

Global Investment Performance Standards

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~~Interpretive Guidance for~~ Statement on Real Estate Effective 1 January 2011

Introduction and Scope

The ~~GIPS standards~~ Real Estate real estate provisions in Section 6 of Chapter I of the Global Investment Performance Standards (GIPS®) apply to:

- Wholly owned or partially owned properties;
- Real estate commingled funds, separate accounts, and unit trusts;
- Unlisted, private placement securities issued by private real estate investment trusts (REITs) and real estate operating companies (REOCs); and
- Equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where ~~returns are primarily derived from some portion of return to the holding, trading, development, or management of~~ investor is related to the performance of the underlying real estate assets.

Real estate includes land, buildings under development, completed buildings, and other structures or improvements held for investment purposes. ~~The Standards apply to firms managing real estate regardless of the level of control the firm has over management of the real estate investments (see the discussion of discretion below).~~

The real estate provisions apply irrespective of whether a real estate investment is producing revenue and also apply to real estate investments with leverage ~~or~~ (gearing). It is important that firms managing real estate investments understand that compliance with the GIPS standards refers to firm-wide compliance which requires adherence not just to the real estate provisions but to all the applicable general provisions of the GIPS standards. The general provisions that do not apply to real estate composites are noted parenthetically within Section 6 of Chapter I of the GIPS standards.

The following investment types are not considered as real estate investments and, therefore, must follow Sections 0–5 in Chapter I ~~addressed elsewhere in the general provisions~~ of the GIPS standards ~~include the following:~~

- Publicly traded real estate securities ~~including any listed securities issued by public companies;~~
- Commercial mortgage backed securities (MBS, CMBS); and
- Private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying real estate.

~~If a portfolio includes a mix of real estate and other investments that are not real estate, then these requirements and recommendations only apply to the real estate portion of the portfolio, and the GIPS carve-out provisions (Sec II.3.A.7.) must also be applied.~~

~~Recognizing that firms may not be able to gather historical valuations and/or records for transactions of real estate~~

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~~assets in order to create a five-year performance history, firms may link non-compliant performance for these assets for periods prior to 1 January 2006 to compliant performance with appropriate disclosure as to why the performance is not in compliance with the Standards.~~

Compliance

~~It is important that firms managing real estate investments understand that compliance with the GIPS standards refers to firm-wide compliance which requires adherence not just to the real estate provisions but to all the provisions of the GIPS standards.~~

The following guidance includes a discussion of issues relating to real estate investments.

Investment Discretion

The GIPS standards require that all actual, fee-paying, discretionary portfolios be included in at least one composite, ~~although the definition of discretion remains with the firm~~. Discretion, ~~which is defined by the firm~~, is the ability of the firm to implement its intended strategy. Each firm must document its definition of discretion and must apply the definition consistently. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

~~The following guidelines are recommended to facilitate appropriate and consistent classification of real estate portfolios as discretionary or nondiscretionary.~~

Discretionary Management:

~~Real estate portfolios are considered discretionary. The firm's definition of discretion must include criteria such that if the firm has sole or primary responsibility, or sufficient decision-making authority for major investment decisions, the real estate portfolio must be considered discretionary. Major decisions may include portfolio strategy, but are not limited to, determining investment search and selection, purchases, sales, acquisitions, dispositions, investment structuring, financing, capital improvements, leasing, and operating budgets. In some cases, client-imposed restrictions may result in some decision-making authority being retained by the client. However, if the manager has sufficient decision-making authority to implement the intended investment mandate, objective, or strategy, the portfolio should, where possible, be considered discretionary. and operating budgets. Clients may not delegate complete investment discretion to firms for real estate investments, but in many cases, the consent requirements and investment constraints imposed do not inhibit the firm's investment policy or decision making to any significant extent. Therefore, the existence of client-imposed investment restrictions such as leverage limits or required client approval of major decisions do not preclude classification of a real estate portfolio as discretionary. Acceptance of primary responsibility by the firm and, therefore, the presence of a discretionary management relationship may be inferred if a portion of the firm's compensation is tied to performance or if the firm's success is assessed based on comparison of the firm's performance to a selected industry benchmark.~~

The following is an example of a discretionary portfolio:

- The manager, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions and therefore can fully implement its investment strategy. This is often the case for products sponsored by the investment manager such as real estate pooled or commingled investment fund vehicles.

