Brookfield's Looking-Glass World

By: **RODDY BOYD** | November 18, 2013

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A wry investor might be forgiven for concluding that peering at Toronto-based Brookfield Asset Management's filings is akin to Lewis Carroll's Alice peeking behind the mirror and finding a universe in reverse.

Consider the third-quarter earnings just released by the real estate management, energy and infrastructure conglomerate, disclosing a handsome $813 million in net income for those three months, walloping the $334 million the public company reported for the same period last year. But instead of popping corks, investors who read the filing will probably want to reach for a bottle of aspirin.

The reality is that a combination of legally permissible accounting maneuvers and Brookfield Asset Management's singular definition of profit allowed it to script a victory.

Pulling the numbers apart, one can find a $77 million fair value gain, representing Brookfield Asset Management's assessment of the appreciation of its assets. While asset values do rise and fall, and corporate managements do have to note such things, at Brookfield an increase in asset values lands in the income statement. Even though this makes the bottom line look better, a smart investor knows to discount every penny of it since this adds no cash to the business.

Also noteworthy is how a $525 million one-time gain booked from a litigation settlement became the quarter's profit driver. This is where the accounting profession goes down the proverbial rabbit hole: Brookfield's filings seem to follow the reasoning of a character in Lewis Carroll's *Through the Looking-Glass*: "When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

The backstory of the litigation settlement is interesting on its own merits. It begins in 1990 when a relatively unknown unit of the AIG insurance colossus called AIG Financial Products struck a 25-year interest rate swap with Brookfield Asset Management's predecessor, Edper, as Edper fell into serious financial trouble. From the start, it appears that much of the AIG Financial Products-Edper relationship wasstar-crossed. And in 2008 when AIG collapsed (before a $137 billion U.S. government rescue), Brookfield decided to terminate the agreement, arguing that this amounted to a default under the terms of their agreement, according to Brookfield Asset Management's 2011 annual report.

Carried on Brookfield Asset Management's books as a $1.4 billion prospective liability in the second quarter of this year—a spike from the $988 million reported at the end of 2011, the number served as the management team's best estimate of what it would eventually have to shell out to square away the matter.

Ultimately Brookfield paid AIG $905 million to settle the suit.

What some investors might find slightly surreal is how, using established accounting rules, a company can settle a liability for less than its previously declared amount (for example, by buying back bonds below their face amount) and consider the transaction a profit. So even though $905 million in cash was sent out the door, Brookfield Asset Management claimed a "profit" of $525 million and flowed the figure through its income statement.

This speaks to the larger issue of Brookfield Asset Management's quality of earnings, a matter discussed in detail in the Southern Investigative Reporting Foundation'sMarch 11 story on the company. Paper gains on an income statement contribute nothing to the growth of corporate value: Because there is no cash, the company can't use these "earnings" to make timely investments, increase dividends or buy back shares.

Brookfield Asset Management is hardly the first company to benefit from paper gains: Big banks and securities brokers have perfected the gambit. But Brookfield Asset Management uses them to great effect.

Many of Brookfield Asset Management's investors and investment bankers dismiss concerns about such issues because a higher income level (usually) serves as ballast to command a higher stock price. But there is a reason that Brookfield seems to have gone to great lengths to keep its share price higher: Partners Limited.

Amounting to what is in effect an old-line Wall Street partnership built into a publicly traded company, Partners Limited consists of a group of about 45 current and former corporate officers of Brookfield Asset Management who privately control 20 percent of its shares—and given Brookfield Asset Management's dual-share structure, its operations and governance, Partners Limited is an oasis of concentrated corporate wealth. Considering Partner Limited's big stake in Brookfield Asset Management and its other subsidiaries,

and the widespread cross ownership of shares by Brookfield Asset Management and its subsidiaries, there is plenty of incentive for the managers of Brookfield Asset Management to use every last loophole to boost earnings.

With Partners Limited's current worth exceeding $5 billion, no one has benefitted more from its public-private hybrid model than Brookfield Asset Management's chief executive, Bruce Flatt. His stake in Partners Limited is now worth more than $713 million.

This is a far cry from the $77 million Brookfield Asset Management disclosed as his aggregate compensation for serving as its CEO from 2002 to 2004 elsewhere in the management information circular.

Regulatory Concerns

Investors brave enough to wade through Brookfield's opaque public filings might take solace in knowing that they aren't the only ones with a laundry list of questions and concerns.

Recently the Securities and Exchange Commission has been peppering Brookfield with a series of increasingly probing queries and, in its own, stilted bureaucratic language, demanding some serious changes to how Brookfield and its subsidiaries disclose details about their operations to investors.

