenues | 423,781 | 388,738 | 822,900 | 764,820 |
| **OPERATING EXPENSES:** | | | | |
| Property operating expenses | 174,158 | 168,992 | 361,441 | 336,618 |
| Property management expenses | 1,187 | 2,452 | 2,457 | 3,935 |
| Investment management expenses | 5,728 | 5,521 | 10,017 | 9,987 |
| Depreciation and amortization | 120,692 | 110,743 | 239,086 | 221,923 |
| General and administrative expenses | 27,064 | 24,024 | 48,488 | 46,100 |
| Other expenses (income), net | 5,459 | (3,128) | 10,297 | (379) |
| Total operating expenses | 334,288 | 308,604 | 671,786 | 618,184 |
| Operating income | 89,493 | 80,134 | 151,114 | 146,636 |
| Interest income | 718 | 10,107 | 9,114 | 20,154 |
| Provision for losses on notes receivable, net | (534) | (735) | (1,693) | (2,278) |
| Interest expense | (102,365) | (95,578) | (203,677) | (190,586) |
| Deficit distributions to minority partners, net | (1,265) | (1,554) | (5,276) | (2,482) |
| Equity in (losses) earnings of unconsolidated real estate partnerships | (843) | 930 | (1,872) | (2,055) |
| Provision for real estate impairment losses | (2,518) | | (2,518) | |
| Gain on dispositions of unconsolidated real estate and other | 139 | 602 | 129 | 21,068 |
| Loss before minority interests and discontinued operations | (17,175) | (6,094) | (54,679) | (9,543) |
| Minority interests: | | | | |
| Minority interest in consolidated real estate partnerships | (2,352) | (85) | 4,590 | (3,793) |
| Minority interest in Aimco Operating Partnership, preferred | (1,925) | (1,782) | (3,707) | (3,564) |
| Minority interest in Aimco Operating Partnership, common | 3,437 | 2,240 | 7,908 | 4,661 |
| Total minority interests | (840) | 373 | 8,791 | (2,696) |
| Loss from continuing operations | (18,015) | (5,721) | (45,888) | (12,239) |

| | | | | |
|---|---|---|---|---|
| Income from discontinued operations, net | 274,054 | 25,050 | 277,381 | 56,776 |
| Net income | 256,039 | 19,329 | 231,493 | 44,537 |
| Net income attributable to preferred stockholders | 13,670 | 16,346 | 27,878 | 32,694 |
| Net income attributable to common stockholders | $ 242,369 | $ 2,983 | $ 203,615 | $ 11,843 |
| Earnings (loss) per common share basic: | | | | |
| Loss from continuing operations (net of preferred dividends) | $ (0.36) | $ (0.22) | $ (0.83) | $ (0.45) |
| Income from discontinued operations | 3.12 | 0.25 | 3.11 | 0.57 |
| Net income attributable to common stockholders | $ 2.76 | $ 0.03 | $ 2.28 | $ 0.12 |
| Earnings (loss) per common share diluted: | | | | |
| Loss from continuing operations (net of preferred dividends) | $ (0.36) | $ (0.22) | $ (0.83) | $ (0.45) |
| Income from discontinued operations | 3.12 | 0.25 | 3.11 | 0.57 |
| Net income attributable to common stockholders | $ 2.76 | $ 0.03 | $ 2.28 | $ 0.12 |
| Weighted average common shares outstanding | 87,790 | 100,494 | 89,381 | 100,494 |
| Weighted average common shares and equivalents outstanding | 87,790 | 100,494 | 89,381 | 100,494 |
| Dividends declared per common share | $ 0.60 | $ 0.57 | $ 0.60 | $ 0.57 |

See notes to condensed consolidated financial statements.