The following are examples where the firm may be able to characterize the portfolio as discretionary, consistent with its definition of discretion:

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- The manager, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions so long as the firm does not exceed specified thresholds agreed to with a non-pooled or non-commingled investment vehicle client.
- The manager retains control over property management (day-to-day operations) and makes strategic acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition recommendations but has to obtain client approval for these items prior to transaction execution.

The following are examples where, in most instances, the firm would characterize the portfolio as non-discretionary, consistent with its definition of discretion:

- The client has complete investment discretion regarding real estate investments.
- The client prohibits or significantly limits repositioning of the portfolio through dispositions.

Nondiscretionary:

Real estate portfolios are considered nondiscretionary if client imposed investment limitations and restrictions hinder or prohibit application of the firm's desired investment strategy. As an example, taxable clients may prohibit or significantly limit repositioning of their portfolios through active or timely sales in order to minimize capital gains taxes. Alternatively, clients may mandate liquidation of their portfolios at a time when the firm believes pricing is not optimal. Additionally, firms may accept special assignments, such as portfolios taken over from other firms, with mandates that are not consistent with their own investment strategy.

Time-Weighted and Internal Rate of Return

The GIPS standards require the use of a time-weighted rate of return because it removes the effects of cash flows, which are generally client driven. Therefore, a time-weighted rate of return best reflects the firm's ability to manage the assets according to a specified strategy or objective, and is the basis for the comparability of composite returns among firms on a global basis.

The one exception to the time-weighted rate of return requirement is in the case of private equity investments where an internal rate of return (IRR) is required. An IRR reflects the effects of the timing of cash flows in a portfolio and is required for private equity assets because the firm controls the cash flows into and out of the portfolio. In these situations, a time-weighted rate of return will not offer the best measure for an investor to compare returns between private equity funds because the time-weighted rate of return will not capture the critical effects of cash flow management within the control of the private equity manager.

Some view the real estate asset class comparable to private equity because of similarities in asset illiquidity, valuation frequency and reliability and extended holding periods. As such, real estate investment management firms are recommended to present the since inception internal rate of return in addition to time-weighted rates of returns.

Separation of Income and Capital Appreciation Components

The GIPS standards for real estate investments require the presentation of component returns, specifically (1) the income return and (2) the change in capital value. Component reporting is important because of the lack of liquidity in real estate investments. If all other investment attributes are equal, higher current income is generally more desirable with real estate, because it equates to lower risk in achieving the total return. The calculation methodology for component returns must also be disclosed. Specifically, component returns are calculated separately using chain-linked (geometrically linked) time-weighted rates of return. Although not required, some investment managers may adjust the chain-linked component returns so that the sum of the income return and the capital return is equal to the total return; the manager is required to disclose this practice.

Disclosures

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In addition to the other disclosure requirements of the GIPS standards, expanded disclosure for real estate composites is imperative because of the subjective nature of real estate valuation and the lack of consistent valuation methods around the world.

Requirements:

- ~~Income and capital appreciation component returns must be presented, in addition to total returns.~~
- ~~Calculation methodology for component returns must be disclosed.~~
- ~~Firm's description of discretion must be disclosed.~~
- ~~Valuation methods and procedures (e.g., discounted cash flow valuation model, capitalized income approach, sales comparison approach, the valuation of debt payable in determining the value of leveraged real estate) must be disclosed.~~
- ~~Range of performance returns for individual accounts in the composites must be presented.~~
- ~~Source of valuation— independent appraiser versus internally prepared— for each reporting period must be disclosed.~~
- ~~Frequency that real estate investments are valued by an external valuer must be disclosed.~~

Valuation

Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- a. ~~Buyer and seller are typically motivated;~~
- b. ~~Both parties are well informed or well advised, and each party is acting in what they consider their own best interests;~~
- c. ~~A reasonable time is allowed for exposure in the open market;~~
- d. ~~Payment is made in terms of cash currency or in terms of financial arrangements comparable thereto; and,~~
- e. ~~The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.~~

Source of Valuation

Globally, valuation procedures and methodologies are not consistent and there is acknowledgment that a range of valuation methodologies exist. However, the GIPS standards require firms implement specific valuation procedures for real estate investments.

