REIS Overview:
Some Thoughts and Observations

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The opinions expressed herein are my own and are not necessarily consistent with the views of REIS, NCREIF and/or PREA.
REIS Overview: Thoughts & Observations

• Some Background:
  – Spillover from the 2008 financial crisis
  – Accounting/regulatory practices called into question
  – Increasing allocations to “alternatives” – including real estate

• Overview of REIS:
  – Mission statement and relationship to Foundational Standards
  – REIS, a joint effort of NCREIF and PREA

• Examples of Reporting Ambiguities & Inconsistencies:
  – Standardizing reporting practices:
    • Compounding frequencies & methodologies
    • Gross v. net leverage presentations
  – Responding to Authoritative bodies:
    • Investment Property Entity (IPE) v. Investment Company (IC)
  – Future initiatives:
    • Risk reporting: The tangled web of leverage and joint ventures (?)

• Summary, Acknowledgments and Q&A
Consider Just One Subset of the 2008 Financial Crisis: Banks & Financial-Service Companies ← Commercial Real Estate

### Commercial Real Estate Net Writedowns

<table>
<thead>
<tr>
<th></th>
<th>4Q-07 ($Smil.)</th>
<th>1Q-08 ($Smil.)</th>
<th>3Q-08 ($Smil.)</th>
<th>4Q-08 ($Smil.)</th>
<th>1Q-09 ($Smil.)</th>
<th>2Q-09 ($Smil.)</th>
<th>3Q-09 ($Smil.)</th>
<th>4Q-09 ($Smil.)</th>
<th>TOTAL ($Smil.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lehman Brothers</td>
<td>$900.0</td>
<td>$1,000.0</td>
<td>$1,300.0</td>
<td>$1,600.0</td>
<td>$2,545.0</td>
<td>$2,545.0</td>
<td>$2,545.0</td>
<td>NR</td>
<td>NR</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>340.0</td>
<td>850.0</td>
<td>470.0</td>
<td>900.0</td>
<td>926.0</td>
<td>1,229.0</td>
<td>283.0</td>
<td>282.0</td>
<td>64.0</td>
</tr>
<tr>
<td>Citigroup</td>
<td>NR</td>
<td>573.0</td>
<td>545.0</td>
<td>518.0</td>
<td>991.0</td>
<td>186.0</td>
<td>386.0</td>
<td>574.0</td>
<td>154.0</td>
</tr>
<tr>
<td>Bank of America</td>
<td>134.0</td>
<td>191.0</td>
<td>263.0</td>
<td>182.0</td>
<td>853.0</td>
<td>324.0</td>
<td>571.0</td>
<td>538.0</td>
<td>837.0</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>NR</td>
<td>0.0</td>
<td>375.0</td>
<td>325.0</td>
<td>700.0</td>
<td>1,325.0</td>
<td>700.0</td>
<td>200.0</td>
<td>(100.0)</td>
</tr>
<tr>
<td>Wachovia</td>
<td>1,088.0</td>
<td>521.0</td>
<td>209.0</td>
<td>347.0</td>
<td>NR</td>
<td>26.0</td>
<td>99.0</td>
<td>242.0</td>
<td>525.0</td>
</tr>
<tr>
<td>Bear Stearns/NY Fed</td>
<td>450.0</td>
<td>150.0</td>
<td>0.0</td>
<td>1,600.0</td>
<td>530.0</td>
<td>NR</td>
<td>NR</td>
<td>NR</td>
<td>NR</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>564.0</td>
<td>697.0</td>
<td>487.0</td>
<td>230.0</td>
<td>298.0</td>
<td>64.0</td>
<td>278.0</td>
<td>97.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>230.0</td>
<td>NR</td>
<td>37.0</td>
<td>954.0</td>
<td>1,131.0</td>
<td>(181.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>NR</td>
<td>266.0</td>
<td>190.0</td>
<td>365.0</td>
<td>723.0</td>
<td>223.0</td>
<td>(94.0)</td>
<td>(20.0)</td>
<td>(33.0)</td>
</tr>
<tr>
<td>RBS</td>
<td>NR</td>
<td>187.0</td>
<td>NR</td>
<td>139.0</td>
<td>74.0</td>
<td>41.0</td>
<td>NR</td>
<td>NR</td>
<td>NR</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>400.0</td>
<td>(500.0)</td>
<td>100.0</td>
<td>(200.0)</td>
<td>(200.0)</td>
<td>(400.0)</td>
<td>200.0</td>
<td>420.0</td>
<td>434.0</td>
</tr>
<tr>
<td>UBS</td>
<td>116.0</td>
<td>443.0</td>
<td>(318.0)</td>
<td>(29.0)</td>
<td>NR</td>
<td>NR</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>4,222.0</strong></td>
<td><strong>4,191.0</strong></td>
<td><strong>3,845.0</strong></td>
<td><strong>6,692.0</strong></td>
<td><strong>8,636.0</strong></td>
<td><strong>5,415.0</strong></td>
<td><strong>5,099.0</strong></td>
<td><strong>2,333.0</strong></td>
<td><strong>1,881.0</strong></td>
</tr>
</tbody>
</table>