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**APARTMENT INVESTMENT AND MANAGEMENT COMPANY**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**
**(Unaudited)**

| | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net income | $ 231,493 | $ 44,537 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 239,086 | 221,923 |
| Discontinued operations | (272,850) | (26,785) |
| Other adjustments | 30,173 | (23,866) |
| Net changes in operating assets and operating liabilities | 12,731 | (23,171) |
| Net cash provided by operating activities | 240,633 | 192,638 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Purchases of real estate | (56,534) | (174,991) |
| Capital expenditures | (307,378) | (268,608) |
| Proceeds from dispositions of real estate | 856,932 | 259,631 |
| Change in funds held in escrow from tax-free exchanges | 345 | 9,975 |
| Purchases of partnership interests and other assets | (20,131) | (25,451) |
| Originations of notes receivable from unconsolidated real estate partnerships | (4,864) | (8,640) |
| Proceeds from repayment of notes receivable | 5,044 | 14,152 |
| Distributions from investments in unconsolidated real estate partnerships | | 1,814 |
| Other investing activities | 310 | 5,154 |
| Net cash provided by (used in) investing activities | 473,724 | (186,964) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Proceeds from property loans | 455,523 | 791,330 |
| Principal repayments on property loans | (600,683) | (528,459) |
| Proceeds from tax exempt bond financing | 21,200 | 82,350 |
| Principal repayments on tax-exempt bond financing | (32,495) | (58,659) |
| Net borrowings on revolving credit facility | 145,000 | 14,000 |
| Repurchases of Class A Common Stock | (352,306) | (136,603) |
| Proceeds from Class A Common Stock option exercises | 440 | 53,232 |
| Payment of Class A Common Stock dividends | (107,808) | (116,363) |
| Payment of preferred stock dividends | (27,903) | (32,720) |
| Payment of distributions to minority interest | (109,654) | (42,178) |
| Other financing activities | 14,031 | (3,401) |

| | | |
|---|---|---|
| Net cash (used in) provided by financing activities | (594,655) | 22,529 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 119,702 | 28,203 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 210,461 | 229,824 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 330,163 | $ 258,027 |

See notes to condensed consolidated financial statements.

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**APARTMENT INVESTMENT AND MANAGEMENT COMPANY**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2008**
**(Unaudited)**

**Note 1 Organization**

Apartment Investment and Management Company, or Aimco, is a Maryland corporation incorporated on January 10, 1994. We are a self-administered and self-managed real estate investment trust, or REIT, engaged in the acquisition, ownership, management and redevelopment of apartment properties. As of June 30, 2008, we owned or managed a real estate portfolio of 1,114 apartment properties containing 188,672 apartment units located in 46 states, the District of Columbia and Puerto Rico. Based on apartment unit data compiled by the National Multi Housing Council, as of January 1, 2008, we were the largest owner and operator of apartment properties in the United States.

As of June 30, 2008, we:

- owned an equity interest in and consolidated 140,750 units in 614 properties (which we refer to as consolidated ), of which 139,259 units were also managed by us;

- owned an equity interest in and did not consolidate 10,662 units in 91 properties (which we refer to as unconsolidated ), of which 5,009 units were also managed by us; and

- provided services for or managed 37,260 units in 409 properties, primarily pursuant to long-term agreements (including 34,038 units in 374 properties for which we provide asset management services only, and not also property management services). In certain cases we may indirectly own generally less than one percent of the operations of such properties through a partnership syndication or other fund.