There are two sources of property valuation:

Independent Valuation:

Independent valuation is conducted by third party appraisers, hired for a fee agreed to in advance which, in instances where the purpose of the appraisal is to estimate market value, is always noncontingent with respect to outcome. An assessment of market value must be performed by a third party who is a professionally designated, certified, or licensed valuer/appraiser who must conduct the external valuation pursuant to the valuation standards of the local governing appraisal body (or bodies). Independent valuers must be a professionally designated, certified or licensed valuer/appraiser and must be authorized by the professional or government body overseeing valuation standards in each country or state. Predominant professional organizations (for example, Appraisal Institute and Royal Institute of Chartered Surveyors) subscribe to essentially the same value valuation theories, principles, and practices. Notably, valuers/appraisers must undergo formal and rigorous training and testing and must accumulate sufficient industry experience to qualify.

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Internal Valuation:

The second source of valuation is performed internally by the real estate investment firm. An internal valuation should consider professional industry approaches to estimating value (e.g., discounted cash flow valuation model, capitalized income approach, sales comparison approach, cost approach), and a professional review and assessment of the known economic, market, and financial variables and factors that can cause material changes in the value of real estate investments. Prudent assumptions must be employed, and the internal valuation process must be applied consistently from period to period, except where a process change would result in a more accurate estimate of market value. The goal of the internal process is that the performance presentation is supported by investment values that are confirmed by the investment manager based on the employment of a professional valuation process that would generally mirror the process employed by the investment manager in assigning values to real estate investments throughout the acquisition and sale processes.

Frequency of Valuation of Real Estate:

Requirements:

- Real estate investments must be valued at market value at least once every 12 months. For periods beginning 1 January 2008, real estate investments must be valued at least quarterly.
- Real estate investments must be valued by an external, professionally designated, certified, or licensed commercial property valuer/appraiser at least once every 36 months.

Recommendations:

- Real estate investments should be valued at least quarterly.
- Real estate investments should be valued by an external valuer/appraiser at least once every 12 months.
- If calculating and presenting the internal rate of return, firms should use quarterly cash flows at a minimum.

Income Return

The income return is defined as the investment income accrued on all assets (including cash and cash equivalents) during the measurement period net of all nonrecoverable expenditures, interest expense on debt, and property taxes. The return is computed as a percentage of the capital employed during the measurement period (defined below):

Capital Return

The numerator in the formula for calculating the capital return (also known as capital appreciation return or appreciation return) is the change in the market value of the real estate investments and cash/cash equivalent assets held throughout the measurement period (end period market value less start period market value) adjusted for all capital expenditures (subtracted) and net proceeds from sales (added). The capital return is computed as a percentage of the capital employed (defined below) through the measurement period:

Capital Employed

The denominator of the return expressions is defined as the 'weighted average equity' (weighted average capital) during the measurement period. Start of period capital values may be adjusted by adding time-weighted capital expenditures and subtracting time-weighted distributions, with the weighting designed to reflect the within period timing of the flows. Other weighting methods are acceptable and for higher frequency time-weighted return computations, weighted inclusion of cash flows may not be required. Once a methodology is chosen, however, it should be consistently applied.