Figures are for global capital-markets operations, except for UBS and RBS, which show U.S. operations. Parentheses indicate net gain. NR means not reported. Writedown figures for Goldman, J.P. Morgan and Morgan Stanley are actually losses (or profits). Writedowns are estimated for Credit Suisse in 3Q-09 and 4Q-09. Writedowns by Goldman and Morgan Stanley in 1Q-09 include December 2008. Lehman’s writedown in 4Q-07 is actually for full-year 2007. Some $7.5 billion of writedowns reported for Lehman from 4Q-08 to 20-09 were divided evenly. UBS transferred $8.2 billion of assets since mid-2008 to a fund owned by Switzerland’s central bank without specifying the associated writedowns. Wachovia’s 4Q-07 writedown includes $488 million taken in 3Q-07. Wachovia’s writedowns for 3Q-09 and 4Q-09 are estimated, based upon previous proportion of writedowns by parent Wells Fargo. Exposures are for last day of quarter. Exposures are estimated for Lehman and Wachovia in 4Q-08 and J.P. Morgan in 4Q-07. Credit Suisse’s exposure figures are on a gross basis. Lehman’s figures include equity investments.

Source: *Commercial Mortgage Alert*, March 26, 2010 (CMAlert.com).
Regulatory Concerns: Who’s Next?

• “Are the numbers right?”
  – Book value vs. fair market value?
  – What is the fair market value of thinly traded assets?
  – “Slow-moving” accounting practices called into question

• If the numbers are wrong, who’s next?
  – One prominent target:
    • Estimated ~$3-4 trillion shortfall in (national) public-sector pension plans
  – There are others (e.g., state & local entities, lease reporting, etc.)
  – The concern: Systemic risk(s) → “too big to fail”

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Regulators to the Rescue! (?)

- Regulators seek to avoid further problems (and embarrassment)
  - A desire for “smart” regulation; however,
    - Overlap among regulators is a concern
    - Inconsistency between regulators is a problem!

- A scramble (collision?) of regulatory initiatives, including:
  - Legislative:
    - Basel III, Dodd-Frank, etc.
  - Authoritative bodies:
    - Domestic:
      - FASB
    - GASB (?)
  - USPAP
    - International:
      - GIPS
      - IFRS/IASB
      - IVSC
• As a means of offsetting lower returns from traditional investments:

• “The largest public pension plans have almost doubled their target allocations to alternative investments in the past five years. The median allocation now stands at 20%”

Aaron Cunningham, *Pension & Investments*, August 23, 2010
The trend of late: Regulators view (private) commercial real estate (equities) as part of the larger group of alternative investments

- conceptually, this view has merit; however,
- operationally, this view presents certain problems:
  
  • wide variety of choices along risk/return continuum
    [core → core+ → value-added → opportunistic]
  
  • wide variety of platforms/structures
    [open-end commingled fund, closed-end separate account, etc.]
  
  • real estate appraisal/valuation tends to be more precise
  
  • real estate finance/credit is highly evolved
    [how to treat levered equity positions?
     (particularly, highly levered positions with “optionality”?)]
  
  • extensive use of “promoted” interests, often in a variety of JV structures

Into the breach steps REIS!