Through our wholly-owned subsidiaries, AIMCO-GP, Inc. and AIMCO-LP Trust, we own a majority of the ownership interests in AIMCO Properties, L.P., which we refer to as the Aimco Operating Partnership. As of June 30, 2008, we held an interest of approximately 90% in the common partnership units and equivalents of the Aimco Operating Partnership. We conduct substantially all of our business and own substantially all of our assets through the Aimco Operating Partnership. Interests in the Aimco Operating Partnership that are held by limited partners other than Aimco are referred to as OP Units. OP Units include common OP Units, partnership preferred units, or preferred OP Units, and high performance partnership units, or High Performance Units. The Aimco Operating Partnership s income is allocated to holders of common OP Units based on the weighted average number of common OP Units outstanding during the period. The Aimco Operating Partnership records the issuance of common OP Units and the assets acquired in purchase transactions based on the market price of Aimco Class A Common Stock (which we refer to as Common Stock) at the date of closing of the transaction. The holders of the common OP Units and Class I High Performance Units receive distributions, prorated from the date of issuance, in an amount equivalent to the dividends paid to holders of Common Stock. Holders of common OP Units may redeem such units for cash or, at the Aimco Operating Partnership s option, Common Stock. Preferred OP Units entitle the holders thereof to a preference with respect to distributions or upon liquidation. At June 30, 2008, after elimination of certain shares of Common Stock held by consolidated subsidiaries, 87,431,180 shares of our Common Stock were outstanding and the Aimco Operating Partnership had 9,544,902 common OP Units and equivalents outstanding for a combined total of 96,976,082 shares of Common Stock and OP Units outstanding (excluding preferred OP Units).

Except as the context otherwise requires, we, our, us and the Company refer to Aimco, the Aimco Operat Partnership and their consolidated entities, collectively.

In December 2007, the Aimco Operating Partnership declared a special distribution of $2.51 per unit payable on January 30, 2008, to holders of record of common OP Units and High Performance Units on December 31, 2007. The special distribution totaled $257.2 million and was paid on 102,478,510 common OP Units and High Performance Units, including 92,795,891 common OP Units held by us. The Aimco Operating Partnership distributed to us common OP Units equal to the number of shares we issued pursuant to our corresponding special dividend (discussed below), in addition to $55.0 million in cash. Holders of common OP Units other than us and holders of High Performance Units received the distribution entirely in cash, which totaled $24.3 million.

Also in December 2007, our Board of Directors declared a corresponding special dividend of $2.51 per share payable on January 30, 2008, to holders of record of our Common Stock on December 31, 2007. Stockholders had the option to elect to receive payment of the special dividend in cash, shares or a combination of cash and shares, except that the aggregate amount of cash payable to all stockholders in the special dividend was limited to $55.0 million plus cash paid in lieu of fractional shares. The special dividend, totaling $232.9 million, was paid on 92,795,891 shares issued and outstanding on the record date, which included 416,140 shares held by certain of our consolidated subsidiaries. Approximately $177.9 million of the special dividend was paid through the issuance of 4,594,074 shares of Common Stock (including 20,339 shares issued to consolidated subsidiaries holding our shares), which was determined based on the average closing price of our Common Stock on January 23 and 24, 2008, or $38.71 per share.

After elimination of the effect of shares held by consolidated subsidiaries, the special dividend totaled $231.9 million. Approximately $177.1 million of the special dividend was paid through the issuance of 4,573,735 shares of Common Stock (excluding 20,339 shares issued to our consolidated subsidiaries) to holders of 92,379,751 shares of our Common Stock on the record date (excluding 416,140 shares held by certain of our consolidated subsidiaries), representing an increase of approximately 4.95% to the then outstanding shares. The effect of the issuance of additional shares of Common Stock pursuant to the special dividend has been retroactively reflected in each of the historical periods presented as if those shares were issued and outstanding at the beginning of the earliest period presented; accordingly, all activity prior to the ex-dividend date of the special dividend, including share issuances, repurchases and forfeitures, have been adjusted to reflect the 4.95% increase in the number of shares, except in limited instances where noted otherwise.

**Note 2 Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America, or GAAP, have been condensed or omitted in accordance with such rules and regulations, although management believes the disclosures are adequate to prevent the information presented from being misleading. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2008, are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The balance sheet at December 31, 2007, has been derived from the audited financial statements at that date but does not include all of the information and disclosures required by GAAP for complete financial statements. For further information, refer to the financial statements and notes thereto included in Aimco s Annual Report on Form 10-K for the year ended December 31, 2007. Certain 2007 financial statement amounts have been reclassified to conform to the 2008 presentation.