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Composite Construction

~~The real estate investment industry continues to debate the efforts, alternatives, and meaningful relevance of composite construction.~~ One of the key principles of the GIPS standards is the ~~notion of the~~ presentation of composite performance, where a composite is defined as an aggregation of one or more portfolios managed according to a similar ~~representing a particular~~ investment mandate, objective or strategy. The real estate provisions of the GIPS standards embrace the notion of composite-level reporting ~~and require real estate investment management firms to present performance in composites defined by investment objective or strategy.~~ Real estate investment management firms are required to present performance in composites defined by investment mandate, objective, or strategy. Real estate closed-end fund composites must be defined by vintage year and investment mandate, objective, or strategy, and the composite definition utilized must remain consistent throughout the life of the composite. The vintage year concept is an important factor for real estate closed-end fund composites and could potentially limit real estate closed-end fund composites to one fund per composite because managers are unlikely to raise another fund with the same strategy in the same vintage year.

Users and recipients of real estate performance presentations, however, frequently request only an aggregation of property-level performance presentations, which ~~is may not be~~ consistent with the composite construction principles of the GIPS standards that are based on investment-level performance. Although ~~While~~ firms are not prohibited from presenting property-level performance outside of a compliant presentation or as supplemental information to a compliant presentation, ~~information according to specific requests from prospective clients,~~ firms are required to make every reasonable effort to provide a fully compliant presentation to all prospective clients. Please see the Guidance Statement on the Use of Supplemental Information for further information ~~of a composite based on investment objective or strategy.~~

The term “investment-level” is intended to reflect the impact of ownership and financing structures and includes all underlying property-level activity. Investment-level returns are distinct from property-level returns, which exclude all of the non-property (investment-level) balance sheet as well as income and expense items.

A real estate investment management firm may be asked to provide an aggregation of historical performance by property type, which is much narrower than any of the broader investment strategies managed by the firm. For example, the ~~GIPS composite construction provisions require firms to prepare composites, where the composite tracks the investment strategy that is pursued for a client or group of clients. But a real estate investment management firm may be asked to~~ provide investment performance ~~prepare a presentation~~ consisting of only ~~its~~ their office building investments, which requires extracting the performance of all office building investments from ~~multiple portfolios within the firm.~~ their broader real estate investment strategies. Such an aggregation is not a composite. This performance can be shown outside of a compliant presentation or as supplemental information to a compliant presentation. If the aggregation is representative of a distinct investment strategy the track record of the narrower mandate may be able to be presented as a carve-out. Please see the Guidance Statement on the Treatment of Carve-Outs for further information. ~~If this grouping represents what would have been achieved with a strategy dedicated to office building investments, the firm may consider this a composite consisting of carve-outs and apply the GIPS carve-out provisions and guidance (see the Guidance Statement on the Treatment of Carve-Outs). If this grouping does not represent what would have been achieved with a strategy dedicated to office building investments, carving out the property-level office building investment returns from portfolios with vastly different investment objectives and strategies will likely not satisfy the composite construction requirements of the Standards. This property-level grouping should then only be presented as supplemental information to a compliant composite presentation (see the Guidance Statement on the Use of Supplemental Information).~~

For periods ending on or after 1 January 2011, the composite construction requirements for real estate closed-end fund composites mandate that closed-end real estate funds, if any, be in separate composites. In addition, provided all composite construction requirements are adhered to, a firm may choose to include open-end and closed-end real estate funds in the same composite because firms are permitted to include a portfolio in more than one

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composite. If a firm includes both open-end and closed-end real estate funds in the same composite, the firm should consider disclosing the types of portfolios included in the composite as part of the composite description. Please see the Guidance Statement on Composite Definition for further information on composite construction.

Fees and Expenses

When calculating returns, the following guidance should be used to help determine how real estate investment management and other fees and expenses are treated.

Gross-of-fees and net-of-fees returns must be net of all property-level expenses. Gross-of-fees and net-of-fees returns must also be net of debt service, including preferred equity dividends.

The difference between gross-of-fees and net-of-fees returns should reflect only investment management fees that the manager charges for providing investment management/advisory services. Investment management fees typically include a recurring base management fee (often calculated on the basis of invested or committed capital) and a performance-based fee (carried interest).