- Pushing back against a “one size fits all (alternative investments)” approach
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• Overview of REIS:
  – Mission statement and relationship to Foundational Standards
  – REIS, a joint effort of NCREIF and PREA

• Examples of Reporting Ambiguities & Inconsistencies:
  – Standardizing reporting practices:
    • Compounding frequencies & methodologies
    • Gross v. net leverage presentations
  – Responding to Authoritative bodies:
    • Investment Property Entity (IPE) v. Investment Company (IC)
  – Future initiatives:
    • Risk reporting: The tangled web of leverage and joint ventures (?)

• Summary, Acknowledgments and Q&A
REIS Mission:

• Mission Statement:
  – Establish and implement information standards for the real estate market to facilitate informed investment decision making

• Without standards, there is no consistency and no transparency
  – Without consistency and transparency, there is no comparability
  – Without comparability, there is no effective evaluation of competing investment opportunities

• REIS is involved in four broad areas of (direct) real estate investing:
  1. Accounting/financial,
  2. Performance measurement,
  3. Portfolio/asset management, and
  4. Valuation.

• An Aside: Difference between:
  – Accounting standards – set by FASB, GASB, IASB, etc.
  – Information standards – set by GIPS, USPAP, etc.
GIPS, U.S. GAAP and USPAP form the Foundational Standards upon which REIS currently depends; however, REIS provides guidance when these standards conflict, are silent or subject to interpretation.

Purpose

Future additions/modifications to the Foundational Standards:

• IFRS/IASB?
• GASB?
• Others (ANREV, ILPA, INREV)?
REIS Organizational Structure & Roles

**Organizational Structure**

- NCREIF (Sponsor)
- PREA (Sponsor)

**REIS Board**
- REIS Council
- NCREIF Standing Committees
- PREA Committee / Affinity Groups
- Board/Council Work groups
- REIS Director of Operations
- Task Force(s)

**Roles**

- Founding sponsor organizations
- Appoint Board Members
- Approve changes/amendments to constitution
- Fund REIS operations

- Official independent governing body of REIS
- Promote and approve REIS
- Provide oversight of Council priorities and direct activities
- Review industry compliance with REIS

- Aligned with strategic plan
- Effectuate objectives of REIS initiative
- Volunteers in each group consists of selected board and council members and other industry participants
- Forges alliances with industry standard setters and participants

- Directed by Council Chair and Board Chair
- Administers content management and maintenance of REIS
- Works with Council Chair as liaison to REIS Board
- Supports Workgroup and Task Force(s)

- Appointed by Board
- Keep REIS current: initiate changes and modifications
- Appoint Task Force(s) and approve activities
- Act as liaison to Foundational Standards Bodies

- Appointed by Council
- Includes Council member(s) and NCREIF/PREA subject experts
- Direct specific projects and effectuate changes to REIS
- Write prospectus, exposure drafts, adopting releases, and other documentation
REIS Board

- **Chair:** John Baczewski, *President, Real Estate Fiduciary Services, LLC*
- Rick Carlson, *(retired)* Global Managing Partner-Real Estate Services, Deloitte & Touche, LLP
- Blake Eagle, *Senior Advisor, NCREIF; (retired) Executive Director, NCREIF*
- Dave Lewandowski, *(retired)* Senior Managing Analyst, State of Wisconsin Investment Board
- Devon Olson, *Director-Real Estate, Utah Retirement Systems*
- Joe Pagliari, *Clinical Professor of Real Estate, The University of Chicago, Booth School of Business*
- Anne Pfeiffer, *Managing Director, Portfolio Manager, JPMorgan Asset Management*
- Lynn Thurber, *Chairman, LaSalle Investment Management*
- Chuck Tschampion, *Director, Special Projects, CFA Institute; (retired) Managing Director, General Motors Asset Management*

REIS Council

- **Chair:** Ken Greguski, *Director, Head of Global Performance and Analysis, RREEF*
- Sally Ann Flood, *Partner, Deloitte & Touche, LLC*
- Bruce Frank, *Senior Partner-Real Estate Group, Ernst & Young, LLP*
- Robert Hess, *Research Consultant; (retired) Prudential Real Estate Investors*
- Maritza Matlosz, *Director, Performance Reporting & Yardi Operations Management, BlackRock*
- Barbara McDowell, *Director, Portfolio Analytics, ORG Portfolio Management*
- Paul Mouchakkaa, *Global Head of Research and Strategy, Morgan Stanley Real Estate*
- Jean-Marie Murphy, *Managing Director, Portfolio Manager, Stockbridge Real Estate Funds*
- Jim Strezewski, *Senior Vice President, LaSalle Investment Management*
- Rick Wincott, *Senior Executive Vice President, Research, Valuation and Advisor, Altus Group USA*
- Nathan Zinn, *Investment Manager, Teacher Retirement System of Texas*
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Broadly speaking, REIS activities fall into three areas:

1. **Present**: Narrow/standardize divergent reporting practices
   - can include ambiguities in the Foundational Standards

2. **Rapid Response**: Reply to initiatives from various authoritative bodies
   - accelerating pace of these pronouncements

3. **Future**: Consider areas where reporting practices can be enhanced
   - areas such as “risk reporting” (≠ risk management)

Let’s examine a sample of each
Narrow/Standardize Existing Practices

• Recognizing that there are sometimes divergent reporting practices:
  
  either
  
  – narrow the range of acceptable practices,
  
  or
  
  – standardize the acceptable practice

• Consider two examples:

  1. Compounding frequencies & methodologies → the rate of return, and
  2. “Gross” v. “net” levered equity positions
Frequencies & Methodologies → Rate of Return (1)

• Present #1| Consider the following (development-like) example:

  – Cash Flows:
    • January 1, Year 1 \((\$10,000)\) \(T = 1.5\) years
    • June 30, Year 2 \(\$12,494\)

  – What is the rate of return? Two general types of solutions:

  1. Lenders/Bond Investors → Simple Return:

     \[ PV \left(1 + \frac{R_s}{n_i}\right)^{T(n_i)} = FV \]

     where: \(PV = \) present value, \(T = \) time (years), \(R_s = \) annual return, \(n_i = \) compounding frequency and \(FV = \) future value

  2. Equity Investors → Compounded Return:

     \[ PV \left(1 + r_i\right)^{T(n_i)} = FV \Rightarrow R_i^c = \left(1 + r_i\right)^{n_i} - 1 \]

     where: \(r_i = \) periodic return and \(R_i^c = \) annual return

  – Which approach is “right”? Both are!
Frequencies & Methodologies → Rate of Return (2)

• Continuing with the earlier example:
  – Cash Flows:
    • January 1, Year 1 ($10,000) ➞ \( T = 1.5 \) years
    • June 30, Year 2 $12,494
  – A variety of mathematically correct answers; use depends on industry convention:

<table>
<thead>
<tr>
<th>Compounding Frequency</th>
<th>( T )</th>
<th>( n_i )</th>
<th>Simple-Return ( R_i^S ) Debt/Bond-Type Users</th>
<th>Compound-Return ( R_i^C ) Equity-Type Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>XIRR</td>
<td>1.5</td>
<td>1</td>
<td>16.00%</td>
<td>16.05%</td>
</tr>
<tr>
<td>Annual</td>
<td>1.5</td>
<td>2</td>
<td>15.41% US Treasuries</td>
<td>16.00%</td>
</tr>
<tr>
<td>Semi-Annual</td>
<td>1.5</td>
<td>4</td>
<td>15.12%</td>
<td>16.00% NCREIF *</td>
</tr>
<tr>
<td>Quarters</td>
<td>1.5</td>
<td>12</td>
<td>14.93% Whole Loans</td>
<td>16.00% Stock Market</td>
</tr>
<tr>
<td>Months</td>
<td>1.5</td>
<td>365</td>
<td>14.85% CMBS</td>
<td>16.00%</td>
</tr>
<tr>
<td>Days</td>
<td>1.5</td>
<td></td>
<td>14.84% Academics</td>
<td>14.84% Academics</td>
</tr>
</tbody>
</table>

* However, NCREIF's use of the Modified Dietz method approximates monthly compounding.
Frequencies & Methodologies → Rate of Return (3)

- A few asides to mention:
  - XIRR is an Excel function, which:
    - uses an annual compounding frequency, and
    - incorporates the exact dates of the cash flows
  - XIRR’s use of exact days has positive and negative effects:
    - Positive: Eliminates the need for mid-month (or quarter) convention
    - Negative: Produces some non-intuitive results because
      - The first half of the year (generally) has 182 days, while the second half has 183
      - Leap Years are incorporated into the calculation
  - We can always convert:
    - from one methodology to the other, and
    - from one compounding frequency to another.
  - “Positive” (or negative) leverage?
    - We compare the rate of return on unlevered assets ($k_a$) to the cost of debt ($k_d$).
    - It is important to have these stated using the same return methodologies.
    - A one-period model of levered equity ($k_e$) returns (with leverage = $LTV$):
      \[ k_e = \frac{k_a - k_d LTV}{1 - LTV} \]
What is the rate of return?