***Principles of Consolidation***

The accompanying condensed consolidated financial statements include the accounts of Aimco, the Aimco Operating Partnership, and their consolidated entities. We consolidate all variable interest entities for which we are the primary beneficiary. Generally, we consolidate real estate partnerships and other entities that are not variable interest entities when we own, directly or indirectly, a majority voting interest in the entity or are otherwise able to control the entity. All significant intercompany balances and transactions have been eliminated in consolidation.

Interests in the Aimco Operating Partnership that are held by limited partners other than Aimco are reflected in the accompanying balance sheets as minority interest in Aimco Operating Partnership. Interests in partnerships consolidated into the Aimco Operating Partnership that are held by third parties are reflected in the accompanying balance sheets as minority interest in consolidated real estate partnerships. The assets of consolidated real estate partnerships owned or controlled by us generally are not available to pay creditors of Aimco or the Aimco Operating Partnership.

As used herein, and except where the context otherwise requires, partnership refers to a limited partnership or a limited liability company and partner refers to a partner in a limited partnership or a member in a limited liability company.

***Use of Estimates***

The preparation of our consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts included in the financial statements and accompanying notes thereto. Actual results could differ from those estimates.

We test for the recoverability of real estate assets that do not currently meet all conditions to be classified as held for sale, but are expected to be disposed of prior to the end of their estimated useful lives. If events or circumstances indicate that the carrying amount of a property may not be recoverable, we make an assessment of its recoverability by comparing the carrying amount to our estimate of the undiscounted future cash flows of the property, excluding interest charges. If the carrying amount exceeds the estimated aggregate undiscounted future cash flows, we recognize an impairment loss to the extent the carrying amount exceeds the estimated fair value of the property. During the three and six months ended June 30, 2008, based on the shortened anticipated holding period for certain properties classified as held for use, we recognized impairment losses of $2.5 million. We recognized no such impairment losses during the three and six months ended June 30, 2007.

If an impairment loss is not required to be recorded under the provisions of Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* or SFAS 144, the recognition of depreciation is adjusted prospectively, as necessary, to reduce the carrying amount of the real estate to its estimated disposition value over the remaining period that the real estate is expected to be held and used. We also may adjust depreciation prospectively to reduce to zero the carrying amount of buildings that we plan to demolish in connection with a redevelopment project. These depreciation adjustments, after adjustments for minority interest in the Aimco Operating Partnership, decreased net income by $2.5 million and $9.9 million, and resulted in a decrease in basic and diluted earnings per share of $0.03 and $0.10, for the three months ended June 30, 2008 and 2007, respectively. For the six months ended June 30, 2008 and 2007, these depreciation adjustments decreased net income by $5.8 million and $20.9 million, and resulted in a decrease in basic and diluted earnings per share of $0.07 and $0.21, respectively.

During the six months ended June 30, 2007, we evaluated the recoverability of our $6.3 million equity investment in a group purchasing organization and a related $3.4 million note receivable. We initiated our evaluation as a result of information concerning its relationships with significant vendors. Based on our evaluation, we recorded impairments of $2.5 million in equity in losses of real estate partnerships and $1.4 million in provision for losses on notes receivable to adjust the carrying amounts of our equity investment and note receivable, respectively, to their estimated fair values. We did not recognize any such impairments during the six months ended June 30, 2008.

During the six months ended June 30, 2008, we reassessed our approach to communication technology needs at our properties, which resulted in the discontinuation of an infrastructure project and a $4.8 million write-off of related hardware and capitalized internal and consulting costs included in other assets. The write-off, which is net of estimated sales proceeds totaling $2.1 million, is included in other expense (income), net. During the six months ended June 30, 2008, we additionally recorded a $1.0 million write off of certain software and hardware assets that are no longer consistent with our information technology strategy. This write-off is included in depreciation and amortization. During the six months ended June 30, 2007, we abandoned certain internal-use software development projects and recorded a $1.8 million write-off of the capitalized costs of such projects in depreciation and amortization.