Brookfield Property Partners, a publicly traded limited partnership spun out of Brookfield Asset Management to hold its commercial real estate operations, has been an object of fascination for the SEC's accounting mavens.
Their communications, in a series of letters and responses carrying on for several months from 2012 to this year, represent an unusually bold turn for the SEC, an agency whose track record is anything but aggressive when it comes to parsing corporate filings to find looming investor headaches.

Using the 2011 annual report as a springboard, the SEC last year sent a series of letters to Brookfield Property demanding clarification of its valuation policy, which, as laid out in footnotes, states in part, "All properties are externally valued on a three-year rotation plan."

To an investor reading the above, the implications appear both rational and plain: Brookfield Property—poised to be one of world's leading real estate managers—calculates the fair value of its assets using a combination of its own (internal) assessments and, for a third of the properties each year, the input of qualified and independent consultants.

Except it doesn't.

The SEC's sustained questioning of Brookfield Property Partners last year about property valuation process eventually forced Brookfield Property Partners, in a written September 2012 reply, that it does not use "external valuations" to value its investment property. So investors can now see that Brookfield Property Partners describes the worth of its portfolio, much in the manner of Humpty Dumpty; the words selected mean whatever it says they are.

(Furthermore, while Brookfield Asset Management and Brookfield Property Partners are legally distinct entities, with separate investors, filings and boards of directors, Brookfield Asset Management directs all of Brookfield Property's operations and consolidates its earnings and assets as its own—as it does for all its subsidiaries. Brookfield Asset Management insists that the boards of its subsidiaries are independent. Yet although the board of one subsidiary, Brookfield Infrastructure Partners, meets the legal definition of independent, as the Southern Investigative Reporting Foundation described in March, five of its eight members have deep economic ties to parent company Brookfield Asset Management.)

But what about all that fancy legal wording describing "internal and external appraisal," which was prominently displayed and repeated throughout the filings of Brookfield Asset Management and its subsidiaries? It seems that this was primarily used for financing purposes. The goal was to give investors and lenders the distinct impression that Brookfield Property Partners relies on a rigorous arm's-length process to value its portfolio when the reality was the opposite.

All seems to be fair in value

Plus there are big ramifications to some clever wording buried in the footnotes of Brookfield Property's annual report.

Last year more than $1.3 billion in fair value changes were flowed into Brookfield Property Partners $2.7 billion in net income, according to its 2012 annual report. In other words, nearly 50 percent of its profits were attributed to accounting entries—existing only on paper—that had nothing to do with leasing or selling properties at a profit.

So here's where a set of truly independent set of eyes reviewing Brookfield Property's portfolio could mean something beyond an abstract legal concept, perhaps a check and balance. Indeed an independent review could result in a different opinion of the value of Brookfield Property's billions of dollars of assets and perhaps a substantial change to its bottom line.

After all, if Brookfield Properties excluded fair value changes from its filing and reported earnings of $1.4 billion, the subsidiary might have warranted a sharply different stock price.

And Brookfield Asset Management seems to be quite mindful of its own stock price of late: After the Southern Investigative Reporting Foundation's March article, Brookfield Asset Management launched an expensive share-buyback program. In putting up the company's cash, a share buyback can serve to increase (or stabilize) a company's stock price by removing the amount of shares publicly available —with the result of establishing a temporary floor for the share's value. It is a popular practice, if rarely as successful as anticipated. (See a chart of Brookfield Asset Management's buybacks.)

An Obscure Company Called MS451 Inc.

Even though some investors might find it promising that the SEC has recently tried to prompt Brookfield Asset Management to be more transparent, a previous attempt by the SEC to elicit more disclosure in 2009 ended up with the agency backing off.

While few companies have financial filings as opaque as Brookfield Asset Management and its subsidiaries, occasionally the veil surrounding their operations can be pierced. And a diligent detective can piece together the lengths to which Brookfield Asset Management has gone to generate even the thinnest claim to income.

A 2008 related-party transaction by another Brookfield Asset Management subsidiary, its residential property developer Brookfield Homes, that prompted the SEC to write an epic 2009 letter with a seemingly endless parade of disclosure-oriented questions.

One of the issues that caught the SEC's attention was a deal struck late in the disastrous real estate year of 2008, when Brookfield Homes sold 451 land plots in the Morningside Ranch residential development outside of San Diego to a Brookfield Asset Management-affiliated related party. This was Brookfield Homes' only land sale in the region for that year. Brookfield Asset Management revealed the stark terms of the deal in its 2008 annual report: On an $18.5 million sale, Brookfield Homes lost $15 million, suggesting that the land's true value was $33.5 million.

In its letter in 2009, the SEC demanded more details about related-party aspects of the deal. But in a departure from the typical response of a public company to the U.S. regulatory body, Brookfield Homes refused to elaborate, saying that Brookfield Asset Management's ownership stake in the entity purchasing the lots was less than 10 percent.