REIS’ Role:

- Should practice be narrowed? Yes, in order to avoid inconsistencies.
- When making the determination:
  - consult with practitioners,
  - review Foundational Standards and REIS Performance Measurement Resource Manual,
  - weigh theoretical and practical considerations, and
  - communicate why a particular decision was reached.

REIS’ Position:

- Closed-end funds → required
- All others → recommended:
  - Disclose the applicable time period, and
  - Disclose the frequency of cash flows used in the calculation.
  - At a minimum, quarterly cash flows must be used.
  - Practical result: Most approved calculations use XIRR.
“Gross” v. “Net” Levered Equity (1)

- Present #2 | Two different presentations concerning levered equity:
  - Under the “gross” reporting approach:
    - assets & debts valued separately at fair market value
  - Under the “net” reporting approach:
    - equity valued separately at fair market value;
    - however, non-assumable debts can be valued at book
“Gross” v. “Net” Levered Equity (2)

- Issues include:
  - As interest rates change, fair market value of (fixed-rate) debts change (inversely)
    - *e.g.*, a rise in interest rates reduces the fair market value of the debt
      \[ \rightarrow \text{which increases the value of the equity (borrower “shorts” debt market)} \]
    - Note: with floating-rate debt, interest rates change
      but, book value of debt \( \approx \) fair market value of debt
  - As a result, two different valuation methodologies produce varying periodic (levered equity) returns
    - However, the (compounded) average returns are identical under both approaches if the loan is held to maturity
    - Consequently, a key impact is the volatility of reported returns
      - not necessarily the case that “gross” approach is more volatile
        - *e.g.*, long-term lease financed with long-term (fixed-rate debt) acts like a hedge
          \[ \rightarrow \text{equity is “immunized”} \]
“Gross” v. “Net” Levered Equity (3)

• Assume the following:
  – Initial Building Value = $100 million
    – appreciation of 2.5% and an income yield of 4.5%
  – Debt Financing = $50 million
    • interest-only at 5.0%, 10-year balloon, non-assumable first-mortgage loan
    • At the end of year one, market interest rates move to 5.5%
      → a mark-to-market adjustment of $1.74 million
"Gross" v. "Net" Levered Equity (4)

- Consider the two presentations:

<table>
<thead>
<tr>
<th>&quot;Gross&quot; Levered Equity Returns</th>
<th>&quot;Net&quot; Levered Equity Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Debt is valued at market)</td>
<td>(Because of non-assumable loan, debt valued at book)</td>
</tr>
</tbody>
</table>

**Balance Sheet:**

<table>
<thead>
<tr>
<th></th>
<th>January 1st</th>
<th>December 31st</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Values</td>
<td>$100,000</td>
<td>$102,500</td>
</tr>
<tr>
<td>Debt</td>
<td>(50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Equity</td>
<td>$50,000</td>
<td>$52,500</td>
</tr>
</tbody>
</table>

**Income Statement:**

<table>
<thead>
<tr>
<th></th>
<th>January 1st</th>
<th>December 31st</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Income</td>
<td>4.50%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Mark-to-Market Adjustment</td>
<td>1,738</td>
<td>0</td>
</tr>
<tr>
<td>Net Income</td>
<td>$3,738</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

**Returns:**

<table>
<thead>
<tr>
<th></th>
<th>Asset- Level</th>
<th>Equity- Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>4.50%</td>
<td>7.48%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>2.50%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Total</td>
<td>7.00%</td>
<td>12.48%</td>
</tr>
</tbody>
</table>

**Returns:**

<table>
<thead>
<tr>
<th></th>
<th>Asset- Level</th>
<th>Equity- Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>4.50%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>2.50%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Total</td>
<td>7.00%</td>
<td>9.00%</td>
</tr>
</tbody>
</table>

- The direction of the difference is a function of the direction of the interest-rate change (e.g., $i \uparrow \Rightarrow k_i \uparrow$).

- The magnitude of the difference is a function of the degree of leverage and the size of the interest-rate change.
• What is the “right” presentation?