***Income Taxes***

In March 2008, we were notified by the Internal Revenue Service that it intended to examine the 2006 Federal tax return for the Aimco Operating Partnership. During June 2008, the IRS issued AIMCO-GP, Inc., the general and tax matters partner of the Aimco Operating Partnership, a summary report including the government s proposed adjustments to the Aimco Operating Partnership s 2006 Federal tax return. We do not expect the proposed adjustments to have any material effect on our unrecognized tax benefits, financial condition or results of operations.

***Adoption of SFAS 157***

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, or SFAS 157. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 applies whenever other standards require assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. SFAS 157 establishes a hierarchy that prioritizes the information used in developing fair value estimates and requires disclosure of fair value measurements by level within the fair value hierarchy. The hierarchy gives the highest priority to quoted prices in active markets (Level 1 measurements) and the lowest priority to unobservable data (Level 3 measurements), such as the reporting entity s own data. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157*, which deferred the effective date of SFAS 157 for all nonrecurring fair value measurements of non-financial assets and non-financial liabilities until fiscal years beginning after November 15, 2008, including interim periods within those fiscal years. The provisions of SFAS 157 are applicable to recurring and nonrecurring fair value measurements of financial assets and liabilities for fiscal years beginning after November 15, 2007, including interim periods within those fiscal years. We adopted the provisions of SFAS 157 effective January 1, 2008, and at that time determined no transition adjustment was required.

*Basis of Fair Value Measurement (Valuation Hierarchy)*

SFAS 157 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

| | |
|---|---|
| Level 1 - | Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets |
| Level 2 - | Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument |
| Level 3 - | Unobservable inputs that are significant to the fair value measurement |

A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Following is a description of the valuation methodologies used for our significant financial instruments measured at fair value on a recurring or nonrecurring basis. Although some of the valuation methodologies use observable market inputs in limited instances, the majority of inputs we use are unobservable and are therefore classified within Level 3 of the valuation hierarchy.

| Fair Value Measurement | Valuation Methodologies |
|---|---|
| Notes receivable | We assess the collectibility of notes receivable on a periodic basis, which assessment consists primarily of an evaluation of cash flow projections of the borrower to determine whether estimated cash flows are sufficient to repay principal and interest in accordance with the contractual terms of the note. We recognize impairments on notes receivable when it is probable that principal and interest will not be received in accordance with the contractual terms of the loan. The amount of the impairment to be recognized generally is based on the fair value of the real estate, the collateral for the loan, which represents the primary source of loan repayment. The fair value of the collateral, such as real estate or interests in real estate partnerships, is estimated through income and market valuation approaches using information such as broker estimates, purchase prices for recent transactions on comparable assets and net operating income capitalization analyses using observable and unobservable inputs such as capitalization rates, asset quality grading, geographic location analysis, and local supply and demand observations. |
| Total rate of return swaps | Our total rate of return swaps have contractually-defined termination values generally equal to the difference between the fair value and the counterparty s purchased value of the underlying borrowings. Upon termination, we are required to pay the counterparty the difference if the fair value is less than the purchased value, and the counterparty is required to pay us the difference if the fair value is greater than the purchased value. The underlying borrowings are generally callable, at our option, at face value prior to maturity and with no prepayment penalty. Due to our control of the call features in the underlying borrowings, we believe the inherent value of any differential between the fixed and variable cash payments due under the swaps would be significantly discounted by a market participant willing to purchase or assume any rights and obligations under these contracts. |

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| Fair Value Measurement | Valuation Methodologies |
|---|---|
| Total rate of return swaps (continued) | The swaps are generally cross-collateralized with other swap contracts with the same counterparty and do not allow transfer or assignment, thus there is no alternate or secondary market for these instruments. Accordingly, our assumptions of the fair value that a willing market participant would assign in valuing these instruments are based on a hypothetical market in which the highest and best use of these contracts is in-use in combination with the related borrowings, similar to how we utilize the contracts. Based on these assumptions, we believe the termination value, or exit value, of the swaps approximates the fair value that would be assigned by a willing market participant. We ca |