The SEC's response a month later was unambiguous: The agency demanded full disclosure, arguing that regardless of the size of Brookfield Asset Management's equity position; it had "a significant financial interest" in the related party.

Brookfield Homes' subsequent reply was conciliatory: "The Company notes the Staff's comment and will provide the requested disclosure in its next Definitive Proxy Statement."

Yet Brookfield Homes' next proxy statement (known in Canada as a management information circular), in 2010, did not contain the information requested nor did subsequent filings, despite the company's assurances.

In 2011 Brookfield Homes was renamed Brookfield Residential Properties after an internal reorganization of its operations.

To date, there appears to be no record of the company ever providing the expanded disclosure. And a Brookfield Asset Management spokesman, who

assured the Southern Investigative Reporting Foundation the company had indeed disclosed the information, declined to provide a link to a filing with it.

Fast-forward to the first quarter of 2013: The very same Morningside Ranch parcels at the heart of Brookfield Homes' 2008 transaction suddenly pop up in the company's corporate disclosures.

Tucked in the back of Brookfield Residential Properties' filing for the first quarter of 2013 is a mention about an unnamed $29 million residential lot in California being purchased from Brookfield Asset Management during the three-month period.

In a departure from the typical corporate language for such transactions, the filing describes the payment as "measured at an exchange value of $29 million." This suggests that cash may not have been used in the transaction.

Using public records, the Southern Investigative Reporting Foundation determined that the Morningside Ranch lots sold by Brookfield Homes in December 2008 were bought by an entity called MS451 Inc., and that by March 2013 MS451 Inc. had sold those lots to Brookfield Residential Properties.

According to California corporate documents, a Brookfield Homes executive namedStephen P. Doyle signed papers for both MS451 Inc. and Brookfield Homes during the late December 2008 transaction, as did Larry Cortes, then the chief financial officer of Brookfield Homes' San Diego area operations and also CFO for MS451 Inc. At least four other Brookfield Homes executives had roles in MS451 Inc., according to these documents.

The Southern Investigative Reporting Foundation's initial efforts to learn more about MS451 Inc. and its owners has led to still more questions. Dissolved in late March 2013 after the California lot deal closed, MS451 Inc. appears to have had three owners: Brookfield Asset Management, with a stake of less than 10 percent, and two brothers, real estate developers James and Charles Schmid, who are the chief executive and president, respectively, of Chelsea Investment Corp.

Brookfield Homes, Chelsea and MS451 Inc. have a few things in common: Two Brookfield Homes alumni (listed in filings as officers of MS451 Inc.) now work

for Chelsea: The aforementioned Larry Cortes is currently a Chelsea project manager, andLiz Zepeda works for Chelsea as a risk analyst (the same role she played at Brookfield Homes).

The purpose of the Schmids' involvement in the deal remains unclear. In deal documents, they are listed as individuals not corporate officers of Chelsea. Several phone calls made to James Schmid's office requesting comment were not returned nor was a call to Charles Schmid's home.

MS451 Inc.'s reasons for involvement with the property are not immediately apparent. And why did the property's prepared lots stay undeveloped during the past half-decade of record low interest rates?

Moreover, the 2008 transaction seems to have been conducted with MS451 Inc. receiving some very favorable terms. During a time of major financial stress for Brookfield Homes, the subsidiary accepted bonds as payment from MS451 Inc.—a company with no assets or operations—and not cash. (In 2008 Brookfield Asset Management provided a waiver when Brookfield Homes could not comply with its net debt to capitalization and minimum equity covenants, an issue the SEC had been quite curious about in its aforementioned 2009 letter.)

At least on paper, the owners of MS451 Inc. did well for themselves, realizing a profit of $10.5 million on the deal. And because of the related-party nature of the transaction, Brookfield Asset Management claimed the full amount of profit as its own. That's the case even though Brookfield Asset Management directly earned only about $1 million from the deal, from its less than 10 percent stake.

While $10.5 million in consolidated earnings is immaterial when considering an income statement the size of Brookfield Asset Management's, it does suggest a further question: How much of the company's earnings come from related-party accounting maneuvers like this one involving MS451 Inc.? Indeed, as the Southern Investigative Reporting Foundation showed in March, Brookfield Asset Management regularly generates hundreds of millions in profit through complex related-party dealings.

In response to reporter questions, Andrew Willis, a Brookfield Asset Management spokesman, sent responses but failed to make any of this any

clearer: Concerning the Brookfield Homes-Brookfield Residential Properties disclosure above, he said, "[Brookfield Residential Properties] disclosed the related party nature and valuation basis for both transactions." He declined to elaborate further when asked follow-up questions.

Brookfield's Brazilian Headache

On Friday when Brookfield Asset Management released its third quarter results, it revealed an interesting development in another whole line of business in another corner of world – one involving potential fraud.