• REIS’ Role:
  – Should practice be narrowed? Still debated.
  – When making the determination:
    - consult with practitioners,
    - review Foundational Standards and REIS Performance Measurement Resource Manual,
    - weigh theoretical and practical considerations, and
    - communicate why a particular decision was reached.

• REIS’ Position:
    • Clarifies valuation criteria.
    • However, refrains from recommending or requiring one presentation over the other.
  
  • Practical result: Mixed approaches still prevalent in practice.
Proposed FASB Changes → IPE v. IC (1)

• **Rapid Response** | FASB circulated proposals to:
  
  – **Investment Property Entity** – Create IPEs strictly for real estate industry:
    • Would require investment properties to be measured at fair value
    • Would significantly change practice for opportunity funds and REITs (that are IPEs):
      – Gross up of properties and related debt, rents and expenses
      – Potential changes to NAV, disclosure requirements, operational issues
  
  – **Investment Company** – Looking to amend ICs and how to account for such:
    • Joint project between the FASB and IASB
    • Converges the definition of an investment company
      – Does not converge the accounting
    • Could change current investment company conclusions
  
• Proposal circulated October, 2011 ↔ Comments were due February, 2012
  – 4 months!

• Effective date yet to be determined.

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3 FASB exposure draft: *Real Estate-Investment Property Entities* (Topic 973).

4 FASB *Financial Services-Investment Companies* (Topic 946).
Proposed FASB Changes → IPE v. IC (2)

- Instituting these two proposals would invite inconsistencies & conflicts:
  - Some audited reports would be prepared at fair market value (FMV) while others prepared at cost
    - Those reporting at cost would likely be some opportunity funds and nearly all single-client accounts
  - Net Asset Value (NAV) would include some items no longer carried at FMV
    - e.g., mortgage receivables
  - Calculation of income and appreciation returns (and, therefore, industry benchmarks and GIPS composites) might shift prospectively.
  - Real estate operating information would not be included in the audited income statements.
  - Global standards are not converged
Proposed FASB Changes → IPE v. IC (3)

- As another example of the inconsistencies and conflicts, consider:

Assume Entity A controls Entities B, C and D

- Substantially all of Entity A’s activities are investing in real estate properties
  - Entity A would be an IPE, but only the investment property (of Entity B) would be reported at fair value

Entity A

- Investment property, invested for total return
- Assets $1,000

Entity B

- Loans, MBS
- Assets $33

Entity C

- Non-investment property
- Assets $34

Entity D
• **REIS’ position:**
  - **IPE** – *Rejects* the FASB’s exposure draft: **REAL ESTATE-INVESTMENT PROPERTY ENTITIES (TOPIC 973)**
  - **IC** – *Supports* the proposed **AMENDMENTS TO THE SCOPE, MEASUREMENT, AND DISCLOSURE REQUIREMENTS OF FINANCIAL SERVICES-INVESTMENT COMPANIES (TOPIC 946),**
    - *as a workable, though less-than-perfect, solution.*

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5 For more details, please see REIS Webinar (2-1-12): *Investors Committee Discussion – FASB Exposure Drafts: Investment Property Entities (Topic 973) and Financial Services-Investment Companies (Topic 946), Amendments to the Scope, Measurement, and Disclosure Requirements. Why investors should care and what investors should do.*
Risk Reporting: Leverage & Joint Ventures

- **Future | Risk reporting (?)**
  - An example: the tangled web of leverage and joint ventures (?)

- **This is a multi-pronged set of issues; consider as subsets:**
  - **Leverage:**
    - increases the volatility of returns,
    - may or may not increase realized returns,
    - a wide variety of debt characteristics
      (fixed- v. floating-rate, cross-collateralized v. not, recourse v. non-recourse, *etc.*),
    - highly levered equity positions create option-like investments, and
    - notoriously difficult to trace leverage through joint ventures.
  - **Joint ventures/incentive fees:**
    - truncate the upside while leaving the investor with downside,
    - represent principal/agent problems:
      - in-the-money promote → conservative behavior
      - out-of-the-money promote → aggressive behavior and/or diminished effort,
    - what’s the expected value of the promote?
      - expected value is tied to volatility of returns (see leverage)
Leverage is difficult to trace with joint ventures (not limited to private-market vehicles).