Fees and expenses should be evaluated to determine their proper treatment when calculating returns. Acquisition, disposition, financing, and development costs on a particular transaction are considered “transaction expenses” and must be deducted from both gross-of-fees and net-of-fees returns regardless of whether the service is performed by the investment manager or a third party. If any of these services are performed by the investment manager, the description of such services performed by the investment manager should be disclosed in the compliant presentation.

Investment-level administrative costs are not required to be deducted from gross-of-fees or net-of-fees returns. In many jurisdictions, however, it is common practice in the real estate industry to deduct such items when computing gross-of-fees and net-of-fees returns. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses.

Inclusion of New Portfolios in Composites

The GIPS standards state that composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. When computing time-weighted rates of return, a “partial period” or “stub period” can occur for the period from a portfolio’s inception up to the beginning of the first full period when a portfolio is placed into the composite. A question that often arises is whether the stub period portfolio performance must or should be captured for time-weighted composite construction purposes. Historically firms have used different approaches to address the partial period issue. The nature of the real estate asset class is unique and is often composed of illiquid investments with infrequent acquisition and disposition activity. In order to standardize the treatment of partial period performance for new portfolios when calculating time-weighted returns, for periods beginning on or after 1 January 2011, real estate composites are required to include new portfolios in composites on the portfolio’s inception date, which is typically the date of the portfolio’s first external cash flow.

Determining the Non-GIPS-Compliant Performance Period for Real Estate Closed-End Fund Composites

The GIPS real estate provisions require that real estate closed-end fund composites present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period end in the compliant presentation. Firms must initially present at least five years of performance (or for the period since the firm’s inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, the GIPS real estate provisions state that firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. However, firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-

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compliant performance is presented for periods beginning on or after 1 January 2006. For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The period for a SI-IRR is from the inception date through the end of the period that is being reported. Unlike time-weighted rates of return, the beginning period for a SI-IRR remains constant and does not change. Therefore, it is necessary to use the period end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the real estate closed-end fund composite history begins 1 January 2003, SI-IRR are required to be presented from 1 January 2003 (inception) through each annual period starting with the period ending 31 December 2006. If the firm chooses to present SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

Application:

1.—The GIPS standards state that the value of a real estate portfolio must be reviewed at least once every 12 months. Is this an internal review and if so, what does it entail?

~~The 12-month valuation requirement for real estate can be satisfied with an internal review or external valuation. In an internal review, the valuation is determined internally, by the firm's management. The firm could determine that relying on values reported in annual reports generally satisfies the current 12-month review requirement because the issuance of the annual report should include a review of the real estate portfolio, a review of net asset value for financial and performance purposes, and review and disclosure of any factors that may result in a material change to net asset value. However, beginning 1 January 2008, real estate investments must be valued at least quarterly.~~

~~An external appraisal is not required every 12 months; the minimum requirement is at least once every 36 months. The frequency of independent external appraisals must be disclosed.~~

2.—Where do real estate mortgages fit within the GIPS standards?

~~For the purpose of performance reporting, real estate mortgages with fixed or variable interest rates are considered fixed income securities. Therefore, the core sections of the GIPS standards are applicable. Participation and convertible mortgages (i.e., hybrid mortgages) are considered real estate investments. In addition, component returns should be allocated as follows:~~

- ~~●—Basic cash interest (current receivable): allocate to income return component.~~
- ~~●—Contingent interest (current receivable): allocate to income return component.~~
- ~~●—Basic accrued interest (deferred): allocate to appreciation return component.~~
- ~~●—Additional contingent interest (deferred; payable at maturity, prepayment, or sale): allocate to appreciation return component.~~

~~Therefore, if the return is currently payable from operations, allocate to the income return. All other sources of return that are deferred or realizable in the future should be allocated to the appreciation component.~~

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3. Should the real estate returns be presented net of leverage, after the effects associated with mortgage and similar long-term liabilities?

Yes, real estate returns should be presented net of leverage (interest expense related to third-party debt) coupled with appropriate disclosure on the amount of leverage that is employed in producing the returns.