It revealed in the "Risks" section a new disclosure that the SEC and U.S. Department of Justice are investigating allegations that a Brazilian private equity unit had bribed local officials to approve certain real estate transactions. A public prosecutor in São Paulo has filed charges against three Brookfield Asset Management executives and seven municipal officials under the country's anti-bribery statutes.

Long a key component of the Brookfield Asset Management empire, the Brazilian operations manage or own more than $13 billion worth of utilities and real estate. Indeed prior to becoming Brookfield Asset Management, the company was called Edper-Brascan, with Bras being short for Brazil.

The recent charges emerged following Brookfield Asset Management's April 2010 dismissal of Daniela Spinola Gonzalez, the former chief financial officer of a Brookfield-managed real estate fund in São Paulo.

Reached by the Southern Investigative Reporting Foundation, Gonzalez said that in the spring of 2009 she uncovered a series of payments to São Paulo municipal officials aimed at obtaining approval of expansion projects at four different malls. Specifically she alleges they were designed to cover up the real estate fund's lack of compliance with a series of pre-expansion mandates from the São Paulo building approval department designed to address a potential increase in traffic flow. When she discovered requests to approve large payments to holding companies she had never heard of, she investigated further and found municipal officials had set up entities to receive payments from the real estate fund.

Gonzalez alleges that when confronted her unit and corporate supervisors, including Steven J. Douglas, then the head of the Brookfield Asset Management's international property portfolio, with news she felt sure would outrage them, she was told repeatedly, "This is the way of doing business in Brazil." The angriest they got about the bribes, according to her, was when they chastised her for discussing sensitive fund business in an email. (In reporting on the claims of Gonzalez, the Southern Investigative Reporting Foundation examined a series of emails between Gonzalez and her supervisors, other internal Brookfield documents and a letter written to the SEC by her lawyers.)

Dismissed in April 2010, Gonzalez filed a labor grievance shortly thereafter in São Paulo. Brookfield Asset Management filed a lawsuit against her in 2011, alleging she had engaged in embezzlement; she says the charges are nothing more than "a complete fabrication to make me seem like a criminal."

Asked about Gonzalez and her charges, Brookfield Asset Management spokesman Andrew Willis said, among other statements, "Notwithstanding the suspect source of the allegations, Brookfield conducted an investigation into these matters. The investigation found no evidence of wrongdoing by Brookfield or any of its employees."

Filed Under:

- Accounting
- Brookfield Asset Management
- Brookfield Homes
- Bruce Flatt
- DoJ
- Investigative Reporting
- Partners Limited
- Roddy Boyd
- Securities and Exchange Commission
- Southern Investigative Reporting Foundation

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This is a sidebar to "The Paper World of Brookfield Asset Management." For more coverage, click here.

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3 thoughts on “Brookfield’s Looking-Glass World”

1. g on **November 18, 2013 at 2:50 pm** said:

Great article, research and reporting!

Does Brookfield have privately placed investment funds and BAM is the investment advisor collecting management and incentive fees? Or do they simply raise the funds through secondaries and invest that capital into real estate? If it’s the former, I am wondering if you have spent any time talking with institutional investors or family offices that might be invested in their funds, and see what level of due diligence they have performed on the company’s back office.

Reply ↓

2. D on **November 20, 2013 at 10:22 pm** said:

I am not sure I follow the motivation behind SIRF’s continuing probes of Brookfield.

On the plus side:
– Brookfield uses market to market accounting for illiquid assets which is prone to abuse
- There are many related party transactions under the Brookfield empire, particularly between BAM and its PTPs.

Having a skilled investigative journalist shed light on these often opaque areas on an ongoing basis is definitely a plus for capital markets.

On the other hand SIRF constantly seems to try to make a mountain out of molehills, if it can’t find genuine big issues. Brookfield’s Sao Paulo affiliate (BISA) was reported in the WSJ yesterday as being victims of potential extortion by Sao Paulo officials.

(http://online.wsj.com/news/articles/SB10001424052702303755504579208200572829672)

Informed readers who know a good deal about graft know that (a) there can be a fine line between bribery and extortion, but particularly in extreme cases, the distinction is very important and it remains to be seen as which is the case in this incident with BISA, and (b) graft is a major challenge with doing business in Brazil.

SIRF would seem to have a bit less of an agenda in its reporting if it provided this contextual background. There were some inaccuracies in SIRF’s prior report on the Paper World of Brookfield, which I will address on that article’s page.

Reply ↓

3. Dino on **November 23, 2013 at 5:57 am** said:

> Nice job. I wonder if the SEC is going to follow up and do their jobs?
>
> Doesn't the bribe violate the Foreign Corrupt Practices Act ? I guess they get a pass on that,too?