Consider the example of a levered fund investing a levered JV/development:

<table>
<thead>
<tr>
<th>Fund-Level Investment</th>
<th>Joint Venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$200 Assets</td>
</tr>
<tr>
<td>Debt</td>
<td>$100 @ 50% Debt</td>
</tr>
<tr>
<td>Equity</td>
<td>$100 @ 50% Equity</td>
</tr>
<tr>
<td>$100 @ 60%</td>
<td>$40 @ 40%</td>
</tr>
</tbody>
</table>

Overall Leverage Ratio = 80%
Risk Reporting: Leverage & Joint Ventures

• When leverage is positive, levered equity looks like:

Illustration of the Expected Return and Volatility of Levered Equity Returns as Leverage Increases

• When leverage is negative, levered equity the line slopes downward!
Consider a numerical example of the “promote”:

**Fund-Level Return Distribution:**
- Average Return: 12%
- Volatility: 15%

**Fund Incentive Structure:**
- Investor’s Preference: 12%
- Residual Split:
  - Investor: 50%
  - Operating Partner: 50%

**Notes:**
- The operating partner’s “promoted” interest creates an option-like return for operator.
- The value of the option reduces the investor’s upside.
• The option-like characteristic of the promote:
- Returns before and after incentive fee (= promote)

Illustration of Venture-Level Returns before and after the Venture Partner's Participation

Likely Returns before JV Participation

Likely Returns after JV Participation
• Fund-Level Returns after Operating Partner:
  – Likely Returns:
    • Fund-Level Returns before Operating Partner 12.0%
    • Operating Partner’s Participation 3.0%
    • Investor’s Net Return 9.0%
  – Volatility (Standard Deviation):
    • JV Deal before Operating Partner 15.0%
    • Operating Partner’s Participation 3.5%
    • Investor’s Net Return 11.5%

• Notes with regard to financial reporting:
  – The operating partner’s “promoted” interest reduces the investor’s net return by 300 bps:
    • Even though the value of the promote equals zero at the most likely return,
    • This is attributable to operating partner’s asymmetric participation in returns.
  – The reduction in the investor’s standard deviation is a statistical illusion:
    • The investor still receives 100% of the economic downside.
• Now that we have a better understanding, what might be next steps?

• REIS’ potential role:

  – What information will better equip investors to make informed judgments?

    • clearer reporting of leverage ratios, including JVs, of major investments,

    • clearer reporting of “pref” and promote structure of major investments
      (note: aggregation “masks” true expected value of promote),

    • scenarios/simulations of when promote is “in-the-money,”

    • what other guarantees and/or promotes might operating partner/developer be
      involved with (early warning on “house of cards” ← “sponsor” risk), and

    • consider methods to help standardize the historical reporting of:
      – past promotes, and/or
      – investors’ net returns.

• REIS’ position:

  – To-be-determined!
• Some Background:
  – Spillover from the 2008 financial crisis
  – Accounting/regulatory practices called into question
  – Increasing allocations to “alternatives” – including real estate

• Overview of REIS:
  – Mission statement and relationship to Foundational Standards
  – REIS, a joint effort of NCREIF and PREA

• Examples of Reporting Ambiguities & Inconsistencies:
  – Standardizing reporting practices:
    • Compounding frequencies & methodologies
    • Gross v. net leverage presentations
  – Responding to Authoritative bodies:
    • Investment Property Entity (IPE) v. Investment Company (IC)
  – Future initiatives:
    • Risk reporting: The tangled web of leverage and joint ventures (?)

• Summary, Acknowledgments and Q&A
Summary

• REIS’ three main efforts:

1. Responses to increasing regulatory pronouncements:
   – We’ve entered an era of increased regulatory oversight
   – The pace seems to be accelerating

2. Narrow the range of acceptable practice(s):
   – We’ve had some “wins”
   – There is still much to be done

3. Consider future areas of involvement:
   – What’s next?
   – Where can REIS add value?

• How can you help?

   – Reply to (and/or encourage advisors) to respond to upcoming REIS survey:
     • Measuring compliance
     • Hoping to improve consistency, transparency and comparability
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  – Nathan Zinn♦,*† – Teacher Retirement Systems of Texas

* Member of REIS Board.
† Member of REIS Council.
♦ Member of REIS Education Committee.
Questions & (Hopefully Sensible) Answers?